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Recent Decisions: Internal Revenue--1965
Treasury Regulations--Discrimination against
Professional Corporations [*O'Neill v. United States*,
281 F. Supp. 359 (N.D. Ohio 1968)]

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The conclusion seems inevitable that if the courts are going to retain their traditional status as guardians of constitutional rights in today's modern era, when much of what has been deemed sacred is being questioned, a more forthright examination of legislation that impinges on these rights must be presented than that found in *Leary v. United States*. Even though the scientific evidence is not entirely conclusive, when first amendment rights are at stake a court cannot ignore the empirical studies, close its ears to the growing dissent over the national policy regarding marihuana, disregard the increasing discontent with the Judeo-Christian heritage which has led many to search for new meaningful experiences, and still maintain guardianship status. It is also doubtful that any *true* "balancing" or adjustment of competing interests can be made when such pertinent considerations are not included in the determination, and this is especially so when an extraordinary weight is accorded the dead hand of the past. It is submitted that if and when the guarantee of religious freedom is given its due, these considerations will be acknowledged and then it might be found that psychedelic religious experience and the "national welfare" are not antithetical.

STEPHEN M. O'BRYAN

INTERNAL REVENUE — 1965 TREASURY REGULATIONS — DISCRIMINATION AGAINST PROFESSIONAL CORPORATIONS

O'Neill v. United States, 281 F. Supp. 359 (N.D. Ohio 1968).

The concept of the "professional association or corporation" is characteristic of a new trend in professional practice. Since the 1930's, and especially since the end of World War II, the growth of "professional corporations" has been significant in number.¹ In many states today accountants, attorneys, physicians, pharmacists, optometrists, and others performing professional services are permitted by statute to incorporate.²

¹ Eaton, *Professional Corporations and Associations in Perspective*, 23 TAX L. REV. 1, 6 (1967). The growth of "professional corporations" is most noticeable within the medical profession. "According to the Public Health Service, there were in 1959, at least 1,623 medical groups of three or more persons, 22.7% of which were incorporated. . . . A reasonable estimate is that today there are at least 3,000 medical corporations and associations, not to mention other professions." Eaton & Maycock, *Final Professional Corporation Regulations are an Improvement — But Not Much*, 22 J. TAXATION 208-09 (1965).

² As of November 1967, 36 states had enacted "professional corporation" laws.

In an effort to halt the continuing growth of professional corporations the Commissioner of Internal Revenue issued the 1965 Treasury Regulations.³ These regulations destroyed the primary incentive for professional incorporation by depriving these corporations of the benefits of corporate tax treatment under the *Internal Revenue Code of 1954*.⁴

In the recent case of *O'Neill v. United States*,⁵ the validity of these regulations was squarely challenged.⁶ The plaintiff was one of 14 doctors employed by Drs. Hill & Thomas Co., a professional association under Ohio law providing radiological services to hospital and individual patients. In 1966 the plaintiff paid federal income tax as a partner in Drs. Hill & Thomas Co. Later the plaintiff sued the United States for a refund of federal income tax paid for the year 1966 maintaining that he should have paid his income tax as an employee-stockholder and not as a partner of Drs. Hill & Thomas Co.⁷ After a careful examination of Ohio's professional

Eaton, *supra* note 1, at 9. "Similar legislation has been introduced in approximately 14 other states, leaving New Hampshire as the only state where nothing has been done. . . . As recently as 1967 there has been legislative activity in Kansas, Montana and West Virginia." *Id.* at 9 n.52.

³ *Empey v. United States*, 272 F. Supp. 851, 852 (D. Colo. 1967) (appeal pending). See Eaton, *supra* note 1, at 15.

⁴ When "classified as 'corporations' for federal income tax purposes, [professional corporations] . . . will permit physicians, attorneys, and other professionals to enjoy the federal income tax advantages of qualified pension and profit-sharing plans and other devices open only to 'employees' . . ." Bittker, *Professional Associations and Federal Income Taxation: Some Questions and Comments*, 17 TAX L. REV. 1-2 (1961).

⁵ 281 F. Supp. 359 (N.D. Ohio 1968).

