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Income Tax: Incorporated Professional Group Treated as a Corporation for Federal Tax Purposes (*Empey v. United States*, 272F.Supp. 851)

Thomas A. Harney
University of Montana School of Law

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and *Mine Workers* fall within this definition, yet they have been upheld by the Supreme Court. Since these methods of practicing law are constitutionally protected, does it follow that they are ethical? Will they help to increase public confidence in the legal profession? The Supreme Court has not specifically answered these questions in the affirmative; rather, it has said that such methods cannot be prohibited. It is clear, nevertheless, that the trend is to narrow "unauthorized" practice of law by a qualified attorney, and the canons of professional ethics must be revised to set realistic guidelines for the future scope of authorized practice.

JAMES P. MURPHY, JR.

INCOME TAXATION — INCORPORATED PROFESSIONAL GROUP TREATED AS A CORPORATION FOR FEDERAL TAX PURPOSES.—On November 1, 1965, taxpayer, an attorney, became owner of 10 per cent of the stock in the incorporated¹ law firm for which he worked. Subsequently he filed a claim for a tax refund on that portion of the 10 per cent of the corporation's net earnings for the last two months of 1965 which had not been paid to him in salary during those two months.² The United States argued that, despite a corporate charter, a Treasury Regulation defined such a corporation to be a partnership and consequently all earnings had to be taxed directly to the individual.³ The District Court held: (1) Treasury Regulations providing that professional organizations, incorporated or unincorporated, could not be taxed as a corporation unless the corporate characteristics were such that the organization more nearly resembled a corporation than a partnership were an invalid exercise of a non-delegable legislative function. (2) Even if the Treasury Regulations were valid, the professional organization more nearly resembled a corporation than a partnership. *Empey v. United States*, 272 F.Supp. 851 (D.Colo. 1967).

For the purposes of federal taxation all business organizations are classified as either partnerships⁴ or corporations.⁵ Consequently, the definitions of these terms must necessarily be broad enough to accommodate those organizations which are neither strictly a partnership nor a corporation. A partnership includes ". . . a syndicate, group, pool, joint venture, or other *unincorporated organization*."⁶ A corporation in-

¹Rule 265, Colo. R. of Civ. Proc.

²The report of the instant case does not contain a summary of facts. Such a summary may be found in 27 J. Tax. at 270.

³Treas. Reg. § 301.7701-2 (1965).

⁴INT. REV. CODE of 1945, § 7701 (a)(2).

⁵INT. REV. CODE of 1954, § 7701 (a)(3).

⁶INT. REV. CODE of 1954, *supra* note 4 (emphasis added).

cludes ". . . associations, joint stock companies, and insurance companies."⁷ These definitions have remained substantially the same for over thirty years.⁸ During this period certain policies have developed which give some aid in determining into which of these categories a business organization belongs. A corporate charter, unless it is a sham,⁹ is usually determinative in classifying an organization as a corporation.¹⁰ An association, which is classified with corporations by the Revenue Code, is an unincorporated organization with characteristics similar to a corporation. Since this is a matter of degree, some difficulty has arisen concerning the degree of similarity necessary for corporate classification. *Morrissey v. Commissioner*¹¹ established the accepted rule for determining what organizations would be classified as "associations." The court said, "the inclusion of associations with corporations implies resemblance but it is resemblance and not identity."¹² In determining whether this "Resemblance" test had been met the court listed certain common corporate characteristics: (1) an entity capable of holding legal title, (2) embarked on a corporate undertaking, (3) with centralized management, (4) continuity of existence, (5) free transferability of interests without affecting the continuity of the enterprise, and (6) limitation of personal liability to the property invested in the enterprise.¹³

After *Morrissey*, professional organizations were classified as associations if they met the "Resemblance" test. Ironically, the government was the first to argue that professional groups could be classified as "associations." In *Pelton v. Commissioner*¹⁴ the government was successful in having a group of physicians, organized as a business trust, classified as a corporation even though the Illinois Supreme Court had ruled that physicians could not incorporate.¹⁵ No essential difference was found between a professional association and a business association. Thus, the income resulting from the group's professional services could be taxed twice: first as corporate and then as personal income. With the realization that they were to be taxed as corporations, professional groups decided to use this result to their advantage. A group of Mon-

⁷INT. REV. CODE of 1954, *supra* note 5 (emphasis added).

⁸The same definition of a partnership is found in the REVENUE ACT of 1926. BARTON & BROWNING, FEDERAL INCOME AND ESTATE TAX LAWS CORRELATED AND ANNOTATED 465 (8th ed. 1930), citing REVENUE ACT of 1926 § 2(a)(2), ch. 27, 44 Stat. The corporate definition dates back at least to 1932. BARTON & BROWNING, *supra*, at 465, citing REVENUE ACT of 1932, § 1111(a)(3), ch. 209, 47 Stat. 169.

