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Professional Corporations: Tax Considerations of Incorporating a Law Firm

Michael J. McGoldrick

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PROFESSIONAL CORPORATIONS: TAX CONSIDERATIONS OF INCORPORATING A LAW FIRM

I. Introduction

One of the foremost questions now being asked by attorneys is whether or not they should incorporate their law practices. The purpose of this note is not to answer this question, but rather to delineate for any such attorney the advantages and the disadvantages of incorporation so that he may make an intelligent decision on his own behalf.

This note is divided into sections discussing historical development, advantages and disadvantages of professional incorporation, and potential tax problems arising from professional incorporation. The first briefly traces the legislative history and case authority from which the Internal Revenue Code's present tax treatment of incorporated law firms has been derived and discusses the legislative changes now being considered by Congress. The second section schematically sets forth the tax and nontax considerations that must be examined before an attorney can make an informed decision on whether to incorporate. The third discusses the major tax problems law firms will encounter in changing to the corporate form.

II. Historical Development

For many years a dispute existed between professionals and the Internal Revenue Service as to whether professional organizations could qualify as corporations under the federal tax laws. Although state law traditionally prohibited professionals from incorporating, doctors and lawyers contended that any professional practice organized as an unincorporated association was entitled to corporate tax treatment, since associations are treated as corporations under the Code. The Internal Revenue Service, on the other hand, maintained that any business barred by state law from operating in the corporate form could not file as a corporation for federal income tax purposes.

This dispute reached litigation for the first time in the celebrated case of United States v. Kintner. Kintner was a physician, licensed and practicing in the state of Montana. For many years prior to 1948, he had been a member of a partnership practicing medicine under the firm name of Western Montana
Clinic. In 1948 the partnership was dissolved, and the former partners executed "Articles of Association" under which they intended to run their clinical practice. These articles stated that the association was formed "for the practice of medicine and surgery as an unincorporated association," which was to be endowed with the "attributes of a corporation" and to be "treated as a corporation for the purposes of taxation." At the end of the association's first taxable year, the Internal Revenue Service rejected its attempt to file a corporate tax return, maintaining that the association was a partnership and that Dr. Kintner and the other physicians must report all of Western's income on their individual tax returns. On appeal, the court ruled that although Montana law barred the practice of medicine in corporate form, the organization possessed the corporate characteristics of associates, business purposes, continuity of life and partial limitation of liability so as to qualify as a corporation under the Morrissey "resemblance" test. In reaching its decision, the court declared that state law had no bearing on the question of whether the organization was entitled to corporate tax treatment:

[It would introduce an archaic element into federal taxation if we determined the nature of associations by State criteria rather than by special criteria sanctioned by the tax law. . . . It would destroy the uniformity so essential to a federal tax system—a uniformity which calls for equal treatment of taxpayers, no matter in what State their activities are carried on.]

Refusing to acquiesce to the court's holding in Kintner, the Service again challenged a professional organization's right to file a corporate tax return in Galt v. United States. In Galt a group of physicians operated a clinic as an unincorporated association in order to gain the federal tax advantages available to corporations. The Service refused to treat the organization as a corporation, arguing that to do so would contradict Texas law which prohibited physicians from incorporating their practices. As in Kintner, the court ruled that although Texas prohibited professional corporations, this had no effect on the association's status for federal income tax purposes; the court further stated that the only applicable criteria was whether the association met the Morrissey-Kintner "resemblance" test. Applying this test, the Galt court found that the clinic was entitled to be taxed as a corporation.

Dissatisfied with the holdings in Kintner and Galt, the Government announced that it would not follow these decisions, and in 1960 the Treasury Department issued new regulations opposing the further formation of professional associations. Although these regulations adopted the characteristics laid down in

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5 Id. at 420.
6 The "resemblance doctrine" originated in Morrissey v. Commissioner, 296 U.S. 344 (1935). In Morrissey, the Supreme Court held that in order to be treated as an "association" taxable as a corporation, a business organization must possess five characteristics: (1) Centralization of management, (2) continuity of life, (3) transferability of interest, (4) limited personal liability, and (5) legal title to property in the organization.
7 216 F.2d 424 (9th Cir. 1954).
Kintner as the federal standard for judging whether an organization should be taxed as a corporation, they further declared that state law would determine whether these characteristics existed in any particular organization.\(^10\) For any professional association operating in a state which barred professional corporations,\(^11\) the immediate effect of the 1960 regulations was to make it virtually impossible for such associations to qualify for corporate tax treatment.\(^12\)

Although these regulations ran contrary to the court holdings in Kintner and Galt, few professionals found it necessary to challenge their validity.\(^13\) Reacting to the 1960 regulations, professional organizations, such as state bar associations, induced state legislatures to enact statutes permitting professionals to form “corporations” or “associations” which qualified under the 1960 regulations as corporations.\(^14\) In response to the enactment of a number of such statutes, the Government in 1965 amended its regulations by the addition of two new sections.\(^15\) The first declared that although organizations may be organized under professional corporation statutes, these statutes “are in and of themselves of no valid...
importance in the classification of such organizations for the purpose of taxation under the Internal Revenue Code. The second stated that professional organizations would be deprived of corporate tax status unless a majority of their business and legal characteristics closely resembled those of a typical business corporation. The two new sections were followed by numerous examples which demonstrated how difficult it would be for a professional organization to meet the requirements laid down in the regulations. In short, the amendments made it impossible for a professional organization to qualify for corporate tax treatment.

The validity of the 1965 amendments was challenged for the first time in United States v. Empey. In this case the plaintiff, an attorney, was an employee-shareholder in a four-man law firm incorporated under Colorado law. In his federal tax return for 1965, the taxpayer reported not only his salary for the year but also ten per cent of the net income of the corporation, despite the fact that none of the corporation’s income had been distributed to him. Realizing that he had overstated his income for the year, he filed a timely claim for a refund of the excess tax paid by him. The Service rejected the petitioner’s claim, ruling that the corporation was a partnership for federal purposes, and therefore that the plaintiff had properly reported his income. The matter went to trial and on appeal the court of appeals sustained the district court’s ruling that the plaintiff was entitled to a refund. In reaching its decision, the court ruled that the revenue regulations of 1965 were invalid and declared that the Code required the Treasury Department to treat as a corporation any entity chartered and operated in good faith as a corporation under state law.

Despite the adverse decision in Empey, the Service continued to maintain that no professional association or corporation could qualify under the 1965 regulations as a corporation. Subsequent to Empey, the Treasury suffered 17 consecutive court defeats on this issue. The majority of these cases followed the Empey rationale: the 1965 regulations were invalid and that any professional association or corporation so labeled by state law automatically qualified as a corporation for federal tax purposes.

As a result of these defeats, the Service announced on August 8, 1969, that it was conceding the issue and that organizations complying with state professional association acts would be treated as a corporation for tax purposes. Thus it now appears that the Treasury will recognize corporate status for any professional organization chartered and operated under state professional association or corporation acts.