⁶ The first case challenging the validity of the 1965 Treasury Regulations was *Empey v. United States*, 272 F. Supp. 851 (D. Colo. 1967) (appeal pending). In this case the plaintiff, a stockholder-employee of Dexler and Wald Co., a law firm incorporated under Colorado law, sued for a refund of 1965 income tax maintaining that the law firm was a professional service corporation and not a partnership. The court held for the plaintiff and ruled the 1965 Treasury Regulations invalid. In addition, the court ruled that even if the regulations were valid, a law firm incorporated under a state statute "was a corporation for federal income tax purposes," because it exhibited characteristics which *resembled* the characteristics of corporations in general. *Id.* at 854.

⁷ The difference in the amount of tax [\$2164.69] results from: (1) the right to deduct as a corporation certain expenditures on behalf of the doctors who would be both the corporation's shareholders and employees, which would not be deductible by the doctors as partners in reporting their income from a partnership; (2) the attribution to the doctors as partners of all of a partnership's net income rather than only the salaries and any dividends which they received as employees and shareholders of a corporation. The deductions to which only a corporation would be entitled are those relating to deferred compensation through pensions and profit-sharing plans which must be for the benefit of an "employee", a term which for these purposes does not include a member of a partnership. Brief for Defendant at 2 n.1, *O'Neill v. United States*, 281 F. Supp. 359 (N.D. Ohio 1968).

association law⁸ the court held that Drs. Hill & Thomas Co. was a corporation under Ohio law and concluded that the plaintiff was entitled to a refund.

The court then considered Treasury Regulation 301.7701-2.⁹ Subsections (a-g) apply to all business organizations and prescribe the following corporate characteristics as necessary to qualify an organization for corporate tax treatment: (1) associates, (2) doing business and dividing profits, (3) centralized management, (4) limited liability, (5) continuity of life, and (6) transferability of interests.¹⁰ Subsection (h) of the regulations applies only to professional corporations and states in part that a professional corporation must possess the same corporate characteristics as any other business organization to qualify for corporate tax treatment under the *Code*. The standards for determining possession of the corporate characteristics under subsection (h), however, are different.

Under subsections (a-g) business organizations are classified as corporations if they exhibit characteristics which *resemble* the characteristics of corporations in general. Under subsection (h) professional corporations are classified as corporations only if they exhibit characteristics which are *identical* to the characteristics of an academic corporation as outlined in the regulations.¹¹ One important conclusion to be drawn from the stringent requirements for professional incorporation under the 1965 Treasury Regulations "is that professional corporations . . . will almost never be taxed as corporations."¹²

The significant issue before the *O'Neill* court was the validity of the discrimination against the "professional corporation" con-

⁸ OHIO REV. CODE ANN. §§ 1785.01-.08 (Page Supp. 1966). The *O'Neill* court was faced with a case of first impression under section 1785.04 in deciding whether a professional corporation enjoys limited liability under the Ohio statute. The court found that the shareholders of professional corporations in Ohio did have limited liability "[s]ince the [Ohio] statute refers to the person who performs and the person who receives professional service [and not to] . . . shareholders of a professional association in their capacity as shareholders." Vesely, *The Ohio Professional Association Law*, 13 W. RES. L. REV. 195, 203 (1962).

⁹ Treas. Reg. § 301.7701-2 (1965), T.D. 6797, 1965-1 CUM. BULL. 553.

¹⁰ See *Morrissey v. Commissioner*, 296 U.S. 344, 359 (1935).

¹¹ Treas. Reg. § 301.7701-2(h)(1)(i) (1965). The regulations apply to a single class of corporations and associations, namely, professional organizations, a special set of illogical standards which are not applied to others. They seek to deny corporate status to professional organizations under the test of identity, while treating all other organizations as corporate if they either are corporate in form or meet the fuzzy test of resemblance. Eaton, *supra* note 1, at 33.