⁹*Gregory v. Helvering*, 293 U.S. 465 (1935); *Higgins v. Smith*, 308 U.S. 473 (1940).

¹⁰*Knoxville Truck Sales & Serv., Inc.*, 10 T.C. 616 (1948); *Cf. Moline Properties, Inc. v. Commissioner*, 319 U.S. 436 (1943); *Burnett v. Commonwealth Improvement*, 287 U.S. 415 (1932).

¹¹296 U.S. 344 (1935). *See also Helvering v. Combs*, 296 U.S. 365 (1935); *Swanson v. Commissioner*, 296 U.S. 362 (1935); *Helvering v. Coleman Gilbert Associates*, 296 U.S. 369 (1935).

¹²*Morrissey v. Commissioner*, *supra* note 11, at 357.

¹³*Id.* at 359.

¹⁴82 F.2d 473 (7th Cir. 1963).

¹⁵*People v. United Medical Service*, 362 Ill. 442, 200 N.E. 157 (1936).

tana physicians organized in the form of a common law association to avoid personal taxation on a pension reserve fund established for the member doctors.¹⁶ Faced with this move, the government changed its position and argued, "that because of the nature of the relationship between doctor and patient and lawyer and client they cannot by organizing or incorporating achieve the status of a corporation for federal tax purposes."¹⁷ In deciding in favor of the doctors, the court rejected the government's argument and distinguished an earlier case¹⁸ which had accepted such an argument.

Again in 1959 a group of Texas physicians succeeded in being taxed as an "association."¹⁹ The court dismissed the government's argument against such a result as a tactic to increase tax revenue and ruled that the case could be "stated and determined under elementary principles of justice."²⁰

In *Foreman v. United States*²¹ a group of Florida physicians were classified as a corporation for tax purposes although they were not allowed to incorporate in that state. The court decided that the group had all the characteristics listed in the *Morrissey* "Resemblance" test, and cited the *Pelton*, *Kintner* and *Galt* cases as precedent for not deviating from *Morrissey* even though professional associations were involved.

This series of decisions recognized two policies established by the Treasury Department through its regulations: state law was of no importance in determining whether an association sufficiently resembled a corporation;²² and doubtful organizations were classified as corporations.²³ In order to change these policies and contain the proliferation of professional associations, the Treasury Department issued new regulations in 1960²⁴ which emphasized the importance of local law²⁵ and began a trend to sweep all doubtful associations into the partnership

¹⁶*Kintner v. United States*, 216 F.2d 418 (9th Cir. 1954).

¹⁷*Instant case* at 852.

¹⁸*Mobile Bar Pilots Ass'n v. Commissioner*, 97 F.2d 695 (5th Cir 1963). The court held that an association of harbor pilots could not be taxed as a corporation for two reasons. First, pilotage was a business in which the pilot became the agent of the owner of the vessel who was responsible to third persons for the pilot's negligence. Second, the association could not be an independent contractor because it owned no property and had no income as an entity. *Supra* at 697. In distinguishing this case the court in *Kintner* said, "by contrast, the Montana doctors are employed by the Association which receives the fees for services rendered by them to patients. It owns the equipment and apparatus necessary for the practice of medicine. The hours and the working conditions of the doctors are fixed by the Association, as is also the vacation time. The compensation they receive comes *not from the patients*, but *from the salaries* paid to them by the Association and a certain percentage of the profits in accordance with the agreement. *United States v. Kintner*, *supra* note 16, at 424.

¹⁹*Galt v. United States*, 175 F. Supp. 360 (N.D. Tex. 1959).

²⁰*Id.* at 361.

²¹232 F. Supp. 134 (S.D. Fla. 1964).

²²Treas. Reg. 86, art. 801-1 (1935).

²³This tendency is summarized in *Morrissey v. Commissioner*, *supra* note 12, at 354-55. See also SCALLEN, FEDERAL INCOME (19....).

²⁴Treas. Reg. § 301.7701-1 to 11 (1960).

²⁵Treas. Reg. § 301.7701-1(c) (1960).

category.²⁶ These new regulations demanded that a majority of the unique corporate characteristics exist before an organization could be classified as an "association."²⁷ In effect, these regulations would have denied corporate classification to any organization existing in a state having the Uniform Partnership Act.²⁸ Most states reacted by passing enabling legislation permitting professional groups to incorporate.²⁹ To neutralize the effect of incorporation the Treasury Department amended the 1960 regulations in 1965.³⁰ These amended regulations deviated further from established policy by announcing that "the labels applied by local law to organizations which may now or hereafter be authorized by local law, are in and of themselves of no importance in the classification of such organization."³¹ Furthermore, the 1965 amended regulations contained a special section which defined professional associations particularly.³² These new regulations emphasized any slight difference resulting from local law, agreements, legal relationship of the members among themselves and with the public, and ethics of the professional group, and then magnified that slight difference into a rule compelling classification as a partnership.