In 1969 a proposal was made in Congress to deny corporate tax advantages to professional corporations. The impetus for legislative action apparently arose

16 Id. § 301.7701-1(c).
17 Id. § 301.7701-2.
18 406 F.2d 157 (10th Cir. 1969).
from a front-page article in the *New York Times* which severely criticized the tax benefits available to professionals who elect to incorporate their practices.\(^{23}\) The article resulted in much debate in Congress and prompted the Senate Finance Committee to propose that HR 13270 be written into the Tax Reform Act of 1969.\(^{24}\) As written, HR 13270 would have eliminated most of the tax advantages now available to professional corporations. But on December 9, 1969, the Senate overwhelmingly voted to delete the proposal from the 1969 Tax Reform Bill which was later adopted by Congress.\(^{25}\)

Presently, there is some doubt as to whether Congress will continue to allow professionals practicing under a corporate charter to receive tax treatment more advantageous than that given to professionals practicing as sole proprietors or in partnership form. Despite its acquiescence, the Treasury Department is presently studying the effects of the tax benefits now being enjoyed by professional corporations and searching for means of closing these loopholes.\(^{26}\) Furthermore, Congressman Wilbur Mills has introduced into Congress the Tax Policy Act of 1972 [H.R. 15230].\(^{27}\) This bill, if enacted into law, will severely curtail the preferential treatment now afforded the professional corporations.\(^{28}\)

Although it is impossible to foresee what action the Congress will take, should it adopt Congressman Mills’ proposal, there would appear to be little reason for attorneys to incorporate their practice.


\(^{24}\) Id.

\(^{25}\) However, the Tax Reform Act of 1969 did adversely affect the tax treatment of corporate law firms in two ways. First, the Act reduced the tax benefits derived from employee pension and profit-sharing plans by partially eliminating capital gain treatment for lump sum distribution. *See* INTR. REV. CODE of 1954, §§ 402(a), 403(a) and 72(n). Second, the 1969 legislation terminated many of the advantages previously available to firms who elected to become Subchapter S Corporations. INTR. REV. CODE of 1954, §§ 1371-78. A Subchapter S Corporation is taxed like a partnership, but its shareholders retain the status of employees. This gave a Subchapter S Corporation a tremendous advantage over the partnership or regular corporate form of doing business. By being taxed as a partnership, the Subchapter S Corporation avoided many of the disadvantages of corporate form, e.g., double taxation, accumulated earnings tax, personal holding company tax and unreasonable compensation problems. *See*, text part IV *infra*. Although taxed like a partnership, the Subchapter S Corporation possessed the corporate attributes of limited liability and continuity of existence, and its attorneys-shareholders held the status of employees. This, prior to 1969, an attorney-shareholder, unlike a partner, was entitled to participate in corporate pension and profit-sharing plans, tax-free sick pay, group term insurance, tax-free medical expense plans, and $5,000 tax-free death benefits. *See*, text part III *infra*. The Tax Reform Act of 1969, by adding § 1379 to the Code, imposed severe limitations upon the retirement plans of such corporations. Specifically, the Act requires any attorney-shareholder of a Subchapter S Corporation to report as income any contributions made by the firm on his behalf to the extent that the contributions exceed the lesser of 10% of his compensation or $2,500.

Since the restrictions of § 1379 do not apply to regular corporations, attorneys deciding to incorporate their practices will find it to their advantage not to make a Subchapter S election. *See* Greenburg, *Special Problems of the Professional Association*, 12th TUL. TAX INST. 82, 98-99 (1971); Note, *Incorporating the Professional Practice: Federal Tax Aspects*, 38 BROOKLYN L. REV. 449, 472 (1971); J. Vassen, *supra* note 21, at § 2.32.


\(^{27}\) P-H PENSION AND PROFIT SHARING ¶ 2.16 (1972).

\(^{28}\) H.R. 15230 calls for the termination of the following tax advantages:

- (1) Capital gain treatment of lump sum distribution from pension funds;
- (2) Exclusion from gross income of sick pay;
- (3) Retirement income credit;
- (4) Qualified stock options;
- (5) $5,000 death benefit exclusion;
- (6) Exclusion from gross income of group term life insurance of employees.
III. Advantages of Incorporation

Pension and Profit-Sharing Plans. It is to the advantage of any attorney to defer until retirement the taxation of income acquired during peak earning years. The Internal Revenue Code of 1954, as amended, permits attorneys to establish retirement plans which achieve this result. For an attorney who is part or sole owner of a law practice, there are two methods of adopting a retirement plan. First, if the attorney's firm is a sole proprietorship or a partnership, he may utilize the Self-Employed Individuals Retirement Act of 1962 [hereinafter referred to as the Keogh Plan]. Second, if the law firm is organized as a professional corporation or a professional association under state law, the attorney can use §§ 401-404 of the Code [hereinafter referred to as the Corporate Plan].

Under both the Keogh and the Corporate Plans the deferral of income is accomplished by the contribution by the firm to the fund, on the attorney's behalf, a set percentage of the attorney's income. This contribution is deductible by the law firm as a business expense, and is excludable from the attorney's gross income until the benefits are actually received. Furthermore, the income generated and accumulated by the fund is exempt from taxation.

However, there are considerable differences between the Keogh and Corporate Plans. The most significant is that under the Keogh Plan only the lesser of 10 per cent of an attorney's salary or $2,500 may be placed tax free into the fund each year. Under the Corporate Plan an attorney may annually have up to $3,750 income tax free into the plan.

A single example demonstrates the dramatic savings gained by adopting a retirement plan. Assume that Attorney B is earning $50,000 taxable income from his practice. Based upon the billed earnings of his partnership, B presently earns an additional $7,500. Having earned an additional $7,500 in a $50,000 tax bracket, B would net approximately 50 per cent after taxes or $3,750. Assuming B invests this $3,750 at 5 per cent, he is going to be earning 2.5 per cent net after taxes. Thus, if B invests the additional $3,750 for each of 25 years, he will build up a retirement fund of approximately $130,000 after taxes.

If, however, B were to set up a qualified retirement plan in accordance with §§ 401-404 of the Code, and if he contributed the same $7,500 per year into the plan, the following would result. The firm's income would remain unchanged since the firm is allowed a deduction for its contribution to the plan just as if the firm paid B an additional salary of $7,500. Assuming that the $7,500 is invested at the same 5 per cent rate, the fund, because it pays no income taxes, would accumulate at 5 per cent a year instead of the 2.5 per cent rate. At the end of 25 years, more than $375,000 will accumulate in B's retirement fund. Upon retirement, B could withdraw the $375,000 in a lump sum or on an installment basis. If he elects to withdraw the $375,000 in one payment, the portion of the amount paid attributable to the corporation's contribution is taxed at ordinary income rates and the portion of the lump sum due to appreciation is taxed at capital gain rates. Computed out, the amount of income B would receive after taxes will be $234,000, that is almost double the $130,000 that he would have under his personal retirement scheme. If B chooses to withdraw the $375,000 on an installment basis, his net income is likely to be even greater than under the lump sum method.

