TAX PITFALLS FOR INCORPORATED PROFESSIONALS

The troubled history of professional associations seeking corporate status for state law and federal taxation purposes is substantially at an end. Every state has enacted some statutory provision for the incorporation of professionals. The statutes vary greatly, however, as to which professionals are included, the number of shareholders required, and the amount of specific regulation undertaken by the state.[1] The In-

1. Alabama: ALA. CODE tit. 10, §§ 10-4-220 to 10-4-239 (professional); tit. 34, § 34-1-9 (public accountants) (1975). Alaska: ALASKA STAT. §§ 10.45.010-.45.260 (1969). Arizona: ARIZ. REV. STAT. ANN. §§ 10-901 to -909 (1970). Arkansas: ARK. STAT. ANN. §§ 64-1701 to -1719 (medical associations), 64-1801 to -1817 (dental associations), 64-2001 to -2018 (professional corporations) (1977). California: CAL. BUS. & PROF. CODE §§ 1800-1808 (dental), 2500-2508 (medical), 2690-2696 (physical therapy), 2995-2996.6 (psychologist), 6160-6172 (legal), 17875-17882 (marriage, family & child counseling); CAL. CORP. CODE §§ 13400-13410 (professional) (West 1973). Colorado: COLO. REV. STAT. §§ 12-2-131 (public accountants), 12-25-103 to 12-25-104 (engineers & surveyors), 12-32-109 (podiatry), 12-35-112 (dental), 12-36-117(1)(m), 12-36-134 (medical), 12-40-125 (optometrists), 12-41-125 (physical therapists), 12-64-111(3) (veterinarians) (1973). Connecticut: CONN. GEN. STAT. ANN. §§ 33-180 to -182 (medical corporations), 33-182(a) to -182(j) (professional corporations) (West 1977). Delaware: DEL. CODE ANN. tit. 8, §§ 601-619 (1969). District of Columbia: D.C. CODE ANN. §§ 29-1101 to -1121 (1970). Florida: FLA. STAT. ANN. §§ 621.01-.15 (West 1969). Georgia: GA. CODE ANN. §§ 84-4301 to -4318 (1970). Hawaii: HAW. REV. STAT. §§ 416-141 to -154 (1969). Idaho: IDAHO CODE §§ 30-1301 to -1315, 54-1235 (1970). Illinois: ILL. ANN. STAT. ch. 32, §§ 415-1 to -17 (Professional Service Corporation Act), 631-47 (Medical Corporation Act) (Smith-Hurd 1969). Indiana: IND. CODE ANN. §§ 23-1-13-1 to 23-1-13-11 (professional), 23-1-14-1 to 23-1-14-21 (medical), 23-1-15-1 to 23-1-15-21 (dental) (Burns 1971). Iowa: IOWA CODE ANN. §§ 496C.1-.22 (Professional Corporation Act) (West 1976). Kansas: KAN. STAT. §§ 17-2706 to -2719 (1973). Kentucky: KY. REV. STAT. ANN. §§ 274.005-.990 (professional), 313.240 (dental), 325.300 (public accountants) (Baldwin 1973). Louisiana: LA. REV. STAT. ANN. §§ 12:801-:815 (legal), 12:901-:915 (medical), 12:981-:995 (dental), 12:1011-:1025 (public accountants), 12:1051-:1065 (chiropractic), 12:1071-:1085 (nursing) (West 1976). Maine: ME. REV. STAT. tit. 13, §§ 701-716 (1969). Maryland: MD. CORP. & ASS'NS CODE ANN. §§ 5-101 to -122 (1976). Massachusetts: MASS. ANN. LAWS ch. 156A, § 1-17 (Michie/Law. Co-op 1974). Michigan: MICH. COMP. LAWS §§ 450.221-.253 (MICH. STAT. ANN. §§ 21.315 (1)-.315(15) (Callaghan 1974)). Minnesota: MINN. STAT. ANN. §§ 319A.01-.22 (West 1973). Mississippi: MISS. CODE ANN. §§ 79-9-1 to 79-9-27 (1974). Missouri: MO. ANN. STAT. §§ 356.010-.200 (Vernon 1971). Montana: MONT. REV. CODES ANN. § 15-2101 to -2116 (1967). Nebraska: NEB. REV. STAT. §§ 21-2201 to -2222 (1976). Nevada: NEV. REV. STAT. §§ 89.010-.270 (professional), 628.325-.370 (public accountants) (1969). New Hampshire: N.H. REV. STAT. ANN. §§ 294A:1-:8 (1974). New Jersey: N.J. STAT. ANN. §§ 14A:17-1 to :17-18 (West 1969). New Mexico: N.M. STAT. ANN. §§ 51-22-1 to 51-22-14 (1969). New York: N.Y. BUS. CORP. LAW, §§ 1501-1516 (McKinney 1970). North Carolina: N.C. GEN. STAT. §§ 55B-1 to -15 (Professional Corporation Act) (1971). North Dakota: N.D. CENT. CODE §§ 10-31-01 to 10-31-14 (Professional Corporation Act) (1973). Ohio: OHIO REV. CODE ANN. §§ 1785.01-.08 (Page 1963). Oklahoma: OKLA. STAT. ANN. tit. 18, §§ 801-819 (West 1974). Oregon: OR. REV. STAT. §§ 58.005-.365 (1977). Pennsylvania: PA. STAT. ANN. tit. 15, §§ 12601-12619 (Purdon 1970). Rhode Island: R.I. GEN. LAWS §§ 7-5.1-1 to .1-12 (1972). South Carolina: S.C. CODE §§ 33-51-10 to 33-51-170 (1962). South Dakota: S.D. COMPILED LAWS ANN. §§ 47-11-1 to 47-11-21 (medical), 47-11A-1 to 47-11A-20 (chiropractic), 47-11B-1 to 47-11B-23 (optometry), 47-11C-1 to 47-11C-23 (podiatry), 47-12-1 to 47-12-20 (dental), 47-13-1 to 47-13-2 (veterinary), 47-13A-1 to 47-13A-10 (legal), 47-13B-1 to 47-13B-18 (public accountants) (1977). Tennessee: TENN. CODE ANN. §§ 48-2001 to -2007 (1970). Texas: TEX. BUS. CORP.

ternal Revenue Service has agreed to recognize the corporate status of professional corporations which are formed in compliance with state law[2] or which have the required attributes of corporate structure.[3] If the professional corporation is carefully organized and formally operated, there will seldom be any reason for income reallocation[4] or deduction disallowance[5] even though the corporation is formed primarily for the purpose of obtaining employee benefits and concurrent corporate deductions.

All ordinary and necessary expenses incurred by a corporation in carrying on its business are deductible.[6] Some of the same deductions would be allowed to anyone engaged in a trade or business[7] or other income producing activity,[8] but in addition, the corporation may provide certain benefits to the professional as an employee and deduct the cost[9] which could not be deducted by the professional as an individual practicing alone or in a partnership. For example, malpractice insurance is

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ACT ANN. art. 1528e (Vernon 1970). Utah: UTAH CODE ANN. §§ 16-11-1 to 16-11-15 (1973). Vermont: VT. STAT. ANN. tit. 11, §§ 801-813 (1963). Virginia: VA. CODE §§ 54-873 to -898 (1970). Washington: WASH. REV. CODE §§ 18.100.010-.100.140 (1971). West Virginia: W. VA. CODE §§ 30-2-5a (legal), 30-3-4b & c (medical), 30-8-3a & b (optometry), 30-10-18 to 30-10-19 (veterinary), 30-14-9a & b (osteopathy), 30-16-17 (chiropractics) (1976). Wisconsin: WIS. STAT. ANN. § 180.99 (West 1961). Wyoming: WYO. STAT. §§ 17-49.1 to -49.2 (1971).

2. In Treasury Information Release 1019 dated August 8, 1969, the Internal Revenue Service conceded that organizations of professionals established under state professional association acts will generally be treated as corporations for federal tax purposes.

The revenue ruling affording professional organizations corporate status lists the cases leading the Internal Revenue Service to concede the matter. It also lists the individual state statutes to be recognized as establishing corporate status for a professional association. It is made clear that the ruling relates only to classification and all other issues are specifically left unaltered, especially the disregard of corporate form issue. Rev. Rul. 70-101, 1970-1 C.B. 278, *as modified in* Rev. Rul. 73-596, 1973-2 C.B. 424.

3. A professional service organization is treated as a corporation or association for federal tax purposes if it has sufficient corporate characteristics to be classified as a corporation rather than a partnership or proprietorship under Treas. Reg. § 301.7701-2(a) (1965). A professional service organization is an organization formed under the auspices of local law or not by one or more persons to engage in rendering professional services for profit. Treas. Reg. § 301.7701-2(h)(1)(i) (1965).

There are certain characteristics found in a corporation which distinguish it from other organizations. They are: associates, an objective to do business and divide gains, continuity of life, centralized management, limited liability, and free transferability of interests. In a particular case, other factors may also be significant. The association will be considered a corporation for tax purposes if it more nearly resembles that form than others such as trusts or partnerships. Treas. Reg. § 301.7701-2(a) (1965).

A professional service association formed and operated under the professional service corporation statutes of a state listed in Rev. Rul. 70-101, *supra* note 2, is considered a corporation for federal tax purposes, otherwise the detailed criteria of Treas. Reg. § 301.7701-2(a) (1965) must be met.

4. I.R.C. § 482.

5. I.R.C. § 269.

6. I.R.C. § 162(a).

7. *Id.*

8. I.R.C. § 212.

9. An ideal fringe benefit is one which affords the employer with a current deduction, while the employee is allowed to defer taxation, or one that relieves the employee of an otherwise non-deductible personal expense.

deductible as a business expense by either the individual practitioner or the professional corporation.[10] On the other hand, an advantage available only within the employee-employer relationship is the tax treatment afforded accident and health plans. The employer may establish a plan[11] for employee accident and health coverage and take current deductions[12] for amounts contributed to the fund without a proportionate amount being included in each employee's gross income.[13] When and if benefits are actually paid directly to the employee under the plan or from the employer, the employee includes only any amount received in excess of the actual expenses incurred in gross income.[14] Payments for serious disability computed with reference to the injury, not absence from work, are not included in the employee's gross income at all.[15] Self-employed individuals are specifically precluded from taking advantage of those provisions.[16] Likewise, disability coverage for employees may be deducted as a business expense by the employer.[17] Disability insurance paid for by an individual is not deductible.

