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Professional Service Organizations:  
A Critique of the Literature

BORIS I. BITTKER

In the seven years that have passed since the states began to authorize doctors, lawyers, and other professional practitioners to organize "professional corporations" and "professional associations," the status of these new-style groups under the Internal Revenue Code has been the subject of a vast polemical literature.

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1 More than 100 items are listed by the ABA Professional Corporations Committee in its 10 page Bibliography of Materials Relating to Tax Status of Professional Corporations (July, 1967). A more selective list would include: Anderson, Tax Aspects of Professional Corporations, U. So. Calif. 1963 Tax Inst. 309 (with bibliography); Grzybek, Professional Associations and the Kintner Regulations: Some Answers, More Questions, and Further Comments, 17 Tax L. Rev. 469 (1962); Eaton, Professional Corporations and Associations, 23 Tax L. Rev. 1 (1967); Mow, Professional Associations and Professional Corporations, 16 Sw. L.J. 462 (1962); Scallen, Federal Income Taxation of Professional Associations and Corporations, 49 Minn. L. Rev. 603 (1965); Snyder & Weckstein, Quasi-Corporations, Quasi-Employees and Quasi-Tax Relief for Professional Persons, 48 Cornell L.Q. 613 (1963); Note, Professional Corporations and Associations, 75 Harv. L. Rev. 776 (1962); Sarner, Associations Taxable as Corporations: A Review and a Look Ahead, Proceedings of New York University Twentieth Annual Institute on Federal Taxation 609 (1962). Since my observations relate to the entire body of discussion, references hereafter to specific articles are intended as illustrative only.

My own views on the classification of new-style professional organization laws are to be found in Bittker, Professional Associations and Federal Income Taxation: Some Questions and Comments, 17 Tax L. Rev. 1 (1961). In a 1963 letter to Congressman Wilbur D. Mills, Congressman Charles L. Weltner said that it was his "understanding that the manuscript of Professor Bittker's article was 'cleared' with the people in the Internal Revenue Service and the Treasury Department before it was published and further that the article was published for the purpose of expressing, through Professor Bittker, the Internal Revenue Service and Treasury Department views . . . ." Because this characterization of my article has been accepted at face value, or at least repeated, by others, I should like to correct the record: I had no information whatsoever, from either official or unofficial sources, that my views coincided with, influenced, or caused a change in the views of anyone in the Internal Revenue Service or Treasury until long after the article was published. This was when, a year or more after its publication, while on a year's sabbatical leave in Italy, I received a newspaper clipping asserting
With few exceptions, the commentators have been sympathetic to the view that professional service organizations are "corporations" as that term is defined by section 7701(a)(3) of the Code; but the reasons offered by those who espouse this view are diverse and contradictory. The only conclusion that they share—their least common denominator, so to speak—is that some professional groups, organized under some state laws, should, under some circumstances, be classified as corporations in applying the Internal

that government officials, in expressing doubts about the corporate status claimed for professional groups organized under new-style statutes, were citing the article. I do not know whether, if this report was true, my article merely buttressed their independent views or convinced them to abandon an earlier contrary conviction. (Naturally, I would prefer to think that, fighting all the way, they were reluctantly won over by the cogency of my arguments.) As to the alleged advance "clearance" of the article, before its publication I sent a nearly final draft to a number of friends in private practice, academic life, and the government. The government officials, as might have been expected, responded with polite but noncommittal acknowledgements, accompanied by not so much as a corrected citation; the other readers, however, offered a number of comments, some of which led to minor revisions before publication.

In conversations with tax practitioners, I have detected much more skepticism about the corporate status of new-style professional organizations than is suggested by the published articles, as well as an undercurrent of uneasiness over the use of these arrangements by lawyers, doctors, and other professional persons. If interests in a professional corporation can be owned by nonemployees, the door may be open to the sale of interests to persons who, though members of the same profession, are acting as "investors" rather than practitioners. For a fanciful inflation of this possibility, see The Day Law Firms Went Public, 5 N.J.S.B.J. 865 (1962)—an item not included in the ABA bibliography. In a more restrained but similarly entrepreneurial vein, an attorney once suggested to me that he might use a professional corporation as a medium of selling, to other attorneys, interests in his successful combination of law practice and real estate speculation.

This uneasiness will be increased by O'Neill v. United States, 68-1 U.S.T.C. ¶ 9251 (N.D. Ohio 1968), decided after this article was in galley, holding that the Ohio professional associations law confers limited liability on the shareholders of an Ohio professional association because clients and patients can look only to the entity itself and to the "person or persons who actually furnish the professional services" for redress in the event of malpractice or other tortious conduct. (Emphasis added.) In my 1961 article (Bittker, supra at 10-13), I suggested that such a construction of professional association statutes would drastically alter the relationship between law firms and their clients. I should think that the American Bar Association's Committee on Professional Ethics (and comparable bodies of other professional organizations) would be concerned about the possibility that a legal opinion rendered by an "employee" of a professional association, inevitably deriving part of its authority from the professional reputation of all "shareholders" of the entity, would not impose personal liability on those who did not "actually furnish the professional services," as held in the O'Neill case. Under Ohio law, this limitation on professional responsibility evidently exists even if the client is not informed of it. However, the canons of ethics require that "restrictions on liability as to other lawyers in the organization" must be made apparent to the client." See ABA Committee on Professional Ethics, Opinion 203 (1961). Querer: who is the "client" when a professional opinion is rendered in a reorganization matter, public offering of stock, etc? If the "client" includes all those relying on such an opinion, how are such limitations on liability to be "made apparent" to them?
Revenue Code. This common core of agreement aside, the arguments for treating new-style professional groups as corporations clash with each other almost as sharply as with the Treasury's contrary view, and they carry widely divergent implications for both professional groups and other taxpayers. The attack on the Treasury has been pressed with such vigor, however, as to obscure both the intramural contradictions of the pro-corporation theories and their radiating implications.