Pub. L. 87-792, 87th Cong., 2d Sess., 76 Stat. 809 (1962). The Keogh Plan is an attempt to give self-employed persons access to retirement plans on a reasonably similar basis to that accorded corporate stockholders-employees. The basic Code sections involved in the qualification and operation of the Keogh Plan are §§ 401-404 of the Code.
15 per cent of his salary invested in a profit-sharing plan, or up to 25 per cent of his salary in a combined profit-sharing pension trust plan. There is also a difference in the way the attorney-beneficiary is taxed upon receipt of the proceeds of the fund. Under the Keogh Plan the proceeds, regardless of whether received in one payment or in installments, are taxed at ordinary income rates. But in the Corporate Plan, if the money is withdrawn in one lump sum that portion of the proceeds due to appreciation of the fund is treated as a capital gain.

To demonstrate how these differences may affect the practicing attorney, compare the results achieved in the following hypothetical. Lawyer A is married, 35 years of age, and a partner in a law firm having a Keogh Plan. His gross annual income is $50,000 and after the maximum $2,500 Keogh investment, he has a net income of $47,500. He requires approximately $32,035 for yearly living expenses and he invests the remainder of his income. Attorney B is in a similar economic position as A except that B’s partnership recently incorporated and inaugurated a corporate profit-sharing plan. As a result of this change, B receives only $43,500 in net income but a $6,500 [15%] contribution to his profit-sharing fund is made.

Result:

<table>
<thead>
<tr>
<th>Partnership</th>
<th>Form</th>
<th>Corporate</th>
</tr>
</thead>
<tbody>
<tr>
<td>$50,000 Gross Annual Income</td>
<td>$50,000</td>
<td></td>
</tr>
<tr>
<td>2,500 Keogh Investment</td>
<td></td>
<td>6,500 Profit-Sharing Contribution</td>
</tr>
<tr>
<td>47,500 Net Income</td>
<td>43,500</td>
<td></td>
</tr>
<tr>
<td>5,000 Deductions</td>
<td>5,000</td>
<td></td>
</tr>
<tr>
<td>42,500 Taxable Income</td>
<td>38,500</td>
<td></td>
</tr>
<tr>
<td>13,340 Tax (without surcharge)</td>
<td>11,465</td>
<td></td>
</tr>
<tr>
<td>34,160 After-Tax Income</td>
<td>32,035</td>
<td></td>
</tr>
<tr>
<td>32,035 Living Expenses</td>
<td>32,035</td>
<td></td>
</tr>
<tr>
<td>2,125 Available for Personal Investment</td>
<td></td>
<td>0</td>
</tr>
</tbody>
</table>

After the first year, B has a $1,875 [$6,500 v. $4,625] total investment edge over A. After thirty years, assuming that both A and B retire at 65 and receive their retirement proceeds in one lump sum, the difference is more pronounced:

<table>
<thead>
<tr>
<th>Individual</th>
<th>Form</th>
<th>Corporate</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 4,625 Yearly Investment</td>
<td>$ 6,500</td>
<td></td>
</tr>
<tr>
<td>109,698 30-Year Net Investment of Personal Savings at 6%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>197,645 30-Year Net at 6% Under the Keogh Plan</td>
<td></td>
<td></td>
</tr>
<tr>
<td>307,343 Total Amount Distributed</td>
<td>513,878</td>
<td></td>
</tr>
<tr>
<td>54,826 Tax on Keogh Distribution</td>
<td></td>
<td></td>
</tr>
<tr>
<td>252,517 Net Distribution</td>
<td>379,740</td>
<td></td>
</tr>
</tbody>
</table>

36 Id. § 404(a) (3) (A).
37 Id. § 404(a) (7).
38 Id. §§ 402(a) (1).
39 Id. §§ 402(a), 403(a).
As shown in the table, after thirty years B's savings will exceed A's by $127,223. Should the attorneys' incomes increase with age, the difference between the Keogh and Corporate yields will be even greater.40

There are other advantages which the Corporate Plan has over the Keogh Plan. In the Keogh Plan no retirement benefits may be paid until the attorney is at least 59.5 years old and not later than when he reaches the age of 70.5 years;41 whereas, under the Corporate Plan benefits may be paid upon retirement, death, or disability.42 The Keogh rules are also more restrictive as to the management of the monies in the plan. Keogh limits the investing of the funds to three media: (1) bank trusts, (2) selected contracts from insurance companies, (3) special United States retirement bonds.43 The Corporate Plan allows investment in any reasonably secure investment.44 In addition, the attorney-beneficiaries may act as trustees of a fund under a Corporate Plan, but not in the Keogh Plan.45 Thus, only the former allows attorneys to avoid the cost of retaining an outside trustee. Also, an incorporated law firm offering reasonable security, may borrow from the corporate retirement fund;46 neither a proprietorship nor a partnership may borrow from a Keogh fund.47

In order to qualify under the Keogh rules, a partnership must provide retirement benefits for all full-time employees who have three years of service with the firm.48 The Corporate plans permit greater discretion in excluding employees. The Code provides that either 70 per cent of all employees must be covered or 70 per cent of all employees must be eligible and 80 per cent of those eligible covered.49 In computing these percentages, neither part-time employees nor employees with less than five years' service need be counted.50 The significance of this advantage is that low income employees, e.g., messengers and secretaries, may be given the option of not participating in the plan.

There is also a difference in the manner in which the proceeds from the deferred compensation plan will be treated if an employee dies before retirement.

40 With an increase in income, the attorney will have more money available for investment in the retirement plan.
41 INT. REV. CODE of 1954, §§ 401(d) (4) (B), 401(a) (9) (A).
45 INT. REV. CODE of 1954, § 401(d).
46 Id. § 503(f).
47 Id. § 503(g).
48 Id. § 401(d) (3).
49 Id. § 401(a) (3) (A).
50 Id.
51 Formerly, an issue existed as to whether the adoption of retirement plans would violate the ABA's Canon of Ethics. To qualify the retirement plan, law firms normally must include nonprofessional employees in the plan. But § 24 of the Canon of Ethics prohibits a lawyer from dividing his fees with anyone except another lawyer. There had been some indication that the ABA ethics committee would prohibit lawyers in a professional corporation from having a profit-sharing plan which includes nonlawyers and beneficiaries, as would be required in order for the plan to qualify for favorable income tax treatment. The ABA has modified its position. Disciplinary Rule 3-102 of the New ABA Code of Professional Responsibility, which became effective in January of this year, specifically provides that "A lawyer or law firm may include nonlawyer employees in a retirement plan, even though the plan is based in full or in part on a profit sharing arrangement."
Under the Keogh rules the proceeds from the fund are included in the deceased attorney's gross estate for tax purposes. The Corporate Plan, however, allows the proceeds from the fund to flow directly to the family free of any federal gift or estate tax.