The 1960 regulations had been neutralized by state legislation. The 1965 amended regulations were neutralized by the court in the instant case. This was accomplished in two ways. First, the court said the regulations were an invalid usurpation of the legislative function.³³ Second, the court said that even if the regulations were valid the Colorado legal organization conformed to the standards of the regulations.³⁴

The court said the regulations were invalid for two reasons. First, they disregard local incorporation. The court reasoned that the Internal Revenue Code's definition of a partnership necessarily excluded incorporated organizations. "An examination of the foregoing definition

²⁶SCALLEN, *supra* note 23 at 675.

²⁷Treas. Reg. § 301.7701-1(a) (1960).

²⁸In emphasizing local law, the 1960 regulations made it impossible for a partnership in a state having the Uniform Partnership Act to sufficiently change its nature so as to acquire continuity of life, centralization of management and limited liability. An agreement for the partnership to continue for a stated period of time which would be sufficient to vest it with continuity of life would be inoperative since the Uniform Partnership Act allows a partner to dissolve the partnership despite this agreement. *See* REVISED CODES OF MONTANA, 1947, § 63-503(2). The partnership could not centralize its management since the Act provides that "all partners have equal rights in the management and conduct of the partnership business." *See* REVISED CODES OF MONTANA, 1947, § 63-301(e). Neither could any agreement limit the partners' joint and several liability so as to acquire limited liability. *See* REVISED CODES OF MONTANA, 1947, § 63-207.

Professor Scallen believes that the Kintner regulations of 1960 dealt effectively with the problem of local law. SCALLEN, *supra* note 23, at 716.

²⁹There now appear to be 35 such states. *See* Goldberg, *What's New in Professional Corporations*. BUS. LAWYER (1967). For applicable Montana statutes see REVISED CODES OF MONTANA, 1947, §§ 15-2101 to 15-2116.

³⁰Treas. Reg. § 301.7701-1 to 301.7701-2 (1965).

³¹Treas. Reg. § 301.7701-1(c) (1965).

³²Treas. Reg. § 301.7701-2(h) (1965).

³³Instant case at 853.

³⁴Instant case at 854.

refers only to 'unincorporated organizations.' By this definition 'incorporated' organizations are necessarily excluded."³⁵ Such reasoning is in conformity with the long-accepted policy to respect the state discretion in issuing a corporate charter.³⁶ Secondly, the court said the Treasury's interpretative regulations were invalid because they did not reflect the case law which had applied the *Morrissey* "Resemblance" test to professional organizations and had classified groups similar to that in the instant case as associations. The court concluded, "there appears to be no case law to the contrary and Congress has not seen fit to take any legislative action to repudiate this uniform and long-standing judicial construction of the statute."³⁷

Although the court's holding that the regulations were invalid was based on traditional rules of statutory construction and controlling case law, its second reason for attacking the 1965 regulations was not as sound. In holding that the Colorado organization could qualify as an association under the 1965 regulations,³⁸ the court ignored these regulations in three ways. First, the court disregarded the regulations' policy to consider only unique corporate characteristics³⁹ by taking into consideration the fact that the organization had associates and was engaged in a business enterprise for profit.⁴⁰ Both of these traits "are generally common to both corporations and partnerships."⁴¹ Secondly, the court considered the organization's corporate charter as conferring some of the needed characteristics.⁴² This was done despite the mandate in the regulations that, "the labels applied by local law to organizations . . . are in and of themselves of no importance in the classification of such organizations for the purpose of taxation under the Internal Revenue Code."⁴³ Thirdly, the court ignored many of the special requirements for continuity of life,⁴⁴ centralization of management,⁴⁵ and free transferability of interests⁴⁶ under the regulations.

A strict application of the 1965 regulations would have called for another result for at least three reasons. Under the 1965 regulations a professional organization could not have continuity of life if "local law, applicable regulations or professional ethics do not permit a member of a professional service organization to share in its profits unless an employment relationship exists between him and the organiza-

³⁵*Id.*

³⁶*Supra* note 10 and accompanying text.

³⁷*Instant case* at 853.

³⁸Treas. Reg. § 301.7701-2(h) (1965).

³⁹Treas. Reg. § 301.7701-2(a) (2) (1965).

⁴⁰*Instant case* at 854.

⁴¹*Supra* note 39.

⁴²*Instant case* at 854.