State Labels

To start with the most simplistic argument offered in support of the “corporate” status of new-style professional organizations, some commentators have asserted that an organization enjoying the label “corporation” under state law must be so treated by the Internal Revenue Service, whether it possesses the corporate characteristics described in the Morrissey case or not; and others have flirted with this theory, without endorsing it wholeheartedly. The theory is that section 7701(a)(3) was intended by Congress to embrace any organization that is called a “corporation” by the state under whose law it was created.

Although the partisans of this view seem to assume that the organization’s state label is to be found in the statute governing its creation and operation, we are not told why the label used by the state in characterizing the organization for tax, regulatory, or other purposes should not be equally efficacious—or even more so, since as used in such statutes the label has practical consequences. On this theory, a professional group would have to be treated as a corporation under section 7701(a)(3) if, despite a neutral label (e.g., “organization”) in the state law authorizing its creation, it was classified as a corporation by the state’s corporate income or franchise tax law. Moreover, if the state’s label is to control, I perceive no reason to distinguish between a state’s use of the label “corporation” and its use of the label “association.” Both terms appear in section 7701(a)(3), with nothing to indicate that one, but not the other, refers to state usage. Thus, the supremacy-of-labels theory would permit virtually all professional organizations to be classified as corporations by reference to their label alone, since the state statutes under examination almost always use either the term “professional corporation” or the term “professional association.” A corollary of this conclusion is that an organization’s classification would depend upon the criteria of the Morrissey case.

\[\text{Morrissey v. Comm'r, 296 U.S. 344 (1935).}\]
only if it were neither a corporation nor an association under state law (e.g., a trust). 8

Despite these radiating implications, the supremacy-of-labels theory seems to be restricted by its advocates to state professional corporation laws, with the result that they would require organizations created under professional association laws to make their way under the Morrissey criteria. Since it is usually conceded or assumed that a solo practitioner cannot qualify under these criteria for want of associates, the supremacy-of-labels theory fails to

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8 Indeed, one might go further. If the terms "corporation" and "association" as used in section 7701(a)(3) take their content from state usage, does it not follow that a state's failure to confer one of these labels on an organization effectively bar it from qualifying as a corporation under section 7701(a)(3)? One might, to be sure, argue that the state label is a sufficient, but not a necessary, condition to corporate status under section 7701(a)(3); but I have seen nothing in the supremacy-of-labels theory to explain why its efficacy should be so restricted, or why—assuming that state labels are controlling—a state's use of the term "partnership" or "joint venture" should not conclusively determine that the organization is a partnership within the meaning of section 7701(a)(2).

In Empey v. United States, 272 F. Supp. 851 (D. Colo. 1967), on appeal to the Tenth Circuit, holding the 1965 regulations invalid, the court rests heavily on the theory that an "incorporated organization" must be classed as a "corporation" because section 7701(a)(2) defines the term "partnership" to include a syndicate, group, pool, joint venture, "or other unincorporated organization." By itself, however, this approach does not supply definitions for either "incorporated organization" or "unincorporated organization"; and it is not clear whether the court regarded the professional group before it as "incorporated" because of its state label, its charter, or its corporate characteristics. Moreover, in its discussion of section 7701(a)(2) and section 7701(a)(3), the court left an undistributed middle: the term "partnership" as defined by section 7701(a)(2) includes "unincorporated organizations," but it does not necessarily follow that section 7701(a)(2) does not also include incorporated organizations if they lack the requisite corporate characteristics. It may have been these gaps in theory that led the court to offer a second ground for its decision, viz., that assuming arguendo the validity of the 1965 regulations, the professional group in question more nearly resembled a corporation than a partnership. This ground weakens the value of the Empey case as a precedent for other taxpayers, both because the group was organized under Colorado's general business corporation law and because the decision rests to some degree on an agreed statement of facts describing the group's mode of operation in practice.

I do not know what to make of the ABA sponsored proposal (51 A.B.A.J. 403 (1965)) to amend section 7701(a)(3) to provide that the term "corporation" shall include:

professional corporations and professional associations formed under the law of any state, the District of Columbia, or any United States possession.

Does the proposal embrace any organization that is called a professional corporation or professional association by the state statute authorizing its formation, regardless of its legal characteristics? Or can an organization qualify only if its characteristics meet an unspecified nationwide set of corporate or association criteria—without regard to its state label? Since any organization, including a partnership, is formed "under the law" of some state, what purpose is served by this part of the definition? Does it mean "under the law of any state relating to professional corporations or professional associations"? If so, what are the identifying marks of such laws?
rescue such doctors and lawyers in professional association states from their "plight." The theory's engaging simplicity is qualified in another way by at least one of its supporters, who would disregard the label if it is a "sham." This qualification throws the baby out with the bathwater; the only way to determine if the label is a sham is to see whether the organization has enough corporate characteristics to deserve the label.

A variation on the label theory, which similarly promises to sidestep the *Morrissey* case, asserts that the only distinguishing touchstone of a corporation is its charter. Inspired by the *Dartmouth College* case, one commentator has put the case as follows:

Basic to this concept of a corporation [i.e., Chief Justice Marshall's view, as expressed in the *Dartmouth College* case] is the granting of a charter by the state or federal government which creates the entity and which endows the entity with the power to act.