¹² Eaton, *Professional Associations as Planning Techniques*, N.Y.U. 24TH INST. ON FED. TAX. 671-72 (1966).

tained in section 301.7701-2 (h) of the Treasury Regulations. The court resolved the issue by ruling this section invalid.¹³ "The discrimination [the court found was] not supported by the statute, judicial precedent, or sound tax policy."¹⁴

The court first questioned whether the discrimination against professional corporations in section 301.7701-2(h) was supported by the statutory language of the *Internal Revenue Code*. The government had contended that section 301.7701-2(h), construing section 7701 of the *Internal Revenue Code*, prescribed a valid test for determining whether a business organization is a corporation for federal income tax purposes. In support of its position, the government pointed to many cases where *unincorporated* business organizations had been found to have corporate characteristics for federal tax purposes.¹⁵ It would logically follow then that business organizations, like Drs. Hill & Thomas Co., *incorporated* under state statutes could well be found *not* to possess the corporate characteristics necessary to qualify them for corporate tax treatment.

The court held the government's position to be inconsistent with the statutory language in section 7701(a) of the *Internal Revenue Code*.¹⁶ Section 7701(a), the court noted, delineates what is meant by the terms corporation and partnership. Under the *Code* partnership is said to include in part "a syndicate, group, pool, joint venture, or *other unincorporated* organization . . ." ¹⁷ The term corporation under the *Code* includes "associations, joint-stock companies, and insurance companies."¹⁸ No provision is made under either of the definitions for the incorporated business organization. While the *Code's* definition of partnership specif-

¹³ The *O'Neill* court was the first court to hold only section 301.7701-2(h) of the regulations to be invalid. *Empey v. United States* went further holding the whole set of regulations to be invalid. The two recent cases of *Kurzner v. United States*, P-H 1968 FED. TAX SERV. (21 Am. Fed. Tax R.2d § 68.5049 (N.D. Fla. July 3, 1968), and *Holder v. United States*, P-H 1968 FED. TAX SERV. (21 Am. Fed. Tax. R.2d) § 68-5051 (N.D. Ga. July 18, 1968), have sustained the *O'Neill* approach holding only section 301.7701-2(h) to be invalid.

¹⁴ 281 F. Supp. at 364.

¹⁵ See, e.g., *Helvering v. Coleman-Gilbert*, 296 U.S. 369, 373-74 (1936); *Helvering v. Combs*, 296 U.S. 365, 368-69 (1936); *Swanson v. Commissioner*, 296 U.S. 362, 365 (1936); *Morrissey v. Commissioner*, 296 U.S. 344, 360 (1936); *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954); *Foreman v. United States*, 232 F. Supp. 134 (S.D. Fla. 1964); *Galt v. United States*, 175 F. Supp. 360 (N.D. Texas 1959).

¹⁶ INT. REV. CODE OF 1954, § 7701 (a) [hereinafter cited as CODE]. These definitions have remained unchanged since their enactment in 1917. 7 J. MERTENS, FEDERAL INCOME TAXATION § 38.02 (1967).

¹⁷ CODE § 7701(a)(2) (emphasis added).

¹⁸ *Id.* § 7701(a)(3).

ically includes *other unincorporated organizations* it prescribes no criteria for determining what is an *unincorporated organization*. In the absence of meaningful criteria, one is drawn to the conclusion that state law determinations were meant to be applied.¹⁹

If indeed this is the applicable test, a business organization incorporated under state law could never be an *unincorporated organization* under the *Code* definition of partnership. Thus, the business organization incorporated under state law must necessarily be considered a corporation under the *Code* definition. Reaching this conclusion the *O'Neill* court stated "that any attempt by the Treasury through regulation . . . to tax an incorporated entity as a partnership . . . runs directly contrary to the language of Section 7701(a)(2) and must be stricken as beyond the statutory purpose."²⁰

The court also questioned whether the regulation's discrimination against the professional corporations was supported by judicial precedent. The government had contended that section 301.7701-2(h) of the Treasury Regulations was a valid "interpretative rule"²¹ that should be given special consideration by the courts.²² The government maintained that section 7701(a)(2) of the *Internal Revenue Code* had been reenacted without change in successive revenue acts since 1917 and that this reenactment indicated legislative approval of the Commissioner's interpretation that state labels are of little significance in determining whether a business organization qualifies for corporate tax treatment under the federal income tax laws.

An examination of the legislative history of section 7701(a)(2), however, gives no indication that Congress has ever examined this particular section of the *Code* indepth.²³ Further, no judicial pre-

¹⁹ *Accord*, Scallen, *Federal Income Taxation of Professional Associations and Corporations*, 49 MINN. L. REV. 603, 622-23 (1965).