Special treatment is also afforded for group-term life insurance provided by the employer. The value of the coverage is included in the gross income of the employee only to the extent that it exceeds the sum of the cost of $50,000 worth of protection and the employee's contributions.[18] Similarly, death benefits up to $5,000 may be excluded from gross income when paid by or on behalf of the employer due to the death of

10. Rev. Rul. 78-210, 1978-1 C.B. 39.

11. Accident and health plans may discriminate among employees, that is, they may be established to cover only a particular class of employees. For example, the plan may cover only professional employees and not clerical employees. It may cover only employees in a particular salary bracket. There must, however, be some rational basis for the class designation other than stock ownership. Treas. Reg. § 1.105-5(a) (1964). On this point is a case where the medical expenses of an attorney and his family were paid by his professional corporation. No other employee of the corporation received such benefits. It was held that the purpose of the plan was to benefit the attorney as a shareholder, not as an employee. The payments were a dividend, and thus not deductible by the corporation. John H. Kennedy, Inc. v. Commissioner, 36 T.C.M. (P-H) 878 (1977). Larkin v. Commissioner, 394 F.2d 494 (1st Cir. 1968).

The accident and health plan may be insured or not insured. Payments are deemed to be received under the plan only if the employee had enforceable rights under the plan at the time the illness or injury occurred. The employee must also have known of the coverage at that time. The I.R.S. regulations do not require that the plan be in writing. Treas. Reg. § 1.105-5(a) (1964). However, health, accident, and death benefits may only be offered pursuant to a written instrument if the employer is engaged in any activity affecting interstate commerce. Employee Retirement Income Security Act, 29 U.S.C. §§ 1002(1)(A)-(B), 1003(a)(1), 1102 (a)(1) (1976); Labor Management Relations Act of 1947, 29 U.S.C. § 186(c) (1976).

12. I.R.C. § 162(a).

13. I.R.C. § 106.

14. I.R.C. § 105(a); Treas. Reg. § 1.105-2 (1956).

15. I.R.C. § 105(c).

16. I.R.C. § 105(g).

17. Treas. Reg. § 1.162-10(a) (1958).

18. I.R.C. § 79(a). *See also* note 11 *supra*.

the employee.[19] Further advantage may be assured by compliance with the requirements for an effective assignment of all incidents of ownership to prevent inclusion in the estate of the decedent.[20] Although part or all of the value of some of the benefits must be included in the employee's gross income, the cost is being shifted from after-tax to pre-tax dollars which can result in a significant savings.

Even more important to the incorporating professional is the availability to employees of pension plan options.[21] Qualified pension plans can provide for deferral of more income than is possible under the limitations set for Individual Retirement Accounts[22] and Keogh Retirement Plans[23] available to self-employed individuals. At the same time, incorporation does not eliminate the possibility of using these two non-qualified[24] methods of deferral in a situation where they are preferred as long as the corporation has no qualified plan covering the same individual.[25]

New restrictions have been placed on cafeteria or flexible benefit plans under which an employee can choose from a variety of benefits, some taxable, and some non-taxable. Amounts contributed by the employer to a plan that discriminates in favor of highly compensated[26] employees must be included in the employee's gross income to the extent taxable benefits could have been elected, regardless of whether they were actually chosen.[27] If a plan is nondiscriminatory, the employer's contributions will be included in the employee's gross income only to the extent taxable benefits are chosen.[28] Deferred compensation is not considered to be a part of the cafeteria plan.[29]

Although the legal barriers to incorporation have been removed, problems remain for the professional who has never organized his practice or allocated his income according to rigid plans established far in

19. I.R.C. § 101(b).

20. Rev. Rul. 69-54, 1969-1 C.B. 221, *as modified in* Rev. Rul. 72-307, 1972-1 C.B. 307.

21. *See* I.R.C. §§ 401-405, 410-415.

22. I.R.C. § 408.

23. I.R.C. § 404(e)(1).

24. This term is used comparatively to designate deferrals which do not fall within the extensive qualifications for multiple-employee plans under I.R.C. § 401 and does not reflect on the legitimacy of the method.

25. An employee who was enrolled in a qualified employee retirement plan could not deduct a contribution to an Individual Retirement Account even though he knew he was going to be fired, and was in fact fired, thus losing all pension benefits because he had not fulfilled the ten years service required under the qualified plan. Orzechowski v. Commissioner, 69 T.C. 750 (1978); I.R.C. § 219(b)(2).

26. The term highly compensated is used to denote a participant who is an officer, a shareholder with more than 5% of the voting power or value of all classes of stock of the employer, an employee who is highly compensated, or a spouse or dependent of an officer, 5% shareholder, or highly compensated employee. I.R.C. § 125(e)(1).

27. I.R.C. § 125(b).

28. I.R.C. § 125(a).

29. I.R.C. § 125(d)(2).

advance. One case [30] was such an egregious example of failure to operate within the corporate form that it was cited as a situation the Internal Revenue Service will continue to litigate in spite of its concession of corporate status to professional corporations.[31] Four radiologists with separate office facilities incorporated under Wisconsin law but continued to pursue their private practices in essentially the same manner they had before. The corporate status was not regularly communicated to clients, there was no unified hiring or supervision, leases and expenses were not handled by the corporation, and billing was not done in the corporate name. Beyond the initial adoption of bylaws, issuance of stock, and election of officers, the only unifying aspects were a central bookkeeping system and bank account. Based on these facts, the court held that the corporation did not earn the income reported by it.

In addition to the federal tax consequences of incorporation to be discussed, the incorporating professional must, therefore, keep in mind the long and demanding list of corporate formalities which will have to be complied with just to maintain the favored status. The professional corporation must have articles of incorporation and bylaws drafted. It must have stock certificates prepared for one or more classes of stock. The corporation must have directors and officers as well as procedures for elections, meetings, resolutions, record keeping and bookkeeping. Certain formalities must be observed in organizing the corporation such as obtaining an employer number [32] from the Internal Revenue Service, and registering the corporation in the state of incorporation. Provision must be made for all activities such as banking, billing, hiring, firing, contracting, and advertising to be conducted by the corporation, in the corporate name. The corporation must establish policies and procedures regarding raises, bonuses, expenses, benefits, vacations, retirement, and stock repurchases. The corporation will be responsible under state and federal programs which require employer contributions such as Social Security,[33] federal and state unemployment insurance,[34] withholding taxes,[35] and workmen's compensation. The corporation will be liable for federal and state taxes and compliance with state and federal laws which regulate corporate activity including state corporate law, state Blue Sky laws, and federal securities law when applicable.

The advantages traditionally associated with incorporation are continuity of life, centralized management, free transferability of interest, limited liability, and special federal tax treatment. Continuity of life and

30. Roubik v. Commissioner, 53 T.C. 365 (1969).

31. Rev. Rul. 70-101, *supra* note 2.

32. Treas. Reg. § 31.6011(b)-1 (1962).

33. I.R.C. § 3102(a).

34. I.R.C. §§ 3301, 3302.

35. I.R.C. § 3402.

centralized management can be achieved by agreement without incorporating. Free transferability of interest simplifies estate planning, but is hardly a sufficient reason by itself for incorporating. The incorporating professional remains liable in most states for his own acts of malpractice, so limited liability does not exist within the professional corporation where it would be most attractive.[36] Ultimately, federal tax advantages are the primary reason for incorporating a professional practice. Careful analysis is essential in each case to determine whether the economic benefits will be sufficient to justify incorporation. Both present and future factors must be examined. The decision will necessarily be based on speculative considerations such as the future needs of the professional's family and the degree of success the professional practice will achieve. The financial analysis must also take into account increased legal and accounting costs. The expenditures that will be required to organize the corporation[37] and oversee its operation,[38] taking care to avoid the federal tax problems presented by the assignment of income doctrine, attribution rules, penalty taxes, disallowance of corporate compensation deductions, and collapsibility provisions, must be considered. The following discussion of those pitfalls,[39] in the order mentioned, will give the reader some idea why the cost incurred in avoiding them is an essential expense.

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36. *See generally* Note, *Accident and Malpractice Liability of Professional Corporation Shareholders,* 10 U. MICH. J.L. REF. 364 (1977).

37. The corporation may elect to amortize its organizational expenses ratably over a period of not less than sixty months. I.R.C. § 248(a).

The type of expenses that may be amortized are legal services incident to drafting the charter, bylaws, and stock certificate terms; accounting services; expenses for meetings and services incurred in forming the corporation and obtaining state registration. Treas. Reg. § 1.248-1(b)(2) (1960).

Examples of expenses which are not considered organizational are commissions and printing costs in connection with the issuance of stock and expenditures in connection with the transfer of assets to the corporation or the reorganization of a previously existing corporation, except as they directly involve formation of the new corporation. Treas. Reg. § 1.248-1(b)(3) (1956).

38. Operating expenses, including the ordinary and necessary cost of management, legal, and accounting services are deductible as business expenses. Treas. Reg. § 1.162-1(a) (1963).

39. Most of the pitfalls a professional corporation might encounter could be avoided by a Subchapter S election under I.R.C. § 1372(a). However, the complexities of Subchapter S status, besides being inordinately rigorous, do not provide the advantages a professional is seeking from incorporation. The corporate shelter is destroyed by the election since corporate earnings are taxed to the shareholders whether distributed or not. I.R.C. § 1373. While salaries qualify for maximum tax limitations under I.R.C. § 1348, undistributed taxable income does not. This could mean taxation at the 70% rate under I.R.C. § 1 instead of at the 50% personal service rate. Further, this previously taxed income account is nontransferable. It is personal to the individual shareholder and can be lost by termination of either the election or the individual's interest in the corporation. Treas. Reg. § 1.1375-4(e) (1968).