There is nothing in the present language of the Code which indicates that Congress intended any other meaning to the term "corporation." The import of the term "charter" is not self-evident, but it seems to imply a grant of authority by the state, recorded in a public office, to an organization that meets a set of standards or requirements. In this sense, one could say that limited partnerships possess charters because they are formed by the execution of a certificate, which must be filed in a designated public office. If this document is not a charter because, although accepted for recordation, its compliance with the statutory requirements is not attested by the signature or seal of a public official, that formality could be readily supplied—with no real-life consequences—by amending the state's limited partnership act. Although there is some difference in conclusiveness between the state's recordation of a limited partnership's certificate and the issuance of a certificate of incorporation, it is important in only a few bizarre situations (where

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4 It does, of course, tell them that if they can get their state legislatures to substitute the word "corporation" for "association" in the applicable state laws, they too will enjoy the magic label.


6 Anderson, *Tax Aspects of Professional Corporations*, U. So. Cal. 1963 TAX INST. 309, 318. At times, Anderson comes close to contending that the touchstone of a corporation is the fact that it is an artificial entity (the need for a charter arising because the form of organization was not known to the common law). I am not sure how he would respond to the fact that limited partnerships, like corporations, are creations of statute, not recognized by the common law. *See* Ruzicka v. Rager, 305 N.Y. 191, 111 N.E.2d 878 (1953); *State v. Williams*, 196 Kan. 274, 411 P.2d 591 (1966).

7 Compare § 2, Uniform Limited Partnership Act, with §§ 49-50, Model Business Corporation Act.
the formalities have been disregarded by the parties, or their attorneys); and a limited partnership's certificate could, without adverse results for anyone, be endowed with the same dignity as a certificate of incorporation. And if this step would enable limited partnerships to be taxed as corporations, I see no reason why ordinary partnerships should not be tricked out with charters by a similar stroke of the statutory pen. (Indeed, why would it not be equally possible for a state to grant charters to wage-earners, thus launching us on an era of "proletarian corporations"?) If, on the other hand, a certificate of organization cannot constitute a charter unless the organization's legal characteristics conform to those of a corporation, the claim that a charter is the distinguishing mark of corporate status is misleading, and ought to be abandoned, because it is only a roundabout way of embarking us on the familiar search for corporate characteristics.

The Insights of Realism

Another prominent theme in the debate on new-style professional organizations is the diminished importance of the traditional characteristics of the corporation, viz., centralized management, free transferability of shares, continuity of existence, and limited liability. Sometimes this point is the prelude to a contention that closely held business corporations, when viewed realistically, are not much different from partnerships, an insight leading in turn to the suggestion that professional organizations should be classified as corporations under section 7701(a)(3) if they resemble closely-held corporations in practice, even if their possession of the orthodox corporate characteristics is debatable. Sometimes, on the other hand, the issue is approached from the point of view of the large partnership, the argument being that such organizations in practice often resemble corporations. In either case, we are asked to be "realistic" rather than "conceptual."

A realistic view undoubtedly leads to the conclusion that many closely held business corporations do not want centralized management or free transferability and hence often arrange to modify or nullify these corporate characteristics by charter provisions, by-laws, or shareholders’ agreements. As to continuity of existence, it may be an irrelevant feature, or even a shortcoming to be redressed

8For "proletarian corporations," which might bring us closer to the People's Capitalism that is envisioned by the New York Stock Exchange, see Bittker, Professional Associations and Federal Income Taxation: Some Questions and Comments, 17 Tax L. Rev. 1, 34 (1961).
by an agreement for a liquidation at a specified time or on the demand of any major shareholder. The fourth item on the traditional list of corporate characteristics—limited liability—may be inconsequential as respects tort claims because the enterprise is fully insured, and negated as to contract claims by a business practice of requiring shareholders to guarantee performance of the corporation's major undertakings.

Having pointed out these undeniable facts of life, the partisans of the professional service organization then argue that it is naive, finicky, or reactionary to fault the new-style state laws for watering down the traditional corporate characteristics that most closely held enterprises do not need in pure form anyway. It should be enough, they seem to argue, if the state law makes some gestures in the "right" direction. Since ordinary closely held corporations often takes steps to qualify or restrict the pristine corporate characteristics with which they are endowed by their creator, we should not cavil if the state itself imposes comparable restrictions on the professional organization at its inception, rather than conferring full-blown corporate characteristics on it and leaving any modifications to the unfettered choice of its members.⁹

The same conclusion is sometimes reached by another route. Instead of comparing the characteristics of the professional organization under examination with those possessed by an ordinary corporation at the time of its organization, we are told to see if it resembles the closely held corporation in operation—i.e., after the naked provisions of the latter's charter have been altered by its bylaws, shareholder's agreement, and, possibly, practice. Corporate characteristics, in this view, should not be defined as they are in the black-letter generalizations of a conceptual treatise, but as illuminated by practice. Thus, since it is not unusual for ordinary closely held corporations to prohibit the transfer of stock to persons who are not active employees, a similar restriction imposed by law on a professional organization is not—it is argued—incon-

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⁹ Scallen at 683: "Centralization of management is a shaky basis for classifying professional or any other groups for tax purposes . . . ." "The relevance of transferability to corporateness is doubtful today . . . ." Id. at 688. "[C]ontinuity [of life] appears at the most a rather minor technical characteristic, if relevant at all." Id. at 677. When Scallen adds to these comments the observation that limited liability—"[p]erhaps in most cases . . . the only criterion of corporateness that has any practical significance," id. at 687—is not essential to corporate status, one wonders what is controlling, in his view, if not the label. But he also cautions against sham labels, without saying which, if any, of the foregoing trivialities (as he sees them) must be present to insure that the label is valid.
sistent with the corporate characteristic of free transferability of interests.