²⁰ 281 F. Supp. at 363.

²¹ Regulations generally are broken down into two classes, namely "interpretive rules" and "legislative rules." . . . Courts will normally consider legislative rules in the light of the authorizing legislation, and will not disturb the rule unless it is unreasonable and not within the authority granted. On the other hand interpretive rules are subject to judicial reversal merely on the independent judgment of the judge. Even though the Internal Revenue Code specifically provides that the Commissioner shall have the power to promulgate all necessary rules and regulations for the enforcement of the taxes therein levied, these regulations have been held to be interpretive regulations. Editorial, *Professional Associations in Ohio*, 31 U. CIN. L. REV. 71, 74 (1962).

²² Courts have often attributed considerable significance to the interpretative regulations due to the fact that these regulations are often the subject of legislative reenactment and long-standing administrative interpretation. See Rogovin, *The Four R's: Regulation, Ruling, Reliance, and Retroactivity*, 43 TAXES 156 (1965).

²³ 281 F. Supp. at 363.

cedent exists to support the Commissioner's interpretation that a state labeled corporation could be found to be a partnership for federal tax purpose.²⁴ In the absence of indepth Congressional examination of section 7701(a)(2) and in the absence of judicial decisions interpreting that section, the government's argument based solely on legislative reenactment was tenuous at best.

The government further argued that section 7701(a)(2) was entitled to special significance by the courts because it had been the subject of long-standing administrative interpretation. The court found, however, that the government's position with respect to professional corporations was neither consistent nor long-standing. The government's shifting course has been briefly charted as follows:

[T]he Treasury has gone from the pre-*Kintner* regulations sweeping all doubtful cases into the corporate category, to a more neutral position in the *Kintner* [1960] regulations relying heavily on local law, and finally to the 1965 regulations, which cast almost all "doubtful" cases (or at least professional organizations) into the partnership category.²⁵

In view of the government's vacillation from initially encouraging the finding of corporate existence in doubtful cases, to later discouraging the finding of corporate existence in doubtful cases, it can hardly be claimed that section 7701(a)(2) has been the subject of consistent and long-standing administrative interpretation. Thus, the *O'Neill* court concluded "that there is no support for this discrimination either in the cases or by reason of statutory interpretation of the Internal Revenue Code."²⁶

The court lastly questioned whether discrimination against professional corporations in section 301.7701-2(h) could be supported by strong tax policy considerations. One justification advocated by the government is that professional corporations do "not earn the kind of income normally earned by a corporation."²⁷ However,

[t]he fallacy of this argument is readily apparent when one considers the large number of corporations presently existing in our economy whose primary income is earned solely from the personal services of their employees. The corporate tax status of businesses engaged in advertising or promotion, investigation, sales, contract

²⁴ *Id.*

²⁵ Eaton, *supra* note 1, at 32-33. The case referred to is *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954).

²⁶ 281 F. Supp. at 364.

²⁷ *Foreman v. United States*, 232 F. Supp. 134, 137 (S.D. Fla. 1964).

janitorial or secretarial service, to name a few, has not been seriously questioned to the Court's knowledge.²⁸

The *O'Neill* court here concluded that "as a matter of tax policy [it could] . . . not see any factual or legal characteristics which would justify different tax treatment of closely held professional service organizations, on the one hand, and closely held non-professional organizations, on the other hand."²⁹

Having found the discriminatory treatment of professional corporations to be unsupported by "statute, judicial precedent, or sound tax policy,"³⁰ the *O'Neill* court concluded that section 301.7701-2(h) of the Treasury Regulations was invalid and judicially unenforceable. Turning to sections 301.7701-2(a-g), the court found that Drs. Hill & Thomas Co. exhibited characteristics which *resembled* the characteristics of corporations in general³¹ and rendered judgment for the plaintiff and granted his request for a refund.

In considering subsections (a-g) of section 301.7701-2, the *O'Neill* court and other courts³² have failed to direct themselves specifically to the government's contention that professional corporations do not meet the corporate characteristics necessary for corporate tax treatment as outlined in section 301.7701-2(h).³³ Instead, the courts have been content to conclude that the stringent requirements for professional incorporation under the regulations are not supported by "statute, judicial precedent, or sound tax policy." It would seem that a more logical approach would be for the courts first to set out the specific instances of discrimination within the regulations, and then to conclude that such discrimination itself is not supported by "statute, judicial precedent, or sound tax policy."