Finally, Keogh plans require that all contributions to the fund vest immediately in the employees, but the Corporate Plan allows vesting to be postponed for a reasonable waiting period and then vesting may proceed on an annual basis, e.g., 10 per cent or 20 per cent a year. By suspending full vesting of the employees' rights for a number of years, the law firm offers its employees an additional incentive for remaining with the firm.

Automobile Expense Benefit. An incorporated law firm may give an attorney up to fifteen cents per mile as a tax-free reimbursement for the business use of his own car, and the firm can deduct this payment as a business expense. In contrast, a partner or self-employed attorney can deduct a maximum of ten cents per mile for the first 15,000 miles and only seven cents thereafter as an automobile business expense. By utilizing the maximum allowable corporate reimbursement, an attorney who travels a great deal may gain some tax-free income. For example, assume that Attorneys A and B each drove 80,000 miles during the business year. A is practicing under a sole proprietorship; B also practices alone but has incorporated. Both attorneys gross $100,000 and their only business deduction is their automobile expenses. Personal deductions aside, A will have a taxable income of $94,460, and an automobile expense deduction of $5,640. B will have a taxable income of $88,000 and an automobile expense deduction of $12,000. Since both A and B are in the 50% tax bracket, their take-home earnings will be $52,870 ($47,230 and $5,640) and $56,000 ($44,000 and $12,000), respectively. By merely practicing under a corporate form, Attorney B has gained $3,130 ($56,000 v. $52,870) in take-home income.

Health, Accident and Other Miscellaneous Benefits Only Available to Common Law Employees. The Code provides a number of tax benefits only to employees, but nowhere in the Code is the term "employee" defined. In the absence of any statutory definition, the courts and the Treasury have given the term its common law meaning. In short, any attorney working for a corporate law firm is considered an employee, but only nonowners of a partnership or proprietorship are considered employees.

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52 INT. REV. CODE of 1954, § 2039(c).
53 Id. § 2039(c)(1).
54 Id. § 401(d)(2).
55 Id. §§ 401(a)(7)-(8).
57 INT. REV. CODE of 1954, § 162(a)(2).
59 See text accompanying notes 64-76 infra.
62 BALLentine's LAW DICTIONARY 399 (3rd ed. 1969) defines employee as "one who is in such a relation to another person that the latter may control the work of the former and direct the manner in which it shall be done."
63 Although § 401(c) of the Code extends the meaning of the term "employee" to include
Because they are considered employees, corporate attorneys have a number of advantages over partners or sole proprietors. Under the Code, an incorporated law firm may provide each of its attorneys with up to $50,000 in life insurance coverage without the premiums being included in the attorneys’ gross income.\(^6\) Moreover, amounts paid for these premiums are deductible by the law firm as an ordinary and necessary business expense.\(^6\) The Code further provides that if a corporate law firm distributes money to a beneficiary of an attorney by reason of the latter’s death, the beneficiary receives up to $5,000 free of income and estate taxation.\(^6\) This death payment is also deductible by the law firm.\(^6\)

Tax-free medical expense plans are another important advantage only available to corporate firms and their attorneys. The Code states that a corporation may provide tax-free medical expense insurance for one or more of its attorneys.\(^6\) These distributions are deductible by the law firm\(^6\) and not taxable to the attorneys.\(^7\) Moreover, benefits paid to the attorneys to cover medical expenses are generally excludable from the attorneys’ gross income.\(^7\) In contrast, partners or sole proprietors must provide their own medical insurance.\(^7\) Furthermore, for income tax purposes partners or sole proprietors can deduct only that portion of their medical bills which exceeds 3 per cent of adjusted-gross income plus $150 for health insurance premiums.\(^7\)

Finally, in an unincorporated law firm, partners or sole proprietors are not paid a salary, but rather, they are given a portion of the firm’s net income. Should a partner or sole proprietor become ill or injured, his firm may continue to give him a portion of its net income, but any such payments are included in the attorney’s taxable income.\(^7\) However, under the corporate form, a firm may pay any sick or disabled attorney up to $100 per week which is tax free to the attorney\(^7\) and deductible by the law firm.\(^7\)

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65 INT. REV. CODE of 1954, § 162(a); Rev. Rul. 56-400, 1956-2 CUM. BULL. 116. The deduction to the corporation is disallowed, however, if the corporation is a beneficiary under the life insurance policies. INT. REV. CODE of 1954, § 264(a)(1).

66 INT. REV. CODE of 1954, § 101(b).

67 Id. § 162(a).

68 Id. §§ 105, 106. See generally Pyle, Accident and Sickness Insurances Under Code Sections 104, 105, 106 and 213, 34 TAXES 363 (1956); Harl, Selected Aspects of Employee Status in Small Corporations, 13 KANS. L. REV. 23 (1964). Section 105 was added as a new section in the 1954 Code for the purpose of providing uniform tax treatment to amounts received under employer accident or health plans whether or not the funds are funded by insurance. H.R. REP. No. 1337, 83rd Cong., 2d Sess. 15 (1954).

69 INT. REV. CODE of 1954, § 162(a).

70 Id. 106.

71 Id. 105(a)-(e).

72 Id. §§ 105(g).

73 Id. §§ 213(a)(1)-(2).

74 Id. §§ 105(g), 61(13).

75 Id. § 105(d). If payments received exceed 75 per cent of the employee’s weekly wage rate, there is a 30-day waiting period before the exclusion becomes effective. If the payments received are 75 per cent or less of the employee’s weekly wage rate, the waiting period is seven days, and the exclusion is limited to $75 per week. The seven-day waiting period is eliminated if the employee is hospitalized at least one day during the seven-day period; in addition, after 30 days the exclusion limit is raised from $75 to $100 per week. Id.

76 INT. REV. CODE of 1954, § 162(a).
Favorable Corporate Tax Rates. For federal tax purposes, a corporation’s income is taxed at the rate of 22 per cent for the first $25,000 and at 48 per cent on income in excess of that amount. Furthermore, the Code provides that 85 per cent of the dividends received by an incorporated law firm from its investments in other corporations are excludable from taxable income. Of course, a second tax is imposed on all corporate income, but only when it is distributed to its shareholders. Despite this “double taxation,” in situations in which an attorney is in a high individual tax bracket, it is his advantage to incorporate his firm and to structure his finances so that the corporation earns and retains up to $25,000 in income per year. By so acting, the attorney is able to shelter the retained amount in the corporation each year at the lower corporate tax rate of 22 per cent, thereby providing additional monies which may be invested in other corporations.

A single example demonstrates the savings offered to an attorney who utilizes the corporate tax rates. Assume that A is self-employed, earns $50,000 annually, hopes to retire in 30 years, and operates his practice as a sole proprietorship. B is also practicing alone, earns $50,000 a year, hopes to retire in 30 years, but he has recently incorporated his business. In 1972, both A’s and B’s practices earn an additional $10,000 and both attorneys plan to invest this extra income in stocks which return 6 per cent annually. A, having earned this additional sum while in a 50 per cent tax bracket, will net approximately $5,000 after federal taxes. Investing $5,000 at 6 per cent, A will gross $300 in interest, but net only $150 after taxes. In contrast, B’s corporation, assuming it pays B a $50,000 salary, will have a gross income of $10,000. Having earned $10,000 at a 22 per cent tax bracket, the corporation will net approximately $7,800. Retaining this amount and investing it at 6 per cent, the corporate firm will gross $464 in interest and net approximately $450.