Professional corporations do not normally have net operating losses, so the Subchapter S pass-through feature of I.R.C. § 1374 would provide no advantage of personal income offset for the shareholder-professional.

For years beginning after 1970 the maximum advantages of qualified pension and profit sharing plans will be unavailable to Subchapter S corporations. I.R.C. § 1379. The use of nonqualified plans would be available, however. Goldsmith v. United States, 41 A.F.T.R.2d 981 (Ct. Cl. 1978); Rev. Rul. 60-31, 1960-1 C.B. 174, *as modified in* Rev. Rul. 70-435, 1970-2 C.B. 100.

ASSIGNMENT OF INCOME

A person may not avoid taxation on income by contracting or assigning away the right to receive the fruits of personal labor.[40] Therefore, it is imperative that the corporation be prominent in all dealings with clients. The corporation must conduct the business. All billing, listing, and advertising must be done in the corporate name. A professional who contracts for services directly is earning personal service income. The professional as an individual is personally responsible on the contract, and consequently invites a finding that the corporation's collection of the fee was really an assignment of income. The fee was legally owed to the professional in his individual capacity. Therefore, the professional should work for the corporation under a written employment contract.[41] The corporation should contract with clients and have the power to designate which professional employee is to perform the service. All corporate formalities required by the state of incorporation should be scrupulously observed.[42]

SECTION 482 REALLOCATION

Gross income, deductions, credits or allowances may be reallocated[43] where necessary to clearly reflect income or prevent tax evasion among controlled[44] and controlling taxpayers.[45] At work is an amalgamation of

40. Before the advent of joint return income tax filing, one couple devised a scheme to divide the husband's income between them in an effort to reduce the husband's tax liability. They entered into a binding contract whereby all property of the parties whatsoever would be held as joint tenants, including his salary from the instant it was paid. The court held, however, that the tax upon net income from personal service was incurred by the wage earner in spite of the immediate relinquishment of half of it. Income from one person's labor may not be anticipatorily assigned to another, since the personal right to the wages would always vest first in the one who earned them. The very act of voluntary divestment implies that dominion and control of ownership existed at least for a moment. Lucas v. Earl, 281 U.S. 111 (1930).

The same result is reached in cases where earned income and the right to receive it are transferred, as where a taxpayer gave his son bond coupons while retaining the income producing property, the bond. Disposition of the right by the transferor is deemed to be a realization. Helvering v. Horst, 311 U.S. 112 (1940); Treas. Reg. § 1.61-7(d) (1964). Similar reasoning applies in corporate situations. Johansson v. United States, 336 F.2d 809 (5th Cir. 1964); Wilson v. United States, 530 F.2d 772 (8th Cir. 1976).

41. Income resulting from the selling activities of the sole employee and major shareholder of a corporation were held taxable to him personally in spite of his request that former customers whom he had served as an individual now pay all commissions to the newly formed corporation. The taxpayer did not observe the necessary corporate formalities, and there was no employment contract which would establish his duties as an employee of the corporation. Foglesong v. Commissioner, 45 T.C.M. (P-H) 1286 (1976).

42. *See* note 1 *supra*.

43. It should be observed that the assignment of income doctrine originated in the courts, pertains to either individuals or corporations and acts to shift the entire amount of income in question to a different taxpayer. Section 482, on the other hand, is a statutory variation of the same principle dealing specifically with two or more trades, businesses, or organizations, and allows for all or only part of the income in question to be shifted to a different taxpayer.

44. Treas. Reg. § 1.482-1(a)(3) (1968).

45. I.R.C. § 482. *But cf.* Gettler v. Commissioner, 44 T.C.M. (P-H) 436 (1975) (reallocation is not inevitable).

taxation principles[46] which seek to restrict the application of tax privileges to the intended recipient. Reallocation has, therefore, been applied to a wide variety of situations where the costs of shared facilities and properties have not been appropriately divided, income from various sources has not been properly attributed,[47] or deductions are taken in a manner which has shifted the tax liability[48] in an unsanctioned manner.[49] This provision is aimed at transactions where two or more organizations, trades, or businesses of a related nature are concerned.[50] Since the reach of this legislation is intended to be broad enough to have an equalizing effect[51] in spite of the controlled nature of the relationship, the trade or business[52] terminology has been given an expansive interpretation.[53]

If the professional retains a personally owned office building at the time of incorporation and leases space to the corporation,[54] as is often done, he is in the business of property leasing.[55] Thus, two businesses

46. The fundamental federal tax policy which requires that a clear reflection of income be presented by the taxpayer's report subsumes additional policies regarding tax avoidance; the assignment-of-income concept; and appropriate application of deductions, credits, and accounting methods.

47. The sole shareholder may not claim that the corporation which conducted all business activities of operating an apartment complex was a sham in order to avoid taxation of the income at both the corporate and shareholder levels. Preferred Properties, Inc. v. Commissioner, 45 T.C.M. (P-H) 66 (1976).

48. The corporation is the taxpayer, not the sole shareholder, in regard to payment for his services rendered as the chief officer of the corporation. Joseph C. Weber, Inc. v. United States, 37 A.F.T.R.2d 1098 (W.D.N.Y. 1975).

49. Reallocation may be necessary even where the distortion was entirely innocent of any intent to avoid taxation. Treas. Reg. § 1.482-1(c) (1968).

50. I.R.C. § 482.

51. Treas. Reg. § 1.482-1(b) (1968).

52. The term trade or business is used in many sections of the Internal Revenue Code, but only one definition of extremely limited use is offered. The definition points out that holding public office is to be considered a trade or business. I.R.C. § 7701(a)(26).

One judicially created test of whether an activity may constitute a trade or business is whether there are goods or services being offered for sale to others. Gentile v. Commissioner, 65 T.C. 1 (1975). Since the matter is left to judicial determination, the term has received either restrictive or broad interpretation depending on the section of the code which is under consideration. Regarding the issue of whether a shareholder is also acting as a proprietor in another business, *see* Whipple v. Commissioner, 373 U.S. 193 (1963).

53. The term trade or business applies equally to individual or corporate activity regardless of its organizational status, location, or ownership for I.R.C. § 482 purposes. Almost any gain-seeking activity could come within the term trade or business. Treas. Reg. § 1.482-1(a)(2) (1968). Therefore, the two businesses may be an activity pursued entirely for individual gain and the formal business of a corporation in which the same individual has a controlling interest, or it may be two separate pursuits of the same individual, or the businesses of two cross-controlled corporations.

54. Section 1231(b) defines property used in a trade or business. In doing so, it gives rise to the inference that holding such property for rental purposes is a separate trade or business. The inference finds support in the cases holding a residence converted to rental use is a trade or business since the taxpayers were not in the business of property rental prior to the conversion.

55. An attorney who moved from his residence to another city but retained the house as rental property and took depreciation on it was, by inference, held to be in the trade or business of renting the former residence since deduction of the total loss sustained on the eventual sale of the property was allowed as an ordinary loss. Hazard v. Commissioner, 7 T.C. 372 (1946), *acq.* 1946-2 C.B. 2. *Accord,* Wasnok v. Commissioner, 40 T.C.M. (P-H) 41 (1971).

with overlapping control are involved if the professional has a controlling share in the professional corporation. The reallocation provisions are concerned with abuses which can occur in just such situations. A variation on this use of lease and leaseback arrangements as a means of shifting income is the transfer of the professional office building to a trust for the benefit of the owner's minor children. The professional corporation then leases the building from the trust. The minor children are in a low tax bracket. Thus, the income from the property is taxed at a lower rate than it would be if the professional retained it. Since the income producing property and income are both transferred out of the professional's control, the assignment of income problem is circumvented. The possibility of reallocation due to overlapping control is also eliminated. The maneuver has met with only mixed success for other reasons, however.[56]

Yet another organizational peculiarity,[57] often employed by professionals, has encountered reallocation problems. When professionals incorporate as individuals and then cause the corporations to enter into partnership with each other,[58] they are clearly inviting a reallocation controversy. The arrangement is advantageous in that each professional has flexibility in establishing salary and benefit plans while also reaping the functional and tax benefits of both incorporation and partnership with other professionals. It may be found, however, that the shareholder-employee and not the professional corporation is really the partner since it is the individual's personal effort that earns the partnership income.[59] The income, deductions and credits might also be reallocated among the corporate partners where the distributions do not correspond to the earnings generated by the separate entities.[60]

If the professional has income from more than one source, such as private practice and/or separate consultation obligations, all activities

56. Where: (1) there is an independent trustee with the power to dispose of the property as well as to lease it, (2) the trust instrument is valid and irrevocable for at least ten years under state law, and (3) the leaseback was not arranged before the trust was established, the deduction of reasonable rent has been allowed to the corporation. Serbousek v. Commissioner, 46 T.C.M. (P-H) 484 (1977); Engel v. United States, 400 F. Supp. 5 (W.D. Pa. 1975); A. H. Phillips Co. v. Commissioner, 46 T.C.M. (P-H) 642 (1977). *Compare* Mathews v. Commissioner, 520 F.2d 323 (5th Cir. 1975), *cert. denied,* 424 U.S. 967 (1976) (the leaseback agreement with the trustee predated the execution of the trust); Perry v. United States, 520 F.2d 235 (4th Cir. 1975), *cert. denied,* 423 U.S. 1052 (1976) (the transaction lacked a business purpose, the lease agreement predated the trust, and the duration of the trust was identical with that of the lease).

57. State law governs what activities and organizational variations a professional corporation may engage in. Most states' enabling acts bring the professional service corporation under the governance of the general corporation laws. *See* note 1 *supra.*

58. "A lawyer shall not hold himself out as having a partnership with one or more other lawyers unless they are in fact partners." CODE OF PROFESSIONAL RESPONSIBILITY DR 2-102(C).