The first instance of discrimination within section 301.7701-2(h) of the regulations is seen in the required corporate characteristic of centralized management.³⁴ The contention here is that the

²⁸ *Id.*

²⁹ *Id.* at 364.

³⁰ *Id.*

³¹ See notes 11-13 *supra* & accompanying text.

³² *Holder v. United States*, No. 801 (N.D. Ga., July 18, 1968); *Kurzner v. United States*, 286 F. Supp. 839 (S.D. Fla. 1968); *Empey v. United States*, 272 F. Supp. 851 (D. Colo. 1967) (appeal pending).

³³ Brief for Defendant at 19-23, *O'Neill v. United States*, 281 F. Supp. 359 (N.D. Ohio 1968).

³⁴ Since associates and an objective to carry on business and divide the gains therefrom are generally common to both corporations and partnerships, the determination of whether an organization which has such characteristics is

professional relationship with a client or patient must always remain confidential and that the professional person cannot be subject to corporate control in the handling of clients and patients and still preserve the professional obligation of confidentiality.³⁵ At this point, however, the courts could point out that all other business organizations striving to meet the corporate requirement of centralized management need show only that some general overriding policy of management is in existence.³⁶ The conclusion could then be drawn that a standard of centralized management so strict as to interfere with each and every decision made by a professional person with respect to every client is discriminatory and invalid.³⁷

A second instance of discrimination within the regulations can be found in the section on limited liability. The contention made is that a professional person cannot claim that his liability is limited to the extent of his shareholder interest in the corporation³⁸ while he denies liability for his professional wrongdoings.³⁹ Here the courts ought to find that "[i]t is not uncommon for shareholders of [ordinary] business corporations to assume certain liabilities" beyond their shareholder interest.⁴⁰ Thus, the courts would

to be treated for tax purposes as a partnership or as an association depends on whether there exists *centralization of management, continuity of life, free transferability of interests, and limited liability*. Treas. Reg. § 301.7701-2 (1965) (emphasis added).

³⁵ In applying the rules . . . relating to centralization of management, a professional service organization . . . under local law [is] not vested with the continuing exclusive authority to determine any one or more of the following matters: (i) The hiring and firing of professional . . . and lay employees, (ii) the compensation of the members and of such employees, (iii) the conditions of employment — such as working hours, vacation periods, and sick leave, (iv) the persons who will be accepted as clients or patients, (v) who will handle each individual case or matter, (vi) the professional policies and procedures to be followed in handling each individual case, (vii) the fees to be charged by the organization, (viii) the nature of the records to be kept, their use, and their disposition, and (ix) the times and amounts of distributions of the earnings of the organizations to its members as such. Treas. Reg. § 301.7701-2(h)(3) (1965).

³⁶ "Officers in ordinary business corporations are allowed to exercise independent judgment in day-to-day operations, so long as this is within the framework of broad policy established by the board of directors." Eaton, *supra* note 1, at 42-43.

³⁷ "Probably not even ordinary, nonregulated businesses could comply with the rigid standards here applied to the professions." *Id.* at 42. *But see* Bittker, *supra* note 4, at 14-15.

³⁸ "A professional service organization has the corporate characteristic of limited liability . . . only if the personal liability of its members, in their capacity as members of the organization, is no greater in any aspect than that of shareholder-employees of an ordinary business corporation." Treas. Reg. § 301.7701-2(h)(4) (1965).

³⁹ Bittker, *supra* note 4, at 13.

⁴⁰ Eaton, *supra* note 1, at 44. Eaton goes on to say that "many jurisdictions have statutes imposing special assessments; and even federal taxes are collectible from

conclude that a ruling that requires the liability of a professional corporation's members to be limited in every aspect of their relationship to the corporation.