<table>
<thead>
<tr>
<th>Sole Proprietorship</th>
<th>Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td>$10,000 Additional Earnings</td>
<td>$10,000</td>
</tr>
<tr>
<td>5,000 Tax (without surcharge)</td>
<td>2,200</td>
</tr>
<tr>
<td>5,000 Net Additional Income Available for Investment</td>
<td>7,800</td>
</tr>
<tr>
<td>300 Annual Return on an Investment Paying 6%</td>
<td>465</td>
</tr>
<tr>
<td>150 Annual Net Return on Investment</td>
<td>450</td>
</tr>
<tr>
<td>5,150 Total Net Income Derived from Earning an Additional $10,000</td>
<td>8,250</td>
</tr>
</tbody>
</table>

77 Id. § 11(b). Code § 51 currently adds a 5 per cent surcharge.  
78 Id. § 243.  
79 Id. § 61(7).  
80 See id. § 243.
Assuming that A's and B's situations remain the same for the next 30 years, that there is no accumulated earnings problem, and that upon B's retirement he will withdraw all the corporation's retained earnings in one lump sum, the situation will be as follows:

<table>
<thead>
<tr>
<th>Sole Corporate Proprietor</th>
<th>Corporate Attorney</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 5,150</td>
<td>Total Net Income Derived From Earning $ 8,250</td>
</tr>
<tr>
<td>An Additional $10,000</td>
<td></td>
</tr>
<tr>
<td>175,104</td>
<td>Total Net Income for Thirty Years Derived from Earning an Additional $10,000 Per Year and Investing It at 6%</td>
</tr>
<tr>
<td>621,717</td>
<td>175,104</td>
</tr>
<tr>
<td>Tax (capital gains treatment) 217,401</td>
<td>Net Savings 404,316</td>
</tr>
</tbody>
</table>

**Nontax Advantages Derived from Incorporating.** The most attractive nontax advantage that an incorporated firm has over a partnership is "limited liability." In all states, a partner in a law firm is fully liable for all tortious and contractual liabilities resulting from his own conduct, and that of his partners, associates, and other employees during the course of their employment. However, in the majority of states in which professional corporation acts have been adopted an attorney is personally liable only for his own wrongful acts and the wrongful acts of those under his control. Thus, by operating as a corporation, the practitioner may decrease the scope of his liability.

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Another attractive feature of corporations is the characteristic of “continuity of existence.” In a partnership the admission or withdrawal of a partner technically terminates the partnership. In most cases, the firm will own tangible assets and accounts receivable necessitating costly accounting expenses and difficult appraisal problems in dividing the assets and in evaluating the liabilities of the firm on such termination. In a corporation, however, the life of the firm does not terminate with the admission or withdrawal of an attorney. In addition, since each attorney’s equity in the firm is in the form of shares of stock and since each normally will have a prearranged buy-sell agreement with the corporation, the above-mentioned accounting and evaluation problems are avoided.

IV. Disadvantages of Incorporation

**Double Taxation.** A partnership is a nontaxable business entity. For purposes of federal taxation any partnership profits or losses are allocated to the partner-attorneys who must include them in their individual returns. Such profits and losses are taxed to the partners at ordinary income rates. On the other hand, the corporation is a taxable entity and must pay federal taxes on its net income. Again, when a corporation’s income is distributed as dividends to the shareholders it is taxable to them as personal income. The undesirable effect this second tax can have on an attorney’s spendable income is illustrated in the accompanying table. Assuming that the corporation is entirely owned by one attorney and that its net after tax income is distributed to him in full, the following table compares the income of a sole proprietor and a sole shareholder of a corporation at different levels.

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**NOTES**

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83 *Rosen, Professional Corporations—Advantages and Disadvantages, 6 Land & Water L. Rev. 685, 703 (1970).*

84 *Note, Professional Associations and Corporations: Tax Considerations, 11 Wm. & Mary L. Rev. 685, 703 (1970).*


86 *Id. § 702.*

87 *Id.*

88 *Id. § 11.*

89 *Id. § 61(a).*

PROPRIETORSHIP VS. CORPORATION

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Sole Proprietor's Tax Liability</th>
<th>Sole Proprietor's Net Income</th>
<th>Corporation's Tax Liability</th>
<th>Dividends Distributed**</th>
<th>Shareholder's Tax Liability***</th>
<th>Shareholder's Net Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 25,000</td>
<td>$ 6,000</td>
<td>$ 19,000</td>
<td>$ 5,500</td>
<td>$ 19,500</td>
<td>$ 4,250</td>
<td>$ 15,250</td>
</tr>
<tr>
<td>50,000</td>
<td>17,000</td>
<td>33,000</td>
<td>17,500</td>
<td>32,500</td>
<td>8,875</td>
<td>23,625</td>
</tr>
<tr>
<td>100,000</td>
<td>45,200</td>
<td>54,800</td>
<td>41,500</td>
<td>58,500</td>
<td>21,500</td>
<td>37,000</td>
</tr>
<tr>
<td>250,000</td>
<td>146,000</td>
<td>104,000</td>
<td>113,500</td>
<td>136,500</td>
<td>68,000</td>
<td>68,500</td>
</tr>
<tr>
<td>500,000</td>
<td>321,000</td>
<td>179,000</td>
<td>233,500</td>
<td>266,500</td>
<td>157,500</td>
<td>109,000</td>
</tr>
<tr>
<td>1,000,000</td>
<td>471,000</td>
<td>329,000</td>
<td>473,500</td>
<td>526,500</td>
<td>339,500</td>
<td>187,000</td>
</tr>
</tbody>
</table>

*Income less individual tax liability.
**Income less corporate tax liability.
***Ignoring the $100 dividend exclusion of § 116.