⁴³Treas. Reg. § 301.7701-1(c) (1965).

⁴⁴Treas. Reg. § 301.7701-2(h) (2) (1965).

⁴⁵Treas. Reg. § 301.7701-2(h) (3) (1965).

⁴⁶Treas. Reg. § 301.7701-2(h) (5) (1965).

tion"⁴⁷ This requirement is based on the premise that the "interest of a shareholder in an ordinary business corporation includes the right to share in the profits of the corporation, and such right is not legally dependent upon his participation in the production of the corporation's income."⁴⁸ Consequently, the Treasury Department reasoned that professional corporations had to have the same divisibility between ownership of stock and participation in the production of the corporate income. However, the Colorado Rules of Civil Procedure provided that members of a legal corporation with certain exceptions had to be actively engaged in the practice of law in the office of the corporation.⁴⁹

Secondly, the group in the instant case did not have free transferability of interests as defined by the regulations. The regulations provided that

. . . if a member of a professional service organization who possesses such an interest may transfer it to a qualified person who is not a member of the organization only after having first offered his interest to the other members of the organization at its fair market value, the corporate characteristics of free transferability does not exist.⁵⁰

Since the members of the organization in the instant case could sell their interest only if the other members did not want to purchase it, this organization did not have the requisite elements of free transferability as defined by the regulations.

Thirdly, the group in the instant case did not satisfy the regulations' requirements for centralization of management. Although the organization did have a board of directors with considerable power,⁵¹ the 1965 regulations provided that a professional corporation could not have centralization of management where a member retained traditional professional responsibility.⁵² Colorado law specifically provided, "nothing in these Rules shall be deemed to diminish or change the obligation of each attorney employed by the corporation to conduct his practice in accordance with the standards of professional conduct promulgated by this court"⁵³

Limited liability seems to be the only unique corporate characteristic, as defined by the regulations, which this organization did have. The regulations provided that limited liability did not exist "if under

⁴⁷*Supra* note 43.

⁴⁸*Id.*

⁴⁹Rule 265 I(D), Colo. R. of Civ. Proc.

⁵⁰*Supra* note 45.

⁵¹*Supra* note 2. The Board of Directors had control over the kinds of cases and clients to be accepted, the assignment of individual cases and clients, the amount of the fees, the professional policies of the association, the procedure and types of records to be kept, and the compensation to be paid both professional and non-professional employees.

⁵²*Supra* note 44.

⁵³Rule 265 II(C), Colo. R. of Civ. Proc.

local law and the rules pertaining to professional practice, a mutual agency relationship . . . exists between the members of a professional service organization . . ."⁵⁴ Colorado law provides that such a relationship does not exist during a period when the professional corporation maintained professional liability insurance which the group in the instant case did.⁵⁵

The importance of the instant case lies in its first method of neutralizing the 1965 regulations — ruling them an invalid exercise of the legislative function. The difference between legislation and legitimate interpretation in many instances is one of degree, and consequently it is sometimes hard to make the distinction. But here the applicable Treasury regulations seem clearly to have passed beyond the field of interpretation.

Already the instant case has received approval from the Ohio District Court which ruled the regulations concerning professional associations invalid both on the grounds that they ignored the corporate charter of the organization and that they were not consistent with either judicial precedent or sound tax policy.⁵⁶

Before the Second World War the medical and legal professions were usually organized in small partnerships. But as the population began to flow towards the urban centers and the need for specialization grew, professional men realized the need for group practice and organized in corporate-like structures including business trusts and common law associations.⁵⁷ In *Pelton*⁵⁸ the government recognized this change in organization and taxed such groups as corporations. If these groups decided to offset the loss resulting from corporate taxation by establishing pension and profit-sharing plans and if eventually the states adapted their corporate codes to accommodate these groups, the federal government should respect these decisions.

THOMAS A. HARNEY

JOINT TORTFEASORS: CONTRIBUTION AND INDEMNITY BETWEEN CONCURRENTLY NEGLIGENT DEFENDANTS DENIED.—Plaintiff was injured in a collision between an automobile in which he was a passenger and a truck driven by defendant. Defendant sought to implead the driver of the automobile alleging he was grossly negligent and should be liable to defendant for any judgment plaintiff recovered. *Held*, defendant had

⁵⁴Treas. Reg. § 301.7701-2(h)(4)(1965).

⁵⁵Rule 265 I(G), Colo. R. of Civ. Proc.

⁵⁶*O'Neil v. United States*, 68-1 USTC (1968).

⁵⁷Ray, *The "New Look" For Professional Corporations and Associations*, 51 A.B.A.J. 882 (1965).

⁵⁸*Pelton v. Commissioner*, *supra* note 14.