59. *See* text at note 30 *supra.*

60. I.R.C. § 482 applies not only to one shareholder with an interest in several corporations but to one or more shareholders with interests in one corporation. B. Forman Co. v. Commissioner, 453 F.2d 1144 (2d Cir.), *cert. denied,* 407 U.S. 934 (1972); Rev. Rul. 65-142, 1965-1 C.B. 223.

should be included as corporate functions at the time of incorporation.[61] This will insure against reallocation among the separate roles and prevent any appearance of acting in disregard of the corporate form.[62]

SECTION 269 DISALLOWANCE

Tax benefits may be disallowed where a corporation is formed or acquired for the principal purpose[63] of obtaining those tax advantages by a person or parent corporation holding at least 50% of either the value or the voting power of all outstanding shares of the corporation.[64] This provision could conceivably be an obstacle for the professional corporation at two different levels. It could be viewed as a threat to the initial incorporation since currently available exemptions for employee benefits and corresponding corporate deductions are the primary reasons for incorporating a professional practice. If only one or two professionals are involved, the "control" test might apply. Application of this sanction has been most often applied, however, to transactions involving such disfavored activities as loss-corporation acquisitions. It has not as yet been applied to the formation of a professional corporation although the term "acquire" probably encompasses the process of organizing a corporation.[65] Disallowance is to occur only when the acquisition is for tax evasion or avoidance.[66] The use of that terminology seems to be directed toward curtailment of an unintended or unsanctioned application of the various tax reducing provisions of the code. Professional incorporation, on the other hand, has been specifically permitted.[67] By way of analogy, the creation of a new and separate domestic corporation to carry on a specific portion of the business activity previously done by another corporation for the primary purpose of gaining the benefits of the Subchapter S

61. Rubin v. Commissioner, 429 F.2d 650 (2d Cir. 1970).

62. Borge v. Commissioner, 405 F.2d 673 (2d Cir.), *cert. denied*, 395 U.S. 933 (1968). *Compare* McGuire v. United States, 23 A.F.T.R.2d 800 (S.D.N.Y. 1969), *aff'd*, 27 A.F.T.R.2d 655 (2d Cir. 1971) (the Internal Revenue Service will not be capricious in applying the reallocation rules where the contract was signed by the corporation).

63. The usual presumption in favor of the correctness of the Commissioner of Internal Revenue's determination is given the additional weight of another presumption. The purpose to evade or avoid federal taxation is presumed to be the principle purpose. The taxpayer has the burden of disproving both presumptions. Treas. Reg. 1.269-5(b) (1962).

64. I.R.C. § 269(a).

65. It may be inferred that the term "acquire" includes the act of organizing a corporation, since one of the regulations promulgated under I.R.C. § 269 addresses the situation where two corporations are formed rather than one in order to obtain the benefit of multiple surtax exemptions or accumulated earnings credits. Treas. Reg. § 1.269-3(b)(2) (1962). This regulation has become obsolete due to the deletion of the I.R.C. § 11(d) surtax exemption and the addition of I.R.C. § 1561 limiting the member organizations of a controlled group to one accumulated earnings credit for the entire group, but the pertinent implication remains. The term "acquire" includes the process of organizing a corporation.

66. I.R.C. § 269(a).

67. *See* note 2 *supra*.

election for the new corporation is not considered tax avoidance for purposes of this provision.[68]

The disallowance of tax benefits may also be a concern where the professional corporation itself acquires another subsidiary business[69] to further postpone distribution of earnings and profits to shareholder-employees in taxable dividends and salaries. State law governs what types of business a professional corporation may acquire. Most states restrict the business undertakings of the professional corporation itself to the performance of professional services or closely related activities. There is less restriction in some states regarding the form of business a professional corporation may acquire as a subsidiary.[70] In a state that allows it to do so, the professional may wish to facilitate long-range planning with such an acquisition. The professional corporation will be indirectly limited to expansion into active enterprise subsidiaries rather than passive investment portfolios by the accumulated earnings[71] and personal holding company penalty taxes.[72] A low-risk active business subsidiary can be a valuable income and estate tax planning tool. It is essential to establish a plan for the expansion before the funds become available.[73] In addition to providing a means of avoiding penalty tax problems without having to distribute the professional corporation's earnings and profits in a form that will be ordinary income to the professional in his shareholder or employee capacity, the subsidiary will serve another important function. All state professional corporation laws put restrictions on the issuance, voting, and transfer of stock to ensure that there is no dilution of liability and professional responsibility by layman control. This creates inheritance problems. A mandatory buy-sell agreement is necessary. In addition to that agreement (where a subsidiary is the primary repository of wealth, having been expanded over the years as funds were available from the

68. Rev. Rul. 76-363, 1976-2 C.B. 90. In spite of the fact that division of a corporation followed by a Subchapter S election is acceptable for I.R.C. § 269 purposes, it is important to note that division of a corporation in order to meet the shareholder test of I.R.C. § 1371(a)(1) is not allowed in spite of technical compliance with the requirements. Rev. Rul. 77-220, 1977-1 C.B. 263.

69. Not only does investment in another business enterprise avoid potential I.R.C. § 541 personal holding company and I.R.C. § 531 excess accumulated earnings problems, the professional corporation will be allowed a deduction for 100% of the dividends received from a corporation which is a member of the same affiliated group of corporations if they have made the appropriate election. I.R.C. § 243(a) & (b)(2). *See* text at note 77 (accumulated earnings) and note 98 (personal holding company) *infra*.

It is to be noted, however, that I.R.C. § 1561 would limit the member organizations of a controlled group to one accumulated earnings credit under I.R.C. § 535 (c)(2) & (3) for the group. I.R.C. § 1564 is central to the provisions dealing with multiple corporations. The primary advantage of a multiple corporation configuration for the professional corporation would be that acquisition of a non-service oriented affiliate would make the group less susceptible to the personal holding company penalty and more conducive to legitimate expansion.

70. *See* note 1 *supra*.

71. *See* text at note 97 *infra*.

72. *See* text at note 102 *infra*.

73. *See* text at note 86 *infra*.

earnings of the professional corporation) a Hartzell-Dean recapitalization[74] may be used to shift most of the accumulated wealth to the professional's children tax free.[75] This could not be done without the subsidiary because the children would not be able to hold shares in the professional corporation. Further, there would be limited opportunity to expand a professional corporation's operation to justify the accumulation of earnings and profits.[76]

ACCUMULATED EARNINGS PENALTY TAX

A penalty tax[77] is imposed on corporations[78] formed or availed of for the purpose of avoiding taxation with respect to the shareholders by

74. Dean v. Commissioner, 10 T.C. 19 (1949), *acq.* 1949-1 C.B. 1; Hartzel v. Commissioner, 40 B.T.A. 492 (1939), *acq.* 1939-2 C.B. 16; Rev. Rul. 74-269, 1974-1 C.B. 87.

75. In its simplest form, the family recapitalization involves a closely-held corporation with only common stock outstanding. The value of the shares must be determined and if the value per share is high, a stock dividend is declared. This is not a taxable event. I.R.C. § 305(a). Shares worth less than $3,000 are then given to each of the shareholder's children. This is not a taxable event. I.R.C. §§ 2503(b), 102(a). A recapitalization is then undertaken whereby common shares owned by the parent are exchanged for preferred leaving the entire remaining common in the hands of the children. A business purpose for the recapitalization is required. Treas. Reg. § 1.368-1(b) & (c) (1962). The desire to prevent disruption of management constitutes a valid business purpose. Rev. Rul. 74-269, 1974-1 C.B. 87. Potential problems under I.R.C. § 305(b)(2) & (3) regarding disproportionate distributions have been circumvented since the recapitalization is an isolated event. It is not part of a plan to periodically increase one shareholder's proportionate interest. Treas. Reg. § 1.305-3(e), *e.g.*, (12) (1974); Rev. Rul. 75-93, 1975-1 C.B. 101. The result is that the value of the parent's stock is frozen for estate tax purposes. The parent will have dividend income from the preferred. The children will have the voting control and responsibility and future appreciation from that point will be shifted to them. The transfer of control is accomplished tax free. I.R.C. § 368(a)(1)(E). For other business purposes, *see* Rev. Rul. 77-238, 1977-2 C.B. 115; Rev. Rul. 76-387, 1976-2 C.B. 96. For guidance in closely-held corporation valuation, *see* Central Trust Co. v. United States, 305 F.2d 393 (Ct. Cl. 1962); Baker v. United States, 172 F. Supp. 833 (S.D. Ill. 1959); Rev. Rul. 59-60, 1959-1 C.B. 237, *as modified by* Rev. Rul. 65-193, 1965-2 C.B. 370, *amplified by* Rev. Rul. 77-287, 1977-2 C.B. 319. *See generally* Ehrlich, *Corporate Recapitalization as an Estate Planning Business Retention Tool*, 34 N.Y.U. INST. FED. TAX. 1661 (1976); Abbin, *Gift, Estate, and Income Tax Exposure From Recapitalizing Closely Held Companies*, 10 U. MIAMI INST. EST. PLAN. 1200 (1976).

76. The professional corporation could invest in various kinds of tax shelter, but the primary advantage there is tax deferral. Deductions are limited to the at risk investment amount for activities such as motion picture ventures, farming, property leasing, and oil and gas shelters. I.R.C. § 465. Even the more favored real estate shelters can backfire. In a nonrecourse real estate shelter, the court denied the depreciation and interest deductions on the ground that the true investment in the property was significantly less than the inflated purchase price. The fair market value was about half the purchase price. The court noted that the holding, absent tax motivation factors, was not aimed at a situation where there was merely a poor bargain involved. Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976).

77. In addition to the normal corporate tax, a penalty tax is imposed at the rate of 27½% on the first $100,000 accumulated taxable income and 38½% on any amount in excess of $100,000. I.R.C. § 531.