Liquidating the Interest of a Retiring Partner. One of the most significant disadvantages of incorporation is the additional taxes incurred when disposing of an attorney-shareholder's interest in the firm. The Code provides a tax option to a retiring partner and his partnership as to how the disposal of his interest in the firm will be treated. First, the parties may elect to handle the partnership's acquisition of the retiring partner's interest as a purchase of goodwill provided that the appropriate provisions are made therefore in the partnership agreement. In this case the Code does not allow the remaining partners to deduct this payment as a business expense, but it does allow the retiring attorney to consider the distribution as a capital gain. Second, the parties may treat this distribution to the retiring attorney as a payment with respect to future income. If the parties decide on this alternative, the payment reduces the taxable income of the remaining partners, but it is ordinary income to the retiring partner. On the other hand, in redeeming an attorney's interest in an incorporated firm, any payment to the attorney-shareholder is taxed as a capital gain, but the outflow of money is not deductible by the firm. The advantageous options available to partners are simply not open to attorneys of a corporate law firm. This disadvantage can be clearly seen in the following example. Assume that both attorneys A and B are retiring from their law firms. Also assume that both attorneys work for similar law firms except that A's law firm is a five-man partnership and B's law firm is a corporation with five shareholders. The income for 1972 is $250,000 for both the partnership and the corporation. The partnership

91 However, by taking out large but reasonable attorney salaries, making maximum contributions to its Corporate Plan, and fully deducting expenses a corporate law firm can avoid or minimize the additional taxes resulting from incorporation.
92 INT. REV. CODE of 1954, § 736.
93 Id. § 736(b).
94 Id.
95 Id. § 736(a).
96 Id. § 702.
97 Id. § 302.
decides to give $A$ $50,000 as payment for his interest in the firm. The corporation gives $B$ $50,000 as a redemption payment for all of his stock. Under § 736(a) of the Code the partnership and $A$ could treat the $50,000 as a purchase of goodwill or as a payment in respect to future income of the firm. If the partnership makes the goodwill purchase, $A$ may treat the $50,000 as a capital gain and the remaining four partners will be taxed proportionately on the full $250,000 income. However, if the partnership and $A$ choose the latter course, $A$ will report the $50,000 as ordinary income and the remaining four partners will be taxed on $200,000. $B$, however, must treat the $50,000 as a capital gain and the corporation is not allowed to deduct it as an expense. Thus, assuming that the four remaining attorneys each take $50,000 in salaries, the corporation's earnings for 1972 will be $50,000 (which presumably will also be distributed as dividends to the remaining attorneys).  

<table>
<thead>
<tr>
<th>PARTNERSHIP CORPORATION</th>
</tr>
</thead>
<tbody>
<tr>
<td>CAPITAL GAINS TREATMENT</td>
</tr>
<tr>
<td>--------------------------</td>
</tr>
<tr>
<td>Corporate Net Income Before Payment of Attorney Salaries</td>
</tr>
<tr>
<td>Partnership's Net Income</td>
</tr>
<tr>
<td>Retiring Attorney's Taxable Income</td>
</tr>
<tr>
<td>Amount of Tax Paid by Retiring Lawyer</td>
</tr>
<tr>
<td>Amount of Tax Paid by Remaining Attorneys</td>
</tr>
<tr>
<td>Corporate Taxable Income</td>
</tr>
<tr>
<td>Tax Paid by the Corporation**</td>
</tr>
<tr>
<td>Total Amount of Taxable Income</td>
</tr>
<tr>
<td>Total Tax Paid</td>
</tr>
</tbody>
</table>

*In computing an individual's tax liability on a long-term capital gain, one half of the gain is added to his ordinary income and is then taxed as ordinary income.

**The corporate tax rate of 48 per cent.

98 The difference will be even greater if the corporate law firm is deemed to be a collapsible corporation. See Int. Rev. Code of 1954, §§ 341(b)(1), (b)(3), (b)(4)(B). Gain from the sale, exchange or redemption of an interest in a collapsible corporation is taxed as
State Property and Capital Stock Taxes. Unlike a partnership, in many states corporations are subject to state property and capital stock taxes. For example, Pennsylvania imposes a property tax of 12 per cent on corporate net earnings and capital stock tax of 7 mills per dollar on the actual value of the equity in the corporation. Thus, in that state, an incorporated law firm with net assets valued at $100,000 and average earnings of $15,000 per year must pay a combined property and capital stock tax of $2,500. This is a substantial expense which a partnership avoids. However, writers in the area do not feel that state taxes are significant:

For most professional associations, the bulk of the earnings will be exhausted through salaries, leaving little as net taxable earnings. The corporate tax is applied only to the latter, since the former is deductible. Furthermore, the Capital Stock Tax should not be a significant consideration, since the capitalization of most associations will be small. The professional association does not require a large capitalization because there is little need for expensive buildings or equipment.

V. Possible Tax Problems Derived from Incorporation

Bunching of Income. Section 706(a) of the Code provides that each partner must include on his individual tax return any income earned by the partnership during its tax year ending within his own tax year. Section 706(b) provides that a partnership may not change its tax year to one different from that used by its members. However, prior to 1954 many firms adopted a fiscal tax year, while their partners utilized a calendar year. By so doing, partners were thus able to defer taxation of a portion of their incomes. For example, assume a partnership has a fiscal year ending March 31 and that its partners are on a calendar year. On December 31, 1972, the partner must include in income all monies earned by the partnership through March 31, 1972. Income earned by the partnership after that date will not be included in the partner’s income until the end of the succeeding tax year, December 31, 1973. In other words, each partner delays including in his gross income until December 31, 1973, the income of the partnership earned from April 1 through December 31, 1972. As long as the partnership continues, this annual lag will exist. However, if the partnership is ordinary income rather than as a capital gain. An incorporated law firm is open to attack as a collapsible corporation because normally its main assets are “unrealized receivables or fees.” Although there are no cases in which the Service has attempted to give such exchanges § 341 treatment, the Service has hinted that it might do so in the future. See Thies, An Estate Planner’s Approach to the Professional Corporation, 109 Trusts & Estates 83, 290 (1970). If the Service does take this position and is successful, the retiring shareholder-employee in our example would be taxed $17,060 rather than $7,190, and the other shareholders and the corporation will continue to pay the same amount of taxes.

103 Id. § 706(b).
104 Section 706(b) restricts the change to a different tax year, but does not require partnerships that are already on a fiscal year to adjust.
dissolved and a corporate law firm is initiated, a partner must include in income for the year the partnership is dissolved all earned income of the partnership not previously reported on the partner’s tax returns.\textsuperscript{105} In other words, if the partnership were to dissolve and become an incorporated law firm on May 1, 1972, each former partner, now employee, would, on December 31, 1972, include in his gross income his portion of partnership income from April 1, 1971, through April 30, 1972, plus all salaries paid to him by the corporation from May 1 until December 31, 1972.\textsuperscript{106} Taxed at peak earning year rates, this results in a considerable burden, and not all partners have sufficient liquid assets to cover such a tax. For this reason many tax experts have doubts about the practicalities of incorporating a firm that has previously elected a fiscal year.\textsuperscript{107}

\textbf{Unreasonable Compensation.} In order to generate sufficient monies for their retirement plans, and in an effort to prevent double taxation of corporate earnings, attorneys may attempt to set their salaries at such a level as to absorb most of the firm’s earnings. However, § 162(a) of the Code provides that a corporation is only entitled to deduct “a reasonable allowance for salaries or other compensation for personal services actually rendered.”\textsuperscript{108} If no services are rendered, or if the services are rendered but the compensation paid is excessive, such payment is not deductible by the firm as a business expense, and the purported salary is treated as a constructive dividend to the shareholder-attorney.\textsuperscript{109} It is therefore imperative that incorporating attorneys structure their practice so that their salaries are reasonable compensation for services actually rendered.