Although a rejection of these "realistic" appeals opens one to the charge of naivété or invincible ignorance, I do not think that the "practical" view of the closely held enterprise contributes very much to the problem at hand. To begin with, this approach would almost certainly require the rejection of centralized management as a corporate characteristic, since by shareholder agreement, many closely held corporations substitute unanimity for representative control. Continuity of existence as a corporate characteristic, with its implication that the corporation is unaffected by the death or other personal exigencies of a shareholder, would evidently take on a new meaning in view of the common practice of requiring a closely held corporation to purchase the stock of a shareholder on his death, termination of employment, etc. Free transferability would also have a more confined meaning if this approach were to be followed. Limited liability is the only traditional corporate characteristic that would be unscathed by the acid of realism, though if business practice (including on the one hand the availability of liability insurance and on the other, the banking custom of requiring shareholders of small corporations to guarantee payment of corporate loans) is to be taken into account, the boundaries of limited liability would also be truncated. None of these qualifications is adumbrated, let alone endorsed, by the extensive case law on the meaning of section 7701(a)(3), nor does its legislative history imply a realistic rather than conceptual comparison of the traditional characteristics of a corporation with the characteristics of the organization under examination.

If business organizations are to be classified in realistic rather than conceptual terms, moreover, many large partnerships—to their chagrin—would be taxable as corporations, without any aid from the new-style professional organization laws that have stimulated the new wave of legal realism. As stated above, the realistic view of the traditional corporate characteristics is sometimes employed to establish that a large partnership, in practice, may resemble a corporation: despite the theory that each partner is an agent for all, a large partnership may be managed exclusively by a committee or managing partner; despite the theoretical nontransferability of interests, the partnership agreement may permit transfers; and despite the theoretical dissolution on the death, bankruptcy, or withdrawal of any one partner, the agreement may provide for a continuation of the business.
From a practical point of view, there is much to be said for the view that such organizations resemble corporations. Before this view is embraced as a proper interpretation of section 7701(a)(3), however, any of its proponents who are members of large law and accounting firms ought to ask how they would respond if the Internal Revenue Service taxed their organizations as associations for all open tax years. I suspect that their briefs, beating a hasty retreat from "realism," would assert that there is a world of difference between a large law firm's partnership agreement and a closely held corporation's charter—and that no matter how widespread the practice of modifying corporate charters by shareholders' agreements may be, the two forms of business organization must be treated differently for federal income tax purposes. One might, of course, reject this predictable flight into conceptualism on the ground that the authors' law review articles are more persuasive than their self-serving briefs. I would subscribe, on the contrary, to the more conservative view that section 7701(a)(3) looks to the traditional characteristics of corporations in determining whether an organization is an association; and that it is the perquisite of Congress, not the Internal Revenue Service or the courts, to decide whether, and how much, section 7701(a)(3) should be infused with this brand of realism.

Moreover, acceptance of the "realistic" approach to corporate characteristics, even if it could somehow be confined to professional organizations, would require us to resolve a latent disagreement among its proponents, viz., should realism stop with an examination of the documents governing the professional organization's conduct, or embrace their impact in practice as well? If two lawyers create a professional association under a statute providing for centralized management, continuity of interest, and transferability of shares, does a realistic assessment of their arrangement lead to the conclusion that it is a corporation because a two-man business corporation will be treated as a corporation even if its corporate characteristics are attenuated or nullified by agreement? Or does realism require us to disregard the formal characteristics of the two-man professional organization, and classify it by reference to its behavior in real life? An affirmative answer to the latter question is implied by the frequency with which "realists" appeal to the undeniable fact that some large partnerships are controlled by management committees, permit interests to be transferred, and continue despite the death of individual partners. If the status of a professional organization is to be decided in the light of realism,
then the brand of realism to be applied will determine whether it qualifies as a corporation or not.

**Tax Equality**

Another major theme in the professional organization literature is tax equality: Professional persons who cannot incorporate under orthodox state laws are at an unfair disadvantage, it is argued, when compared with other taxpayers. The complaint of inequality is based almost wholly on the fact that one must be an employee to participate in a qualified pension or profit-sharing plan. Since the owner of an individual business proprietorship can convert himself into a shareholder-employee of a one-man corporation, it is argued that an attorney or physician who is prevented by professional ethics (or other rules) from taking a similar step is the victim of tax discrimination.

This argument was, of course, an important element in the long campaign that culminated in the enactment of the Self-Employed Individuals Retirement Act of 1962:

The primary reason for the [proposed legislation] is to give self-employed persons access to retirement plans on a reasonably similar basis to that accorded corporate stockholder employees. It thus tends to correct a discrimination in present law under which self-employed individuals—sole proprietors and partners—are prevented from participating in retirement plans established for the benefit of their employees although owner-managers of corporations may do so. Self-employed individuals have contended for many years they are treated unfairly under present law.

... In many cases, self-employed individuals are prohibited by State law from operating their trade or business in the form of a corporation. Thus, in these cases, there is no possibility that a self-employed person could obtain the benefits of a retirement plan under existing law by forming a corporation to conduct his trade or business and becoming its employee. Although a number of States recently have enacted new legislation to eliminate some of the obstacles to professional corporations and associations, your committee believes it desirable to provide by Federal legislation that a self-employed individual may participate in employee retirement plans without becoming an artificial employee of his own corporation. Thus, professional individuals could continue to practice their profession in the traditional manner; that is, as self-employed individuals. Moreover, this legislation would ease the pressure on State legislatures to enact special professional corporation laws.10

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Despite the 1962 legislation, the complaint of discrimination has continued, but in modified form: post-1962 discrimination is seen in the fact that self-employed persons who are permitted by state law to incorporate can now choose between a self-employed retirement plan and a qualified employee plan, while physicians, attorneys, and some other professional groups can use only the self-employment route. Because employee plans have certain advantages over self-employed plans, we are told that professionals continue to be second class citizens.