78. Personal holding companies, foreign personal holding companies and corporations exempt from taxation under Subchapter F are expressly exempt from this penalty tax. I.R.C. § 532(b).

accumulation instead of distribution of earnings and profits.[79] Accumulation beyond the reasonable needs of the business is determinative of the intent to avoid taxation unless the taxpayer is able to show by a preponderance of the evidence, that the forbidden intent did not exist.[80] There is a procedure, however, for shifting the burden of proof.[81] If the taxpayer supplies a statement within the allotted time which sets forth the grounds upon which he intends to rely in proving the accumulation was reasonable, the burden of proving the accumulation unreasonable is then with the government.[82]

The prohibited tax avoidance motive need not be the primary motive, but may be only one factor if the accumulation is unreasonable.[83] In respect to the amount in excess of the reasonable needs of the business, the tax is imposed on the adjusted accumulated taxable income of the corporation,[84] with allowance for dividends paid and an accumulated earnings credit.[85]

There is no requirement that the accumulated earnings be invested immediately in the business enterprise, but there must be a specific,

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79. I.R.C. § 532(a).

80. I.R.C. § 533(a).

81. I.R.C. § 534. The burden of proof is shifted, if the deficiency notice does not specifically state an amount attributable to accumulated earnings or if the taxpayer submits a timely statement containing sufficient grounds upon which he intends to refute the allegation of excess accumulated earnings. I.R.C. § 534; Treas. Reg. § 1.534-2(d) (1959).

82. The courts have not always made the important distinction between what is procedurally required in order to shift the burden of proof, and the substantive requirement that the accumulation be reasonable and the plans be definite. J. Gordon Turnbull, Inc. v. Commissioner, 373 F.2d 87 (5th Cir.), *cert. denied,* 389 U.S. 842 (1967). I.R.C. § 533(a) requires that the corporation prove the accumulation was reasonable. If the burden of proof is shifted, the government must prove the accumulation was not reasonable. I.R.C. § 534 does not contemplate prejudgment proof of the merits of the taxpayer's case, rather that the statement submitted be sufficient to show the grounds upon which the taxpayer intends to establish his case. Motor Fuel Carriers, Inc. v. Commissioner, 559 F.2d 1348 (5th Cir. 1977).

The possibility of rebutting the presumption of a tax avoidance motive based on deadlock over the corporation's distribution policy or minority dissent can easily backfire. By analogy to the collapsibility regulations, the forbidden intent might be found to exist in persons who are in a position to determine the corporation's policies by dissent in spite of their minority position. Treas. Reg. § 1.341-2(a)(2) (1955).

For cases turning on the minority interest factor, *see* Mountain State Steel Foundries v. Commissioner, 284 F.2d 737 (4th Cir. 1960); Ted Bates & Co. v. Commissioner, 34 T.C.M. (P-H) 1476 (1965).

Deadlock may be a sufficient reason for accumulation. Casey v. Commissioner, 267 F.2d 26 (2d Cir. 1959). However, where any of the deadlocked interests has as its motive the forbidden purpose to avoid taxation the penalty will be imposed. Atlantic Properties, Inc. v. Commissioner, 519 F.2d 1233 (1st Cir. 1975).

83. Brumer, Moss & Cohen, P.A. v. United States, 37 A.F.T.R.2d 802 (S.D. Fla. 1976).

84. I.R.C. § 535(b).

85. A corporation subject to I.R.C. § 531 is allowed to accumulate $150,000 over its lifetime without incurring any penalty for excess accumulation. I.R.C. § 535(c).

definite, and feasible plan outlining the intended use.[86] The plan must contemplate a reasonable business need that will arise within the foreseeable future and not at some indefinite time as yet unascertainable.[87] The amount may not exceed that which a prudent businessman would retain in the particular circumstances.[88] The plan must have existed at the time the accumulation was made and should be documented in the corporate minutes or otherwise.[89] The plan must be consistent with the needs of the business, not the disparate interests of the shareholders.[90]

The reasonable needs of the business may include, but are not limited to expansion or replacement of the facility, acquisition of a business enterprise by purchase of stock or assets, retirement of a bona fide business indebtedness, provision of working capital, and funding of loans or investments for suppliers or customers as may be required to maintain business relationships.[91]

Purposes which will be considered unreasonable are loans or personal benefits to shareholders, loans unrelated to any business purpose, loans to a related[92] corporation in another line of business, investment in property or securities unrelated to the business of the corporation, and accumulation for protection against unrealistic hazards.[93]

The reasonable needs of the business language in the code has been expansively interpreted to include any and all lines of business into which

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86. When I.R.C. § 537 was added to the Internal Revenue Code in 1954, the Senate Finance Committee explained the change as follows:

> In any case where there exists a definite plan for the investment of earnings and profits, such corporation need not necessarily consummate these plans in a relatively short period after the close of the taxable year. However, where the future needs of the business are uncertain or vague, or the plans for the future use of the accumulation are indefinite, the amendment does not prevent application of the accumulated earnings tax.

S. REP. No. 1622, 83rd Cong., 2d Sess. 318 (1954).

87. *Id.*

88. Treas. Reg. § 1.537-1(a) (1959).

89. Bromer, Moss & Cohen, P.A. v. United States, 37 A.F.T.R.2d 802 (S.D. Fla. 1976). Documentation of the plans formulated for use of corporate accumulated earnings will facilitate substantiation under I.R.C. § 534 should that become necessary. However, it has been held that "the requirement of 'specific, definite, and feasible' plans does not demand that the taxpayer produce meticulously drawn, formal blueprints for action . . . ." 559 F.2d 1348 (5th Cir. 1977).

90. *Id.* If the accumulation is for the redemption of stock, the corporation must be able to demonstrate that such a move is essential to its own commercial well-being. *See, e.g.,* Mountain State Steel Foundries v. Commissioner, 284 F.2d 737 (4th Cir. 1960); Gazette Publishing Co. v. Self, 103 F. Supp. 779 (E.D. Ark. 1952); Dill Mfg. Co. v. Commissioner, 39 B.T.A. 1023 (1939). *But see* Cadillac Textiles, Inc. v. Commissioner, 44 T.C.M. (P-H) 292 (1975); Pelton Steel Casting Co. v. Commissioner, 28 T.C. 153 (1957), *aff'd,* 251 F.2d 278 (7th Cir. 1958) (may not be for the redemption of a majority shareholder's interest).

91. Treas. Reg. § 1.537-2(b) (1959).

92. A related corporation in this case is one the capital stock of which is owned directly or indirectly by the shareholders of the taxpayer corporation where both corporations are controlled by the same shareholders. Treas. Reg. § 1.537-2(c)(3) (1959).

93. Treas. Reg. § 1.537-2(c) (1959).

the corporation may vertically or horizontally expand.[94] If unrelated businesses are engaged in by a single corporation,[95] presumably the needs may be aggregated and the accumulation of one used to meet the needs of the other.[96] This is expressly allowed where one corporation acquires another corporation as long as the latter is truly a subsidiary, not just a stock investment.[97] It is essential to the statutory intent that mere investment in another business or other passive investments be distinguished as impermissible due to their similarity to cash accumulation for tax avoidance purposes.

PERSONAL HOLDING COMPANY PENALTY TAX

The personal holding company tax[98] is confiscatory in nature,[99] its intent being to force distribution of earnings[100] in certain narrowly specified circumstances.[101] The penalty is designed to discourage the use of a corporation to collect and be taxed on passive investment income at the flat corporate tax rate which would otherwise be taxable at higher graduated personal income tax rates. The "incorporated pocketbook" is thus deterred.[102] The tax is not imposed unless at least 60%[103] of the corporation's adjusted ordinary gross income[104] is personal holding company income[105] and more than 50% of the value of its stock is owned, directly or indirectly, actually or constructively, by five or fewer shareholders.[106]

94. I.R.C. § 537(a); Treas. Reg. § 1.537-3(a) (1959).

95. The implication that a drastic change of business is acceptable is implicit in the fact that a former prohibition, Treas. Reg. 118 § 39.102-3(b), was eliminated in the 1954 regulations. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 8-22 (3d ed. 1971) [hereinafter cited as BITTKER & EUSTICE].

96. Sandy Estate Co. v. Commissioner, 43 T.C. 361 (1964); Lannom Mfg. Co. v. Commissioner, 21 T.C.M. (P-H) 133 (1952).

97. The accumulating corporation must own at least 80% of the voting stock of the second corporation or a showing of special circumstances will be required. Treas. Reg. § 1.537-3(b) (1959).

98. I.R.C. § 541.

99. In addition to the normal corporate tax, there is imposed a personal holding company tax equal to 70% of the undistributed personal holding company income. I.R.C. § 541.

100. Imposition of the personal holding company penalty tax precludes liability for the penalty tax of I.R.C. § 531 on excess accumulated earnings. I.R.C. § 532 (b)(1).

101. I.R.C. § 543.

102. Paul, *The Background of the Revenue Act of 1937*, 5 U. CHI. L. REV. 41 (1937).

103. I.R.C. § 542(a)(1).

104. I.R.C. § 543(b)(2).

105. Personal holding company income includes such items as dividends, rents, royalties and amounts received on personal service contracts. I.R.C. § 543(a).

106. I.R.C. § 542(a)(2).

Retroactive reduction[107] of this penalty tax liability is permitted by distribution of a deficiency dividend.[108]

The provision of particular concern to professional corporations relates to income from personal service contracts. The income of a professional corporation will be personal holding company income if the oral or written service contracts[109] name the professional who will personally perform the services,[110] and the named professional owns directly, indirectly, or constructively,[111] 25% or more by value of the outstanding stock of the corporation[112] at any time during the same year. It will be a problem if anyone other than the corporation is given the power to designate who will perform the services.[113] Further, the dividend income from any subsidiary corporations could present personal holding company problems even if the professional corporation itself is carefully organized to avoid the definitional restrictions.

The earnings of a professional corporation will normally be allocated to salaries and other distributions so that there is little undistributed profit upon which the tax could be levied. Also a corporation with five 20%-shareholders would be outside the statutory limitation entirely.

On the other hand, it would seem that the one-man professional corporation would be in serious jeopardy. Although true to some extent, several rulings mitigate the danger by acknowledging that there is always a possibility that an outside consultant may be called in[114] as long as the contract would not prohibit substitution if the situation warranted it.[115] In any case, the mere fact that a client customarily seeks the services of a particular professional does not automatically constitute the prohibited designation of a professional by the one for whom the services will be performed.