Since corporate law firms are relatively new, there are very few precedents which will guide a firm in its efforts to set high but reasonable salaries for its shareholders-attorneys. Although the Code is silent on this matter, most writers in this field anticipate that if a lawyer earned $70,000 annually from his former practice, he may safely withdraw the same amount from the corporation in the form of a yearly salary.\textsuperscript{110} However, a strong minority of tax experts have severely criticized this position.\textsuperscript{111} One writer succinctly expressed the minority view as follows:

It is seductive, but possibly simplistic, to conclude that just because a former partner who is now an employee-shareholder had in a comparable prior year a $100,000 partnership share of earnings, that he can safely be paid a “salary” of $100,000 by his new corporation. One might say: “Well, he can go elsewhere and earn $100,000; accordingly, the corporation in an adversary economic situation would have to pay him $100,000 to hold him.” What is ignored is that in the partnership situation his $100,000 was not

\textsuperscript{105} See INT. REV. CODE of 1954, §§ 701, 702.
\textsuperscript{106} Example adapted from Note, Advantages and Disadvantages of Forming a Professional Association in Pennsylvania, 43 Temp. L.Q. 152, 162 (1970).
\textsuperscript{107} See, e.g., Thies, An Estate Planner’s Approach to the Professional Corporation, 109 TRUSTS & ESTATES 83, 256 (1970).
\textsuperscript{108} INT. REV. CODE of 1954, § 162(a).
\textsuperscript{111} See Alexander, Some Tax Problems of a Professional Association, 13 W. RES. L. REV. 212, 215-18 (1962); Thies, supra note 107, at 256.
alone recompense for his personal services. It included a return on his investment in the partnership. To attempt to justify a $100,000 salary today because of a $100,000 partnership share last year is to compare lemons with grapefruits.112

Once a corporate law firm has decided upon a reasonable salary, it must still satisfy the second requirement, i.e., the compensation must represent payment for actual services rendered, rather than a distribution of corporate earnings and profits.113 For the typical attorney this will not be a problem since all of his income can generally be attributed to services personally rendered. However, in the larger firms, where senior partners often devote a great deal of time to public projects but still receive full salary—a salary that far exceeds their financial contribution to the firm as measured by billable hours—this second requirement may prove to be very vexatious.114 In such circumstances, the Service may rule that the attorney's compensation was not a salary for services actually rendered but a dividend distributed from the firm's profits. As a practical matter, the corporation must analyze the contributions made by senior partners, including goodwill, business brought in and administrative duties, and adjust their salaries accordingly.

Accumulated Earnings Tax. As previously discussed, it is to the advantage of any attorney in a high individual tax bracket to incorporate his law firm and to structure his practice so that the corporation earns and retains up to $25,000 in income per year.115 However, should an attorney elect to do so, he must exercise care in order to avoid the special penalty taxes contained in §§ 531-537 of the Code.116 These sections impose a tax of 27½-38½ per cent on any accumulated earnings of a corporation in excess of $100,000, unless such additional earnings are retained for the purpose of meeting the reasonable business needs of the firm.117 Although the Code does not spell out what constitutes "reasonable business needs," the Treasury Department has issued specific guidelines to assist attorneys in making this determination.118 Treasury Regulation § 1.5732-2(b)119 indicates that firms may accumulate corporate earnings and profits in order to finance the purchase of equipment,120 to acquire additional office space,121 to

112 Thies, supra note 107, at 256.
114 See Klamath Medical Serv. Bureau v. Commissioner, 261 F.2d 842 (9th Cir. 1958), aff'g 29 T.C. 339 (1957). In Klamath a group of Oregon physicians organized a private corporation that provided medical services and hospital facilities to the public. The physicians, although only supplying the medical services, structured their salaries on the basis of the entire corporate income, including income generated from the hospital facilities. The total amount paid to them exceeded their personal billings for medical services. The court held that the compensation received by the physicians was reasonable only up to 100 per cent of their billings and disallowed corporate deductions for compensation above that amount, finding such deductions to be a distribution of corporate profits.
115 See text accompanying notes 77-80 supra.
117 Id. § 532(a). The tax is imposed at the rate of 27½ per cent for the first $100,000 of accumulated earnings and at the rate of 38½ per cent on any excess over that amount, Id. § 531. In computing the tax, however, corporations receive a $100,000 credit before incurring the penalty tax. Id. § 535(c).
119 Id. § 1.537-2(b). See also Treas. Reg. § 1.537 (a) (1970).
120 Id. § 1.537(b) (1) (1970).
121 Id.
expand its working capital,\textsuperscript{122} or to pay off its indebtedness.\textsuperscript{123} Furthermore, judicial decisions suggest that other purposes may justify the retention of corporate earnings, \textit{e.g.}, the need to fund pension and profit-sharing plans for employees,\textsuperscript{124} the obligation of providing for the redemption of deceased or disqualified shareholders' stock,\textsuperscript{125} and the necessity of protecting against various business risks and contingencies such as self-insurance against casualties and malpractice suits.\textsuperscript{126}

In light of the guidelines discussed above, a corporate law firm should be able to justify a substantial retention of earnings.\textsuperscript{127} However, if excess earnings begin to accumulate beyond reasonable limits, the funds should be utilized for increased contributions to the employees' retirement fund or distributed as dividends to the attorneys-shareholders.

\textit{Personal Holding Company Tax}. In addition to the regular corporate income tax, an incorporated law firm is susceptible to being taxed as a personal holding company.\textsuperscript{128} Under § 541 of the Code a special penalty tax, at the rate of 70 per cent, is imposed on the "undistributed personal holding company income" of any personal holding company.\textsuperscript{129} For definitional purposes, a personal holding company is any incorporated law firm in which more than 50 per cent of its outstanding stock is owned directly or indirectly by not more than five attorneys and in which at least 60 per cent of the firm's adjusted ordinary gross income for the taxable year is "personal holding company income."\textsuperscript{130}

In the context of an incorporated law firm, personal holding company income refers to the fees generated by an attorney-shareholder who has at least 25 per cent interest in the firm and who has performed services under a contract wherein a person other than the law firm had the right to designate the attorney who was to perform the services.\textsuperscript{131}

Four elements must be present before the personal holding company tax will be imposed on a firm's retained earnings.

\begin{enumerate}
\item at least 60 per cent of the firm's adjusted gross ordinary income is derived from personal services.\textsuperscript{132}
\end{enumerate}

As can readily be seen, an incorporated law firm renders legal services from which

\begin{itemize}
\item \textsuperscript{122} \textit{Id.} § 1.537-2(b) (4) (1970).
\item \textsuperscript{123} \textit{Id.} § 1.537-2(b) (3) (1970).
\item \textsuperscript{124} \textit{See} Bremerton Sun Publishing Co., 44 T.C. 566 (1965).
\item \textsuperscript{125} \textit{See} Oman Constr. Co., 24 T.C. Mem. 1799 (1965). In this case the Tax Court held that the need to purchase the stock of a dissenting minority stockholder is a reasonable reason to accumulate earnings.
\item \textsuperscript{126} B. Bittker & J. Eustice, \textit{Federal Income Taxation of Corporations and Shareholders} \S 8.03 (3d ed. 1971).
\item \textsuperscript{128} \textit{See} generally Friedman, \textit{Liquidation of Corporations Becoming Domestic Personal Holding Companies Under the Revenue Act of 1964}, 20 Tax L. Rev. 435 (1965).
\item \textsuperscript{129} \textit{Int. Rev. Code of 1954}, § 541.
\item \textsuperscript{130} \textit{Id.} §§ 541(a) (1)-(2).
\item \textsuperscript{131} \textit{Id.} §§ 543(a) (1)(A)-(B).
\item \textsuperscript{132} \textit{Id.} § 542(a)(1).
\end{itemize}
substantially all of its income is derived. Such services are personal services and therefore all firms would possess this first element.