It is of course true that the disparity between those who can incorporate and those who cannot has not been wholly eliminated, but the gap has been narrowed by the 1962 legislation. Moreover, the character of discrimination depends on the groups being compared. As compared with self-employed persons who are free to incorporate, professionals seem to be the victims of discrimination. When compared with other relevant groups however, they are the beneficiaries of discrimination. I refer to the millions of employees whose employers have not established qualified retirement plans, as well as the additional millions of employees whose participation in qualified plans is an illusion because their benefits will never vest. Like attorneys and physicians, these taxpayers provide personal services for compensation—but being employees, they cannot establish self-employed retirement plans. From their point of view, therefore, attorneys and physicians have been since 1962 the beneficiaries of discrimination, and the discriminatory distance between these groups will be enlarged if professional corporations are recognized for tax purposes.

Whatever decision Congress might choose to make in these circumstances, it would be inappropriate for a court—faced with the debatable issue of the validity of a new-style professional organization law—to be swayed by the argument that professionals are, on balance, the victims of tax discrimination. As suggested, this argument is tenable only if one accepts the unarticulated major premise that self-employment is the critical test of discrimination, so that physicians, attorneys, and other professionals “belong” with those businessmen who can readily incorporate. If one assumes, to the contrary, that they “belong” with persons who purvey personal services, most of whom are employees and have no opportunity to establish qualified retirement plans, they are not the victims of

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11 The 1962 legislation for self-employed retirement plans was liberalized in 1969 by the repeal of section 404(a)(10) and an amendment of section 401(e)(2).
discrimination. There are times when a court cannot make any contribution to the over-all rationality of the legal structure from which an issue has emerged for judicial determination; on such occasions, a modest, albeit old-fashioned, view of the judicial function—deciding cases, not doing justice—should prevail.

In any event, those who believe that new-style professional groups should be taxed as corporations offer reasons that differ widely in their impact on the equality issue. If the state label is controlling, equality can be achieved by all professional practitioners in states that are willing to confer the corporate label. If realism is controlling, some practitioners will achieve equality but others will not. If solo practitioners cannot qualify for corporate status (as some commentators believe), they will be left in outer darkness everywhere. Other divergencies in the views of the pro-corporation commentators will have similarly discriminatory consequences within the professions, the nature and extent of the discrimination being dependent upon the ability of diverse professional organizations to qualify as corporations under the divergent theories offered by these commentators.

Solo Practitioners

Responding to skepticism about the feasibility of centralized management, free transferability of interests, and continuity of existence in the case of professional practice, the supporters of professional organization statutes point to group practice medical clinics and large law firms as proof that a professional organization may possess these corporate characteristics. This refutation, however, puts its proponents in a dilemma. If their premise is that group practice of the type described is typical of the professions, they find themselves face-to-face with the undeniable fact that

12 An alternative, more refined statement would be: Of those persons who purvey personal services, some (physicians, attorneys, etc.) can establish retirement plans under H.R. 10, others (plumbers, etc.) have a choice between H. R. 10 and incorporation, and still others can participate in a private retirement plan only if their employers choose to establish one. Some of the latter have enough leverage (by virtue of special occupational talents, collective bargaining, etc.) to exert pressure on their employers; others lack such leverage, and have only the power to quit the job and look for another if they want to be covered by a private retirement plan. Even these persons have a choice between covered and uncovered employment (and between employment and self-employment), but in this sense, physicians and attorneys also can control their fate by turning from self-employment to salaried jobs.

It is surprising that advocates of tax equality have not climbed on the “proletarian corporation” bandwagon, see note 8 supra, since it would enable all purveyors of personal services—practicing lawyers, law professors, bank clerks, drapers’ assistants, etc.—to create their own qualified pension plans.
medical and legal practice in the United States is now, and for some time to come is likely to be, heavily dominated by solo practitioners (including, in the case of attorneys, small aggregations that may call themselves partnerships but that share only rental, secretarial, and research expenses, not their fees). If, on the other hand, the premise is that group practice (though not typical) is possible, it seems to imply that only a small fraction of practitioners would qualify for corporate treatment even under the new-style statutes, because they are the only ones who could realistically claim to be governed by the corporate characteristics allegedly conferred by these statutes.\textsuperscript{13}

This implication is reinforced by the caution or reserve with which many commentators, so positive in most of their assertions, confront the status of the solo practitioner under the new-style statutes. If the state law calls itself a “professional association” statute, it is often admitted, explicitly or implicitly, that the solo practitioner’s lack of associates prevents him from qualifying as an association under section 7701(a)(3). If the law uses the label “professional corporation,” a few commentators (especially those who argue that labels are controlling) assert that the solo professional practitioner is as much entitled to corporate treatment as the one-man business enterprise organized under a conventional corporation statute; but most seem uneasy with this comparison, expressing or implying doubts about the solo practitioner’s right to be taxed in accordance with the state label.

This caution is quite commendable, in my opinion; but the supporters of the new-style statutes must find it galling, since it blights any hope these statutes will correct the tax inequality that they perceive in existing law. The most that can be claimed, in these circumstances, is that large firms may be able to qualify for corporate tax treatment, leaving most practitioners with H.R. 10 as their only vehicle for tax reduction. If the new statutes should prove to be efficacious for large professional firms, but not for the solo practitioner (or for his indistinguishable colleague, the “partner” who shares his expenses but not his income with other practi-

\textsuperscript{13} Group medical practice is constantly cited to establish that large aggregations are now typical of the organization of medical care in the United States. The old time doctor with a black bag full of pills is hard to find today, but not because medical practice is dominated by groups like the Mayo Clinic. The U.S. Public Health Service has estimated that, in 1959, only about 7 per cent of physicians in private practice belonged to medical groups—even though its definition of group practice required only 3 full-time physicians. Very few groups had more than a dozen physicians, and only a handful were comparable in size to large big-city law firms. \textit{Public Health Service Publication No. 1063, Medical Groups in the United States}, Table 6, at 12, Chart 7, at 28 (1963).
tioners), a new distinction would be created within each profession, and it would support the thesis that recognition of the new statutes will heighten rather than reduce the "inequality" of existing law.