REASONABLENESS OF SALARIES

There is perhaps no greater difficulty in determining what will be found to be a reasonable salary in the context of a professional corporation than any other closely-held corporation, but that is little solace in light of

107. A claim for the deficiency dividend deduction must be filed within 120 days after the deficiency has been determined. I.R.C. § 547(e).

108. The deficiency dividend must be distributed within 90 days after the deficiency has been determined. I.R.C. § 547(d)(1).

If the dividend is paid by a distribution of property, the amount of the deficiency dividend deduction will be based on the corporation's adjusted basis in the property and not its fair market value. Fulman v. United States, 98 S. Ct. 841 (1978); C. Blake McDowell, Inc. v. Commissioner, 67 T.C. 1043 (1977).

109. Rev. Rul. 69-299, 1969-1 C.B. 165.

110. I.R.C. § 543(a)(7)(A).

111. The broad attribution of ownership rules of I.R.C. § 544(a) apply in determining whether the 25% ownership exists.

112. I.R.C. § 543(a)(7)(B).

113. *See* note 108 *infra*.

114. *See* Claggett v. Commissioner, 44 T.C. 503 (1965), *acq.* 1966-2 C.B. 4.

115. Rev. Rul. 75-67, 1975-1 C.B. 169; Rev. Rul. 75-250, 1975-1 C.B. 172; Rev. Rul. 75-249, 1975-1 C.B. 171; Rev. Rul. 71-372, 1971-2 C.B. 241 (services not unique).

the taxpayer's burden of proof,[116] and unavailability of advanced rulings[117] in either case.

The corporation is allowed to deduct all ordinary and necessary[118] expenses incurred in its business including a reasonable allowance for salaries.[119] The regulations point out, however, that what purports to be a deductible salary[120] may be found to be a dividend[121] and thus not deductible to the corporation.[122]

Gross income is defined as including all income from whatever source derived.[123] Anything which increases the taxpayer's net worth[124] is to be included in gross income for taxation purposes unless specifically excluded.[125] The income need not be received in the form of cash. Property and services may also constitute income.[126] If the wage earner's services are compensated in a form other than money, the fair market value of the property or services received must be included in gross income.[127] As an employee, the professional will, therefore, be required to include in gross income the value of any fringe benefits for which there is no specific exclusion. Such additional compensation amounts will be considered along with the employee's normal salary in making a determination of reasonableness.[128]

The regulations stress that the compensation must be for services actually rendered[129] and should not exceed an amount ordinarily paid[130] for such services[131] by similar organizations in like circum-

116. Botany Worsted Mills v. United States, 278 U.S. 282 (1929).

117. Rev. Proc. 79-14, 1979-10 I.R.B. 30.

118. Justice Cardozo enunciated the classic interpretation of what is ordinary and necessary in 1933. "Necessary" is deemed to be that which is "helpful and appropriate." "Ordinary" he found must remain relative, the answer to be found from "life in all its fullness." Welch v. Helvering, 290 U.S. 111 (1933).

119. I.R.C. § 162(a)(1). The reasonableness of salaries is measured against that "ordinarily paid for similar services." Treas. Reg. § 1.162-7(b)(1) (1958).

120. I.R.C. § 162(a)(1).

121. Treas. Reg. § 1.162-7(b)(1) (1958). A shareholder-director's salary must also be found to be a dividend. United Builders Supply, Inc. v. United States, 41 A.F.T.R.2d 654 (S.D. Miss. 1978).

122. I.R.C. § 311(a)(2).

123. I.R.C. § 61(a).

124. Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955).

125. I.R.C. §§ 101-24.

126. Treas. Reg. § 1.61-2(d)(1) (1963).

127. *Id.*

128. Contributions to a qualified retirement plan must satisfy the requirements of I.R.C. §§ 162 & 212. I.R.C. § 404(a). Thus the entire amount of salary and retirement plan contribution combined must be reasonable for the deduction to be allowed. Quinn v. United States, 40 A.F.T.R.2d 5097 (D. Md. 1976); Edwin's, Inc. v. United States, 501 F.2d 675 (7th Cir. 1974); Bianchi v. Commissioner, 66 T.C. 324 (1976), *aff'd*, 553 F.2d 93 (2d Cir. 1977).

129. Treas. Reg. § 1.162-7(b)(1) (1958).

130. Graham v. Commissioner, 45 T.C.M. (P-H) 1292 (1976).

131. It would seem that a senior professional who deals less and less with clients would have to be paid less to conform with the "compensation for services rendered"

stances.[132] The reasonableness of the salary is essentially a fact question in each case.[133] It is to be noted in that regard, that excessive payments, particularly contingent compensation amounts which display a close relationship to the recipient's stockholdings, will invite close scrutiny as a possible distribution of earnings rather than remuneration based on services performed.[134]

Until recently there was some uncertainty as to whether a reasonable return of capital would be implied in the absence of any dividend history. One case had held that a set return on investment would be allocated in circumstances where there was a dilatory dividend policy even if the salaries were found to be reasonable.[135] In several subsequent cases the court declined to apply the automatic dividend rule, holding that the fact no dividends were declared did not preclude a finding that the salaries of highly compensated officer-shareholders were reasonable.[136] The Internal Revenue Service has now officially stated that where salaries are found to be reasonable in light of all the facts, including the corporation's dividend history, the salary deduction will not be denied on the basis of any conclusive presumption of a dividend distribution.[137]

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requirement. However, the courts have recognized that a value must be assigned to other kinds of service such as public relations and efforts which have built up the enterprise since these are factors commonly considered in establishing salaries to be paid senior professionals. Ledford Constr. Co. v. Commissioner, 46 T.C.M. (P-H) 859 (1977); Medical Collection Corp. v. Commissioner, 46 T.C.M. (P-H) 1075 (1977).

132. Treas. Reg. § 1.162-7(b)(3) (1958).

133. Some of the factors to be weighed by the court or jury in considering the reasonableness of the salary are: the kind of services to be performed, the degree of responsibility required, the time spent providing the services, the level of training and personal capability involved, the relationship of the compensation to gross and net profits, the size and sophistication of the business, the general economic conditions, the relationship between salaries and shareholder distributions, the relationship of salaries paid to shareholder-employees and non-shareholder-employees, and any relevant salary histories. East Tenn. Motor Co. v. United States, 453 F.2d 494 (6th Cir. 1971); Mayson Mfg. Co. v. Commissioner, 178 F.2d 115 (6th Cir. 1949); Patton v. Commissioner, 168 F.2d 28 (6th Cir. 1948).

134. Branchi v. Commissioner, 66 T.C. 324 (1976); Treas. Reg. § 1.162-7(b)(1) & (2) (1958).

135. In spite of the specific and detailed finding that the high salaries paid to the two shareholder-owners as employees was reasonable and in line with the services performed as officers, the court held that under the circumstances of such a profitable business, the very success that justified such generous salaries would also require a substantial return on capital investment. Since the salary may not be deducted to the extent that it is in reality a distribution of corporate earnings and profits, and no dividends had been paid since the inception of the corporation, the court adjusted the amounts deducted as salaries to reflect a 15% return on the capital investment of the employee-shareholder-owners. McCandles v. United States, 422 F.2d 1336 (Ct. Cl. 1970).

136. The United States Tax Court stated, "[W]hile the absence of dividends may indicate the presence of disguised dividends, it does not convert compensation determined to be reasonable into dividends." William E. Davis & Sons, Inc. v. Commissioner, 44 T.C.M. (P-H) 977 (1975). Similar holdings obtained in Quinn v. United States, 40 A.F.T.R.2d 5097 (D. Md. 1976) *and* Good Chevrolet Co. v. Commissioner, 46 T.C.M. (P-H) 1158 (1977).

137. Rev. Rul. 79-8, 1979-2 I.R.B. 6.

Bonuses may also give rise to dividend interpretation.[138] Therefore, the desire to reward exemplary employee performance should be anticipated in the form of an established policy regarding bonuses stated in the employment contract. The criteria should be clearly stated there and again in the records when a bonus is declared. Bonuses should be declared formally, preferably at a time prior to when the earnings and profits for the year are known.[139]

Although the corporation and its shareholder-employees might wish to contract that any disallowed salary payments must be returned to the corporation thus affording a business deduction for the employee,[140] such an agreement may give rise to the inference that the salary is at least questionable, if not unreasonable.[141]

COLLAPSIBLE CORPORATION PROVISIONS

There have not been cases as yet to delineate what degree of danger the collapsible corporation provisions may present for professional corporations. It is, therefore, imperative that this potential problem be anticipated and carefully avoided [142] long before sale, liquidation or redemption is to occur.

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138. In holding that bonuses claimed as a deductible business expense under I.R.C. § 162(a)(1) were really a distribution of dividends based on earnings and profits, the court enumerated the following factors:

1. The bonuses were in exact proportion to the officers' stockholdings.
2. Payments were in lump sums rather than as the services were rendered.
3. There was a complete absence of formal dividend distributions by an expanding corporation.
4. The system of bonuses was completely unstructured; i.e., bonuses were computed periodically throughout the year on no apparent pre-set basis.
5. Taxpayer's consistently negligible taxable income was an indication that the bonus system was based on funds available rather than on services rendered.
6. The stock redemption agreement between Nor-Cal and Mr. Hobson [president of the corporation]. [The agreement was for a past redemption of stock, Hobson to be paid 35% of the net profit of the corporation for a five year period, with net profit to be after tax profit plus all bonuses and salaries to the officers in excess of 60% of the fee billings.]
7. Bonus payments were made only to the officer-shareholders . . . .

Nor-Cal Adjusters v. Commissioner, 503 F.2d 359, 362 (9th Cir. 1974). *See also* Barton v. Commissioner, 25 A.F.T.R.2d 746 (7th Cir. 1970).

139. Pepsi-Cola Bottling Co. v. Commissioner, 37 A.F.T.R.2d 369 (10th Cir. 1976); Branchi v. Commissioner, 66 T.C. 324 (1976). *But see* Osborne Motors, Inc. v. Commissioner, 45 T.C.M. (P-H) 680 (1976); Central Freight Lines, Inc. v. Commissioner, 45 T.C.M. (P-H) 84 (1976); Schanchrist Foods, Inc. v. Commissioner, 46 T.C.M. (P-H) 559 (1977). (Where salary and bonuses combined present reasonable compensation for the services rendered, the deduction is allowed.)