(2) more than 50 per cent of the corporation's stock is owned, directly or indirectly by not more than five attorneys.\textsuperscript{133}

This second element will automatically be found in any incorporated firm with less than ten attorneys-shareholders, and may exist in an incorporated firm with ten or more attorneys-shareholders unless each attorney holds approximately the same interest in the corporation.

(3) the fees were earned by an attorney-shareholder who had a 25 per cent or more interest in the outstanding stock of the corporation.\textsuperscript{134}

The third element will normally exist only in small firms, thus allowing the larger firms to avoid the personal holding company tax. For example, a five-man firm in which each attorney holds a 20 per cent interest in outstanding capital stock could not satisfy this requirement.

(4) in the contract between the client and the firm, someone (client) other than the corporation must have the right to designate which attorney is to perform the services.\textsuperscript{135}

The Internal Revenue Service will presume that this fourth element exists, unless the contract states that the corporation retains the right to designate the attorney who shall handle the matter.\textsuperscript{136}

If a law firm is found to be a personal holding company, the penalty tax can be avoided in two ways. First, the firm could distribute all of its income in the form of salaries, but this may lead to unreasonable compensation problems.\textsuperscript{137} Second, the firm could distribute its personal holding company income to its shareholders in the form of dividends.

\textit{Exchange of Partnership Assets for Stock.}\textsuperscript{138} Theoretically, the transformation of a partnership into a corporation is a three-step process. First, the partnership is dissolved. Second, the firm's property, \textit{i.e.}, accounts receivable, accounts payable, furniture, fixtures, office space, equipment, and other partnership property, is distributed pro rata to its former owners. Third, each attorney transfers his share of the distributed property to the corporation in exchange for stock and other securities. Under \S\ 351 of the Code, partners do not recognize any gain or loss on the transfer of such property, provided they collectively own at least 80 per cent of the corporate stock immediately after the transfer.\textsuperscript{139} Similarly, the

\textsuperscript{133} \textit{Id.} \S\ 542(a)(2).

\textsuperscript{134} \textit{Id.} \S\ 543(a)(7)(A).

\textsuperscript{135} \textit{Id.} \S\ 543(a)(7)(B).


\textsuperscript{137} \textit{See} text accompanying notes 108-14 \textit{supra}.


\textsuperscript{139} \textit{Int. Rev. Code} of 1954, \S\ 351(a).
corporation does not recognize any gain or loss upon receipt of the property, but merely assumes the transferor's basis in the property. However, despite the fact that § 351 transfers are immune from capital gain or loss treatment, there are several adverse tax consequences which may result from incorporation.

Generally, the principal asset of any firm is its accounts receivable and it normally operates on a cash-basis method of accounting. A law partnership, therefore, does not record accounts receivable as earned income until payment is actually received. Because a firm usually does not receive any payment from its clients until the requested service is completed, it constantly has a substantial number of accounts outstanding for which taxable income has not yet been recognized.

In the past the Internal Revenue Service has taken the position that a cash-basis taxpayer cannot utilize § 351 in order to avoid the taxation of income, i.e., the taxes on accounts receivable and work in progress. Thus, if the partnership's receivables are conveyed to the new corporation, the Service may deem this transfer as "an assignment of income" and argue that it is not protected by § 351. If the Service is successful, both the former partners and the corporation must report the value of the accounts receivable as income, thereby subjecting the earnings to double taxation.

Most writers in this area maintain that there is little risk of the courts upholding the Service's stand.

Although it was once a burning issue, most students of this area have concluded that there is little or no risk in transferring receivables to newly formed corporations in a Section 351 transaction. The "assignment of income" bugaboo is simply not in point. Plainly there is an "assignment of income"—a sale or exchange of income items for stock... it is simply that Congress has said in Section 351 that the realized gain shall not be recognized if the requirements of that section are met.

Furthermore, there are a number of judicial decisions which have rejected the Service's position and have permitted transferors to convey receivables to a corporation without declaring them as personal income.

Analogous to the problem of outstanding accounts receivable is the problem of outstanding accounts payable. Normally a law firm which operates on a cash basis will have some unpaid liabilities for which the firm has not taken any tax deduction. In the past the Internal Revenue Service has argued that the new corporation must capitalize the accounts payable and cannot deduct them as a business expense. In effect, the Service's position causes the former partners...
and the new corporation to lose this deduction. However, the majority of writers feel that the IRS's argument is weak and contrary to § 351. But in addition, it has been suggested that the Service will no longer challenge the transfer of accounts payable.

But incorporators must be aware of a third possibility of adverse tax consequences arising out of the transfer of partnership property. This problem arises out of the fact that there is an exception to § 351 contained in § 357(c). This section provides that a transferor of property does recognize gain to the extent that any liabilities assumed by the corporation exceed the transferor's basis in the property transferred. Since the firm's accounts receivable will have a zero basis, the accounts will not offset the transferred accounts payable in regard to § 357(c). Therefore, unless the firm has other assets whose cumulative bases equal or exceed the amount of liabilities assumed by the corporation, the transferors may recognize some gain on the transfer of property to the corporation.

VI. Conclusion

As stated in the introduction, the goal of this article was not to advocate or to denounce the incorporation of law firms, but rather to sketch the many elements that must be considered before an attorney could make an informed decision on his own behalf. In making this decision, attorneys must meticulously analyze the previously discussed benefits, detriments and problems of incorporation, and assiduously apply them to their particular situations. In addition, attorneys must take into consideration the possibility that Congress may curtail the disparate treatment between professional corporations and partnerships, thereby reducing the time and money spent on incorporation to a meaningless expense. Finally, attorneys must scrupulously study their state statutes in order to avoid any unexpected pitfalls which might affect their firm's and their own tax status.

Michael J. McGoldrick

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147 See Thies, supra note 142; Note supra note 138, at 457.
148 See, e.g., Greenberg, supra note 138, at 86-87.
149 INT. REV. CODE of 1954, § 357(c).