The Treasury Regulations

Although the proponents of new-style professional organizations are unanimous in attacking the Treasury's 1965 regulations, their harmony shatters when they turn to the pre-1965 regulations. Those who regard the 1960 ("Kintner") regulations as a proper interpretation of section 7701(a)(3) must base their case for corporate treatment on a four factor analysis of each new-style professional organization, corporate status being attained only if it possesses more corporate than noncorporate characteristics. (As pointed out above, solo practitioners would be excluded for want of associates, and there is disagreement on whether an organization is to be subjected to the four factor analysis if it bears the state label of corporation.) To some commentators, however, the Treasury's 1960 regulations are no more acceptable than the 1965 version; for them, the claim to legitimacy is lodged in an earlier generation of regulations. This denial of authenticity to the 1960 regulations is based partly on a procedural contention (viz., that the Treasury did not have the power to alter the pre-1960 regulations because they had been frozen into law by congressional reenactment of section 7701(a)(3) and by legislative acquiescence), and partly on substantive grounds (viz., that the four factor analysis of the 1960 regulations was erroneous, along with its requirement that more characteristics be corporate than noncorporate to qualify for corporate status).

Rejection of the 1960 regulations, however, creates as many problems as it solves. As with the Spanish and Austrian royal families, it is not clear how far back we must go to find anybody with a clear title to the public's allegiance. Is the crown to be awarded to Regulations 33, issued under the Revenue Act of 1913?

14 This support for the pre-1960 regulations is not based on any enthusiasm for their content. Scallen says of the pre-Kintner regulations that their criteria were not based on "practicality." Scallen at 716. Eaton is even harsher:

In the early evolution of regulations . . . the Treasury charted an erratic and often dubious course. The language used was not clear; it changed over the years; and the so-called corporate characteristics from time to time mentioned in the regulations were various instead of merely the two (limited liability and continuity of life) stressed by Congress.

Eaton, Professional Corporations and Associations, 23 Tax L. Rev. 1, 3 (1967).

Even so, it is argued that the regulations in one of their pre-1960 incarnations were put, by congressional acceptance, beyond the power of the Treasury to change.
which characterized limited partnerships as corporations? To Regulations 45 (Revenue Act of 1918), which excluded limited partnerships, but included in the association category "[a]n organization the membership interests in which are transferable without the consent of all the members, however the transfer may be otherwise restricted, and the business of which is conducted by trustees or directors and officers without the active participation of all the members as such"? To Regulations 86 (Revenue Act of 1934), stating that federal tax law "makes its own classifications and prescribes its own standards of classification," and that "[l]ocal law is of no importance in this connection"? Or is the only legitimate definition to be found in one of the other sets of Regulations—65, 74, 77, 94, 101, 111, or 103? 16

Whether their search for regulations that will support the new-style professional organization leads them all the way back to the 1913 bedrock, or only to a more recent pre-1960 level, our archaeological commentators are bound to undermine the foundations on which other groups—real estate syndicates, theatrical ventures, etc.—have been resting comfortably since 1960. 17 The choice of pre-1960 regulations is relevant to professional groups as well, not only because it would establish the criteria to be applied in classifying new-style professional organizations, but also because the standards found in the earliest rules might permit some professionals to qualify for corporate status without resort to the recently enacted statutes. Indeed, there are statements in some early regulations that, taken at face value, would impose corporate status on many professional groups even if they prefer to be taxed as partnerships.

In short, the theory that an unspecified set of pre-1960 regulations contains the authoritative interpretation of section 7701(a)(8), which only Congress has power to change, has been advanced

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15 Although Scallen, at 661, 672, characterizes this statement as "ludicrous" and "absurd," it may have been the ultimate reason why Kintner was decided for the taxpayer, i.e., if "local law is of no importance," then one might overlook the fact that the Kintner clinic's bylaws were probably, at important points, unenforceable under state law.

16 The history of the regulations is completely set out, with quotations and summaries, in Scallen at 648–71.

with surprisingly little attention to the proper place to stop. If you unpeel enough of an artichoke, after all, you get to the inedible choke itself.

The Kintner Case

Supporters of the new-style professional organization laws are lavish in their citations of the Kintner case,\textsuperscript{18} which is offered as proof that the Treasury's 1960 and 1965 regulations were plainly wrong and that compliance with a new-style state statute entitles an organization to corporate status.

If Kintner is as authoritative and convincing as these unqualified endorsements imply, however, why did professional partnerships, by and large, think that they needed H.R. 10 or a new-style state law to establish qualified retirement plans? Why did the advisers of all but a handful of professional partnerships hesitate to rely on Kintner? To be sure, in 1956 the Treasury indicated its nonacquiescence in Kintner (which was decided in 1954), and in 1960 it wrote this rejection into the regulations.\textsuperscript{19} But there was a period of more than a year between the decision and the 1956 ruling when taxpayers might have been expected to act in droves on the strength of Kintner if it were persuasive as its supporters now assert; and similar massive reliance would have been natural between 1957, when the government retreated somewhat from its 1956 ruling,\textsuperscript{20} and 1960, when the regulations were issued. After 1960, to be sure, the new regulations would have been more of a deterrent to action in reliance to Kintner;\textsuperscript{21} but a tax adviser might have reckoned that the regulations would cut little ice with the judiciary, especially given their forensic purpose, if he was as sure of his ground as the latter-day apostles of Kintner claim to be.