140. Oswald v. Commissioner, 49 T.C. 645 (1968), *acq.* 1968-2 C.B. 2; Rev. Rul. 69-115, 1969-1 C.B. 50.

141. Pahl v. Commissioner, 67 T.C. 23 (1976); Saia Elec., Inc. v. Commissioner, 43 T.C.M. (P-H) 1284 (1974).

142. The Internal Revenue Service will not ordinarily issue an advanced ruling on the collapsibility of a corporation. Rev. Proc. 72-9, 1972-1 C.B. 718, *amplified by* Rev. Proc. 77-45, 1977-2 C.B. 579.

A complete liquidation normally results in capital gain or loss[143] to the shareholder,[144] and property distributed is received with a basis equal to the fair market value at the time of distribution.[145] However, the shareholder who disposes of stock in a collapsible corporation, whether in full or partial liquidation, or by implication even in redemption circumstances,[146] must declare gains as ordinary income.[147]. The non-recognition treatment afforded under a twelve-month plan of complete liquidation[148] and under a one-month plan of complete liquidation[149] will usually be

143. I.R.C. §§ 1222 & 1223.

144. I.R.C. § 331(a)(1).

145. I.R.C. § 334(a).

146. The sale or exchange of stock, distribution in partial or complete liquidation for part or full payment of the stock exchanged, or a distribution under I.R.C. § 301(c)(3)(A) providing non-dividend treatment of the excess above adjusted basis by a collapsible corporation is considered ordinary income to the extent it would be long-term capital gain but for its collapsible nature. I.R.C. § 341(a).

This provision does not include short-term capital gains which may still be offset by short-term capital losses under I.R.C. § 1222. Likewise, it does not influence tax-free exchanges of stock under I.R.C. §§ 351, 355, 361 & 1036.

It has been noted that the redemption of stock giving rise to long-term capital gain under I.R.C. § 302(a) has been omitted from the I.R.C. § 341(a) list presumably because the term "partial liquidations" is carried over from pre-1954 terminology without recognition of the fact that the 1954 Code no longer includes redemptions as part of that concept. Most distributions by collapsible corporations, however, reflect a "corporate contraction" which would be covered by I.R.C. § 341(a)(2) anyway. BITTKER & EUSTICE, *supra* note 95, at 12-4 n.6.

147. I.R.C. § 341(a).

148. The gain realized by shareholders will qualify for non-recognition under I.R.C. § 337 if I.R.C. § 341(e)(4) is applicable to property sales made by the corporation during the twelve month period commencing with the adoption of the liquidation plan and the corporation is, therefore, not considered to be collapsible. The exemption of I.R.C. § 341(e)(4) is applicable to the corporation and is not determined on a shareholder-by-shareholder basis. The exemption pertains only to the appreciation in value of properties which are ordinary-income assets in the hands of the corporation or would be such in the hands of a more than 20% shareholder. There is no consideration given to shareholders with lesser interests, nor is there any application of the constructive dealer test. To qualify for the exemption, the 15% appreciation restriction of I.R.C. § 341(e)(2) must be met and the corporation must sell substantially all of its assets within the 12 month period. The liquidation may not include distribution in kind of property which was or will thus become subject to depreciation, amortization or depletion. The non-recognition exemption does not apply to any sale or exchange with or to a more than 20% shareholder or related person. The asset by asset approach means that assets having a basis in excess of their fair market value may be sold to a major shareholder for less recognition while gain assets are sold to outsiders under the non-recognition provisions. City Bank of Washington v. Commissioner, 38 T.C. 713 (1962); Virginia Ice & Freezing Corp. v. Commissioner, 30 T.C. 1251 (1958). Unfortunately, I.R.C. § 341(e)(4) may apply to exempt the corporation from taxation of the asset sales in a situation where I.R.C. § 341(e)(2) does not protect the particular shareholder. Such a shareholder would be one with an interest over 5% but not more than 20%. In this situation, had I.R.C. § 341(e)(4) not applied, I.R.C. § 337 would not have applied. The corporation would have realized and recognized substantial gain, preventing collapsibility, and thus affording the shareholder capital gain treatment. *See* text at note 173 *infra*.

149. A one month liquidation under I.R.C. § 333 must meet the exemption test of I.R.C. § 341(e)(3) in the case of a collapsible corporation. The exemption applies to all of the shareholders or to none of them. This exemption is concerned with the assets as they relate to a shareholder with more than a 5% interest. The constructive dealer test does not apply. The net increase in the assets may not exceed 15% of the corporation's net worth. Treas. Reg. 1.341-6(f) (1975).

unavailable to the collapsible corporation and its shareholders[150] unless an exception takes the corporation out of the collapsibility category.

The designation of collapsibility occurs when the corporation is found to have been established or used principally[151] for the production of property[152] with a view toward sale, liquidation, or distribution before the corporation has realized any substantial[153] portion of the taxable income.[154] That is, the corporation produces something which will appreciate. Before the appreciation is realized by the corporation, the property is distributed to the shareholders in a corporate liquidation or other stock transaction. The shareholder seeks to be taxed at the capital gains rate[155] where the production of the property would otherwise have produced ordinary income without the incorporation step.[156] The production property is broadly interpreted to include any kind of tangible or intangible property the corporation produces, including fees and accounts receivable.[157]

An objective standard has been established to aid in the determination of whether the forbidden view existed at any time during the relevant manufacture, production, construction or purchase.[158] The corporation

150. Manassas Airport Indus. Park, Inc. v. Commissioner, 66 T.C. 566 (1976), *aff'd*, 557 F.2d 1113 (4th Cir. 1977); Leisure Time Enterprises, Inc. v. Commissioner, 56 T.C. 1180 (1971).

151. It has been held that the word "principally" in the section dealing with collapsible corporations modifies "manufacture, construction or production of property" not "with a view to." Weil v. Commissioner, 252 F.2d 805 (2d Cir. 1958).

152. The dollar amount expended for manufacture, production, construction, or purchase is irrelevant. There is no *de minimis* provision in that respect to prevent application of the collapsible corporation penalty. Rev. Rul. 72-422, 1972-2 C.B. 211.

153. A corporation which has realized one third of the taxable income to be derived from its production property is not collapsible for purposes of I.R.C. § 341(a). Rev. Rul. 72-48, 1972-1 C.B. 102.

154. I.R.C. § 341(b)(1).

155. A complete liquidation of a corporation is treated as a sale of stock which will be accorded capital gains treatment. I.R.C. § 331(a)(1). The shareholder's basis for the property received is the fair market value at the time of distribution. I.R.C. § 334(a).

156. The collapsibility provisions were added to the Internal Revenue Code in 1950 to eliminate the advantages obtained by the use of a tax avoidance device which was particularly popular in the movie industry. Key production people and actors incorporated to produce each separate movie. Investment was minimal with production being financed by loans. At completion the corporation was liquidated before the movie was distributed. Therefore, the corporation received no income from the movie. The difference between the cost of the stock and the proportionate value of the assets, that is, the proportionate estimated value the movie would have when distributed (profit), was reported as capital gain by each shareholder. Profits are ordinarily taxable as ordinary income. Thus, by liquidating before the profits were realized, the producers converted ordinary income into capital gains and also avoided taxation at the corporate level. O'Brien v. Commissioner, 25 T.C. 376 (1955); H.R. REP. No. 2319, 81st Cong., 2d Sess. 56 (1950); S. REP. No. 2375, 81st Cong., 2d Sess. 45 (1950).

157. Treas. Reg. § 1.341-2(b)(4) (1955).

158. A finding of collapsibility is appropriate if the forbidden view existed at any time during manufacture, production, construction or purchase, not just at the time it was commenced or completed. Sidney v. Commissioner, 273 F.2d 928 (2d Cir. 1960); Glickman v. Commissioner, 256 F.2d 108 (2d Cir. 1958); Burge v. Commissioner, 253 F.2d 765 (4th Cir. 1958); Treas. Reg. § 1.341-2(a)(3) (1955).

is presumed to be collapsible if the section 341 assets[159] comprise 50% or more of the fair market value of all assets of the corporation and 120%[160] or more of the adjusted basis of the section 341 assets.[161] Cash, obligations which represent a capital asset in the hands of the corporation, and stock in any other corporation are excluded from the total assets figure. This is required in determining what percent the section 341 assets are in order to eliminate the possibility of watering down the corporate net assets figure.[162] Where production is continuous, the view is also deemed to be continuous.[163] By contrast, the view does not exist at all where stock is sold without any choice due to circumstances beyond the seller's control. An example would be where an unforeseeable event triggers a commitment to sell under a buy-sell agreement.[164]

Application of the collapsible corporation provisions is limited in three ways. First, the shareholder must own, directly or constructively,[165] more than 5% by value of the outstanding shares during or after production of the section 341 assets.[166] Second, the whole transaction[167] will qualify for capital gains treatment if the collapsible production does not account for 70% or more of the gain on a disposition.[168] Third, the ordinary income treatment does not apply to gain realized three or more years after production is completed.[169]

Application of the collapsible corporation provisions can further be avoided if one of the statutory exceptions applies. The criteria are intricate,[170] but they can be categorized as they apply first to the corporation

159. Section 341 assets are defined as being property held for less than three years which is stock in trade held primarily for sale to customers, unrealized receivables and fees, or I.R.C. § 1231(b) property which has been used in connection with the pertinent manufacturing, construction, production or sale activity. I.R.C. § 341 (b) (3).

160. The appreciation is measured against basis, not the shareholder's investment. Treas. Reg. § 1.341-3(a) (1955).

161. I.R.C. § 341(c) (1).

162. I.R.C. § 341(c) (2).

163. Diecks v. Commissioner, 65 T.C. 117 (1975).

164. Crowe v. Commissioner, 62 T.C. 121 (1974). The sale mandated under agreement due to disagreement between equal shareholders was found to be only a remote contingency rather than a "circumstance which reasonably could be anticipated" as mentioned in Treas. Reg. § 1.341-2(a) (3) (1955).