The third instance of discrimination within section 301.7701-2(h) is seen in the area of free transferability. Here, the argument made is that the corporate characteristic of free transferability is not met by the professional corporation if there exists a stipulation that all shares of stock must be sold only to licensed professionals and that in the event of the death of a shareholder, the stock must be first offered to the corporation before it can be sold to others.⁴¹ The courts might well rule that, even though there are restrictions attached to the transferability of professional corporation stock, the restrictions are scarcely sufficient to find the element of free transferability totally lacking.⁴² Indeed, the courts could hold that the unique requirement, that professional corporation stock must be freely transferable to anyone at any time, is unduly strict and clearly discriminatory and invalid.

The final instance of discrimination within the regulations is found in the section dealing with continuity of life. The contention here is that personal agreements among professional members of an organization to repurchase the stock of members whose employment relationship has terminated does not satisfy the corporate requirement of continuity of life under the regulations.⁴³

shareholders under the rules of transferee liability of section 6901. None of these encroachments on pure limited liability has ever been held to diminish corporate status." *Id.* See also Scallen, *supra* note 20, at 685.

⁴¹ [I]f the interest of a member of a professional service organization constitutes a right to share in the profits of the organization which is contingent upon and inseparable from the member's continuing employment relationship with the organization, and the transfer of such interest is subject to a right of first refusal, such interest is subject to a power in the other members of the organization to determine not only the individuals whom the organization is to employ, but also who may share with them in the profits of the organization. . . . [I]f a member of a professional service organization who possesses such an interest may transfer his interest to a qualified person who is not a member of the organization only after having first offered his interest to the other members of the organization at its fair market value, the corporate characteristic of free transferability of interests does not exist. *Treas. Reg. § 301.7701-2(h)(5)(ii)* (1965).

⁴² See Eaton, *supra* note 1, at 46. *But see* Bittker, *supra* note 4, at 20.

⁴³ If local law, applicable regulations, or professional ethics do not permit a member of a professional service organization to share in its profits unless an employment relationship exists between him and the organization, and if in such case, he or his estate is required to dispose of his interest in the organization if the employment relationship terminates, the continuing existence of the organization depends upon the willingness of its remaining members, if any, either to agree, by prior arrangement or at the time of such termination, to acquire his interest or to employ his proposed successor. The

The courts should hold that the corporate characteristic of continuity of life has generally been applied to the continued existence of an organization and not necessarily to the continued existence of an organization's shareholders or employees.⁴⁴ The courts could then conclude that the regulation is discriminatory and invalid in directing that the corporate characteristic of continuity of life be geared to the continued existence of the individual shareholder and not to the continued existence of the professional corporation.

In dealing specifically with the government's contention that professional corporations do not meet the corporate characteristics necessary for corporate tax treatment, the courts would not only present a more thorough analysis with respect to the issue of the validity of the regulations, but they would also have established a strong foundation upon which to find that the instances of discrimination within the regulations are not supported by "statute, judicial precedent or sound tax policy." The courts' analysis, however, should not stop here.

The 1965 Treasury Regulations were issued by the Commissioner of the Internal Revenue Service to halt the growth of professional corporations.⁴⁵ More precisely, these regulations were an attempt to preclude professional people from enjoying the benefits of corporate tax treatment under the federal income tax laws. The severe attitude adopted by the Commissioner, as evidenced by the stringent requirements for professional incorporation, was founded on the belief "that professional corporations are 'inherently different' from . . . ordinary business corporations."⁴⁶ Thus far, only the validity of the regulations has been challenged by the courts. The real issue, however, is whether the professional corporation is so inherently different from the ordinary business organization as to justify denial of corporate tax treatment under the federal tax law.

An examination of the legislative history of the federal tax laws reveals that corporations have always been permitted to retain excess profits in the hope that these profits might be reinvested

continued existence of such a professional service organization is similar to that of a partnership formed under the Uniform Partnership Act, whose business continues pursuant to an agreement providing that the business will be continued by the remaining members after the withdrawal or death of a partner . . . and is essentially different from the continuity of life possessed by an ordinary business corporation. Consequently, such a professional service organization lacks continuity of life. *Treas. Reg. § 301.7701-2(h)(2) (1965).*

⁴⁴ Eaton, *supra* note 1, at 40. *But see* Bittker, *supra* note 4, at 17.

⁴⁵ See note 3 *supra*.

⁴⁶ Eaton, *supra* note 12, at 671-72; Eaton, *supra* note 1, at 36-37.