The failure of more than a handful of taxpayers to rely on Kintner is even more revealing when one notes how little the taxpayer stood to lose if his challenge to the Treasury's position had ultimately failed. Hundreds, if not thousands, of professional groups have been organized under the new-style professional organization laws despite the Treasury's adamant refusal to accept their validity, the strategy being in large part that they have a good deal to gain from victory and little to lose if they are un-

\textsuperscript{18} United States v. Kintner, 216 F.2d 418 (9th Cir. 1954); see also Galt v. United States, 175 F. Supp. 360 (N.D. Tex. 1959).

\textsuperscript{19} Rev. Rul. 56-23, 1956-1 CUM. BULL. 598.

\textsuperscript{20} Rev. Rul. 57-546, 1957-2 CUM. BULL. 886.

successful. In this respect, the area is *toto caelo* different from corporate reorganizations, stock redemptions, and some other transactions, where a bad guess is so disastrous that tax advisers shrink from challenging an interpretation by the Internal Revenue Service no matter how erroneous they think it is.

The reason *Kintner* attracted almost no passengers, in my opinion, is that its seaworthiness was suspect from the outset. The district court held in that case that the medical clinic of which Kintner was an associate "fully" met the *Morrissey* criteria of centralized management and continuity of life, that it scored somewhere between a partnership and a corporation as to transferability of interests, and that it closely resembled a partnership in that the liability of its associates was not limited. In finding that the association enjoyed continuity of life despite the death or withdrawal of a member, a point that it characterized as "most decisive," the district court accepted at face value the statement in the articles that "[n]either the death, insanity, bankruptcy, retirement, resignation or expulsion of a Member shall cause a dissolution of the Association," although this provision was inconsistent with section 31 of the Uniform Partnership Act, in force in Montana for the taxable year before the court. (The taxpayer's brief, indeed, conceded the applicability of partnership law to the association: "In the instant case, we deal with a partnership, and the members could not limit their personal liability as a matter of state law if they so desired.") Nothing in the opinion holds, or even suggests, that any member who desired to cause a dissolution of the association could not do so. This action would be a breach of

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22 The district court's opinion, 107 F. Supp. 976 (D. Mont. 1952), which is more explicit than the appellate court's, seems to have been fully endorsed on appeal. The Kintner clinic's articles of association are reprinted in *Modern Legal Forms* § 6462 (Supp. 1967).

The court's uncertainty on the transferability point is surprising, since the articles of association provided that "[t]he interest of a Member as a Member of the Association shall be non-assignable," a prohibition that was not relaxed even to permit the transfer of a deceased or retired member's interest to another member. On death, retirement, withdrawal or expulsion, a member was entitled under the articles to receive certain retirement and death benefits, but nothing else; thus, he could not transfer an interest in the profits of the firm. On the death of the last survivor of the original members, however, the association was to terminate; at that time, or on an earlier termination by a three-fourths vote of its Senior Members, the assets were to be divided among its then members. The consequences of a purported assignment of *this* interest were unclear. Perhaps it would result in a forfeiture of the member's interest on the theory that it was tantamount to a withdrawal; on the other hand, choses in action having been assignable for several centuries, perhaps it would confer on the transferee rights similar to those created by an attempted assignment of an interest in a partnership.

23 Brief for Taxpayer at 17.
contract, to be sure, for which the member would be liable for any damages that could be proved; but in this respect, the *Kintner* agreement did not differ from the agreements that govern many large partnerships. By contrast, a corporate charter effectively prevents a shareholder from causing the organization's dissolution.

The district court's determination that the *Kintner* association was governed by "centralized management through representatives of the members" was equally unpersuasive. Here again, unless Montana law was idiosyncratic in some respect not explained in the opinion, the Uniform Partnership Act nullified the effort of the members to achieve centralized management and its concomitant, a denial of any member's authority to bind the association except when empowered to do so by an elected executive committee. Under section 9 of the Uniform Partnership Act, any partner has the power to bind the partnership by any act apparently carrying on its business in the usual way, unless his lack of authority is known to the person with whom he is dealing. A partner's action in violation of the clinic's rules would have been a breach of the agreement, having internal consequences, but in this respect—as with the procedure for electing a managing group—the clinic's management was no more centralized than that of many, if not most, large partnerships.

Two other aspects of *Kintner* reduced its usefulness as a precedent for other taxpayers. On appeal, the government's brief relied almost exclusively on Montana's prohibition of the corporate practice of medicine to support its contention that the Kintner clinic was not a corporation within the meaning of section 7701 (a)(3):

Granting as the court below held that the Association was endowed with more of the formal attributes of a corporation than of a partnership, it cannot be regarded for tax purposes as if it were a corporation because the activity in which it purported to engage—the practice of medicine—was not one which could lawfully be carried on by an artificial corporate entity. The federal taxing statute, while not to be circumscribed by local law definitions of partnerships and corporations, does not treat as a corporation an unincorporated organization which is prohibited from incorporating.24

24 Brief for United States at 9.

The same heavy emphasis on a single issue occurred in Foreman v. United States, 232 F. Supp. 134 (S.D. Fla. 1964):

The government's contention centers largely upon the premise that since physicians cannot legally form a corporation for the practice of medicine in the State of Florida, that therefore, regardless of whatever other tests the association might
Since this contention virtually invited the taxpayer's counterclaim that the government was trying to repudiate the statement in the regulations that "local law is of no importance," it is perhaps understandable that the government's brief refrained from pushing a second argument that would have called forth the same response, viz., that the clinic's alleged corporate characteristics lacked under local law the effectiveness claimed for them by its articles of association. A careful practitioner, however, would surely have been disturbed by that argument's brooding presence, especially if he thought that local law was excessively denigrated by the pre-1960 regulations. A second point to be noted in evaluating *Kintner* as a precedent is the court's finding of business purpose for the form chosen:

That for many years prior to the 30th day of June, 1948, the Western Montana Clinic was a partnership composed of doctors practicing their profession in Missoula, Montana. That as the Clinic grew in size, the management became cumbersome because of the necessity for the consent of the partners to various details of the management and business of the clinic, and that likewise the continuity of the partnership organization was constantly interrupted by the death or resignation of old members and the addition of new ones. In addition to the normal problems attendant upon the frequent dissolution and reorganization of the partnership, difficulty was experienced by the Clinic in attracting young men to the group as the capital contributions required to purchase interests in the partnership became increasingly larger, and the financial stability of the partnership was rendered uncertain by the possibility of the death or retirement of partners who had substantial ownership in the partnership property.

For the purpose of minimizing the problems mentioned in the preceding paragraph, the partners of the Western Montana Clinic, on June 30, 1948, organized the Western Montana Clinic, and Association, by the adoption and execution of Articles of Association... Absent this history, which was elaborated by detailed testimony, the provisions of the articles of association to which the district
court pointed in deciding that the clinic resembled a corporation might have been dismissed as window-dressing. To the discriminating tax adviser, in short, Kintner simply did not emit the odor of sanctity when it first appeared in the law reports.

Another curious aspect of the belated enthusiasm engendered by Kintner is the impact the decision would have had, if wholeheartedly accepted, on many professional organizations that were not seeking corporate classification. If the governing rules of the Kintner clinic were sufficient, regardless of their effect under state law, to require its classification as an association under section 7701(a)(3), many law firms and other professional groups with similar provisions for a management committee and continued existence would be equally entitled to—or saddled with—corporate tax status. An examination of any form book will uncover provisions for centralized management and continuity of life, resembling those in the Kintner agreement, that are offered to the country lawyer as suitable for inclusion in partnership agreements. If Kintner is to be believed, a lot of unpaid corporate income taxes are waiting patiently to be assessed against organizations using these common forms.

Of course, if the Treasury had acquiesced in Kintner despite its unsatisfactory analysis of the issues, there would have been a wave of Kintner-style professional organizations; but in modeling their agreements on Kintner, they would have been relying not on the persuasiveness of the decision, but on the complacence of the government.

In these comments on the arguments for classifying professional service organizations as corporations, I have not addressed myself directly to whether these groups satisfy the criteria of the Morrissey case and the regulations. On this ultimate issue, I set out my views at length in 1961, and I have not been persuaded either by the contrary opinions expressed by others or by the wisdom that is said to come with age to modify my conclusion that "the state legislation under review ... combines the award of a label with a bit of nibbling away at the fringes of partnership law." 28 On re-

27 See Scallen at 687 n.406: "Almost any so-called corporate characteristic—centralized management, transferability of shares, division of profits with preferences to certain owners for income or assets in liquidation, etc.—can be imparted to a partnership by agreement."

28 Bittker, Professional Associations and Federal Income Taxation: Some Questions and Comments, 17 Tax L. Rev. 1, 30 (1961). Others have, wittingly or unwittingly, made the same point. For example:
viewing the arguments that have been adduced by others for treating new-style professional organizations as corporations, I would now add that the proffered theories—which vary greatly from one proponent to another—require drastic revisions in the process of classifying offbeat organizations. These novel approaches differ so much in their impact on professional groups, as well on the status of other types of business organizations, as to constitute an admission—unmistakable even though implicit—that the case for corporate treatment is quite weak, and that it requires support from new and untested modes of defining “association.”

Question: . . . If we incorporate lawyers are we not going to make it that much more difficult to stop unauthorized practice in the wrong areas?

Armstrong: I think it does make the position that we have consistently taken, that lay corporations should not engage in the practice of law, more difficult in seeing that our own corporations are under proper safeguards. There is a distinction, however, because ours [i.e., a professional corporation] is not a corporation except, we hope, for tax purposes. It does not have the powers and it has a great many more restrictions than an ordinary corporation would have . . . .

(Panels discussion, Professional Associations: Substance, Ethics and Taxation, 1962 ABA Section of Real Property Probate & Trust Law, Proceedings, Part I, p. 25, at 32 (emphasis added).

See also id. at 28:

Hannaford: The professional corporation or association statutes that have been passed in twenty states have been called by many people a tax gimmick. The history of this will show why I do not consider it a tax gimmick, at least as far as a large segment of the medical profession is concerned. (Emphasis added.)

(Opposition obviously can differ on the meaning of “large segment,” see note 13 supra.)

As the problem is viewed by Snyder and Weckstein: “a professional practitioner requires a special kind of employer, an evanescent one, who is there for tax purposes but disappears when professional services are rendered and earnings are distributed.” Snyder & Weckstein, Quasi-Corporations, Quasi-Employees, and Quasi-Tax Relief for Professional Persons, 48 Cornell L.Q. 613, 615 (1963). See also debate in ABA House of Delegates (Honolulu, 1967), on continuation of the Special Committee on Professional Corporations, in which the secretary of the committee responded to critics as follows:

If somebody doesn’t like the word “corporations,” even though everybody who has anything to do or say in that corporation has to be a lawyer and only lawyers may operate their structure, and when they do it, believe me it would be no different than that which goes on in most of the partnerships of any substantial size, but if people don’t like the word “corporations,” there are many of the state statutes which don’t use that term but use the term association.

Transcript at 65 (emphasis added).