165. The attribution rules of I.R.C. § 544(a) apply in determining constructive ownership for purposes of the collapsible corporation provisions. I.R.C. § 341(e) (10); I.R.C. § 341(d).

166. I.R.C. § 341(d) (1).

167. It is to be noted that the principle of collapsibility requires an all or nothing determination. I.R.C. § 341(a).

168. I.R.C. § 341(d) (2).

169. I.R.C. § 341(d) (3). As long as accounts receivable continue to be produced, the three year period will not begin to run, so this exemption is of little use to a professional corporation. *See* text at notes 157 and 163 *supra*.

170. Treas. Reg. § 1.341-6(a) (1) (1975). The exceptions, when applicable, eliminate the necessity of even determining collapsibility if any of four types of transaction is involved, whether or not the situation falls within the I.R.C. § 341(d) limitations. The first two exceptions in I.R.C. § 341(e) allow shareholders to see or exchange their stock or receive distributions in certain complete liquidations (not partial liqui-

and then as they pertain to each shareholder. Imposition of the penalty is eliminated unless the net unrealized appreciation[171] of the production assets[172] exceeds 15% of the net worth of the corporation.[173] However, if a shareholder, who is considered to own 5% of the outstanding stock by value, sells or exchanges his stock or receives a distribution on it, he must also qualify individually.[174] There is no implied exception for profits that would have been taxed as capital gains if sold by the shareholder as an individual.[175]

One final means of escaping the collapsible corporation penalty tax is available. The shareholder will be allowed to report capital gains rather[176] than ordinary income on the sale of stock if the corporation consents[177]

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dations) on a shareholder by shareholder basis without the threat that the I.R.C. § 341(a) penalty will be imposed. The specific shareholder who owns more than 5%, but not more than 20%, of the value of the outstanding stock must take into account the net unrealized appreciation in assets of the corporation that would be subsection (e) assets if he held them personally.

If any shareholder is considered to own more than 20% of the stock, all corporate assets and the holdings of all other shareholders will be tainted by the one individual's imputed dealer status. This situation also exists if there were any transactions in the preceding three years that would have resulted in dealer status had the shareholder acted in his personal capacity instead of through the corporation.

The third exception permits a corporation that meets the 15% test to use the I.R.C. § 333 one-month complete liquidation not normally available to collapsible corporations.

The fourth exception permits corporations that meet the 15% test to use a § 337 twelve-month plan of liquidation as long as the assets do not end up in the hands of a 20% shareholder of someone related thereto if the property would then be eligible for an exhaustion, wear and tear, obsolescence, amortization, or depreciation deduction by either the shareholder or the corporation.

171. Net unrealized appreciation is the adjusted basis of the assets subtracted from their fair market value. Unrealized depreciation is the fair market value of the assets subtracted from their adjusted basis. The unrealized gain and loss are then netted to determine the net unrealized appreciation. I.R.C. § 341(e)(6). For a case where contracts were held to have zero appreciation, *see* Diecks v. Commissioner, 65 T.C. 117 (1975).

172. I.R.C. § 341(e)(5)(A). The term "subsection (9)(e) assets" does not include property used in the trade or business of the corporation or that would be such in the hands of any 20% shareholder. Thus it does not include I.R.C. § 1231(b) property or capital assets. One exception is that the term "subsection (e) assets" does include property used in the trade or business if there is a net unrealized depreciation involved or if there is a net unrealized appreciation and the assets would be neither capital assets nor I.R.C. § 1231(b) property in the hands of any more-than-20% (5% shareholder if I.R.C. § 333 is used) shareholder. The term "subsection (e) assets" also includes such property as copyrights; literary, musical, or artistic compositions; letters and similar property which is not subject to the exclusions just discussed if created in while or in part by the personal efforts of or specially for any 5% shareholder.

173. I.R.C. § 341(e).

174. The specific shareholder test is satisfied if the net unrealized appreciation in subsection (e) assets does not exceed fifteen percent of the corporation's net worth. *See* explanation at note 148 *supra*. Treas. Reg. § 1.341-6(a)(5) (1975).

175. Braunstein v. Commissioner, 374 U.S. 65 (1963); I.R.C. § 341(e).

176. This special provision applies only where there is a true sale of stock rather than a redemption, liquidation, or other non-liquidating distribution. I.R.C. § 341(f).

177. Any subsidiary corporation of which the parent corporation owns 5% or more by stock value must also file a consent or the parent's consent will be inadequate to afford selling shareholders the I.R.C. § 341(f) option. I.R.C. § 341(f)(6). For specific instructions on time and manner of filing the corporation's consent, *see* Rev. Rul. 69-33, 1969-1 C.B. 100.

to recognize gain[178] where it would not otherwise be recognized. The corporate gain may be capital gain or ordinary income as long as it is recognized.[179] The corporate assets subject to this provision are land, real property interests[180] and unrealized receivables or fees, whether or not they are capital assets.[181] Assets in production[182] at the time of the shareholder's sale of stock, or improvements to real property commenced within two years after the sale[183] are included. This, of course, has a far reaching significance where the accounts receivable of a professional corporation are concerned.

Once filed, the consent remains in force for six months whether or not a sale occurs.[184] The consent is irrevocable for that period and is activated automatically by a qualified sale which takes place within the six months.[185] Any shareholder[186] who makes use of this privilege is barred from using it with respect to another corporation for a period of five years.[187]

If the professional corporation desires to liquidate entirely this morass of collapsible corporation regulations can normally be circumvented. A partial liquidation, split-up, or individual termination is another matter which has been analyzed elsewhere.[188]

Accounts receivable are usually the professional corporation's major asset. They are taxed to the corporation which contracted for and performed the services which gave rise to them.[189] Any corporate windup could be timed to follow collection of the required percentage[190] of open accounts receivable and distribution of the earnings therefrom in salaries or whatever manner is customarily used by the particular professional corporation. No new accounts would be undertaken by the corporation for some time prior to liquidation.

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178. When the corporation later disposes of its subsection (f) assets, it will be barred from application of the non-recognition provisions under I.R.C. §§ 331, 336, or 337.

The temporary rules do not as yet specify the character of gain the corporation must recognize, so presumably it is determined in the usual way under I.R.C. § 1223.

179. Real property interests do not include mortgages or security interests for purposes of this section. I.R.C. § 341(f)(4)(A).

180. I.R.C. § 341(b)(4).

181. I.R.C. § 341(f)(4)(A).

182. I.R.C. § 341(f)(4)(B).

183. I.R.C. § 341(f)(4)(C).

184. I.R.C. § 341(f)(1).

185. I.R.C. § 341(f)(2).

186. A sale by any person who is related under I.R.C. § 341(e)(8)(A) is included. I.R.C. § 341(f)(1).

187. I.R.C. § 341(f)(5).

188. Lee, *Termination of Interest in the Professional Corporation*, 36 N.Y.U. INST. ON FED. TAX. 123 (1978).

189. Siegel v. United States, 464 F.2d 891 (9th Cir. 1972); Rev. Rul. 53-255, 1953-2 C.B. 10.

190. *See* note 153 *supra*.

A one month plan of liquidation [191] could be used to shorten this awkward transition period.[192] There would be some serious disadvantages to the use of that method however. The corporation's earnings and profits are taxed as ordinary income to the shareholders.[193] Any depreciation recapture or tax benefit recapture would constitute earnings and profits [194] when triggered by the liquidation.[195] Also, the liquidating corporation's earnings and profits must be computed on the accrual method [196] up to the date when all property has been distributed and the liquidation is complete. The receivables would be included in earnings and profits until then and taxed to the shareholder-professional as an ordinary income dividend.[197]

The complexities of liquidation are exacerbated where a professional corporation is concerned due to the fact that some accounts will not be billable until ongoing services are completed. It remains to be seen whether the corporation or the individual professional will be deemed to have earned this anomalous income.

CONCLUSION

By incorporating, the professional is able to take advantage of the tax benefits available to employees while the corporation is able to deduct the cost of those benefits from earnings as a business expense. The result is a shift from after-tax dollars to pre-tax dollars being used to pay for the benefits. This can provide a significant savings for the professional each year. Double taxation, that is taxation at both the corporate level and the individual level, will still leave a net advantage in most cases, but this factor must be carefully investigated before incorporation.

The real cost of incorporation is its rigid requirement, for tax purposes, of acting strictly within the corporate form, or rather the serious penalties which can result if that is not done. The only answer is careful legal and financial planning and thorough documentation. If the profes-

191. The plan must be adopted before the first distribution occurs, but the transfer need not occur in the same calendar year as the adoption of the plan. Once the plan goes into operation and distribution begins, however, it must be completed within the same calendar month. I.R.C. § 333; Treas. Reg. § 1.333-1(b)(1) (1965).

192. It is essential that the timing be carefully executed since I.R.C. § 333 is unavailable to a collapsible corporation except when the standards of I.R.C. § 341(a) are met or where I.R.C. § 341(a) does not apply because the three year waiting period of I.R.C. § 341(d)(3) has passed. Rev. Rul. 63-114, 1963-1 C.B. 74, *amplified by* Rev. Rul. 72-422, 1972-2 C.B. 211; Rev. Rul. 57-491, 1957-2 C.B. 232.

The latter exception is not available in the case of a twelve month liquidation plan under I.R.C. § 337. Leisure Time Enterprises, Inc. v. Commissioner, 56 T.C. 1180 (1971).

193. Treas. Reg. § 1.333-4(c) (1955).

194. Rev. Rul. 74-396, 1974-2 C.B. 106.

195. Investment credit recapture, on the other hand, increases the tax liability and, therefore, is not included in the corporate earnings and profits.

196. Treas. Reg. § 1.333-4(b)(1) (1955).

197. Garrow v. Commissioner, 43 T.C. 890 (1965), *aff'd*, 368 F.2d 809 (9th Cir. 1966).

sional corporation wishes to be accorded corporate status for the tax benefits that status affords, it must act at all times and in all ways like a corporation.

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