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Taxes - Corporate Taxation - Classification of Professional Service Corporations for Income Tax Purposes - Empey v. United States, 272 F. Supp. 851 (D. Colo. 1967), aff'd, 406 F.2d 157 (10th Cir. 1969)

T. Michael Carrington

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COMMENTS

TAXES — CORPORATE TAXATION — CLASSIFICATION OF PROFESSIONAL SERVICE CORPORATIONS FOR INCOME TAX PURPOSES.* — *Empey v. United States,* 272 F. Supp. 851 (D. Colo. 1967), *aff'd,* 406 F.2d 157 (10th Cir. 1969).

A GROUP of Colorado lawyers formed a professional service corporation pursuant to a rule promulgated by the Colorado Supreme Court.[1] Plaintiff Empey, a stockholder in this corporation, applied for a tax refund allegedly due him. When the Internal Revenue Service failed to take affirmative action on the refund application, Empey brought suit in federal district court.[2] The government argued that the organization to which Empey belonged was not a corporation for federal income tax purposes. The Tenth Circuit Court of Appeals affirmed the trial court's determination that this was a corporation for federal tax purposes and the regulation saying that it wasn't, was contrary to the *Internal Revenue Code,* previous case law, and previous regulations.

As a result of the decision in *Empey,* professional corporations and associations have gained a stronger foothold for survival and have become an important consideration in tax planning for professional service people. These professional associations had traveled an uncertain path; the developments up to *Empey* have formed into a somewhat comical story of the battle between the Treasury and the professional service taxpayer. The development and future of the tax treatment problem for professional service taxpayers are the subjects of this article.

The conflict on how to treat an organization for tax purposes appeared in 1935 when the United States Supreme Court held in *Morrissey v. Commissioner*[3] that a trust set up to run a business resembled an association enough to be treated for tax purposes like a corporation. Thus, if an organization's characteristics resembled

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* The Treasury officially abandoned its long opposition to corporate tax treatment for professional service corporations in August 1969. Technical Information Release No. 1019 Aug. 8, 1969. The Release allows corporate tax treatment for those persons incorporating under state laws professional service corporations. Currently, only four states do *not* allow such corporations: Iowa, Nebraska, New York, and Wyoming. 56 TAXES ON PARADE No. 35, part 1, at 4, July 30, 1969.

[1] On December 5, 1961, at the request of the Colorado Bar Association, the Colorado Supreme Court promulgated rule No. 231, now rule 265 *Colo. R. Civ. P.*

[2] Empey v. United States, 272 F. Supp. 851 (D. Colo. 1967), *aff'd,* 406 F.2d 157 (10th Cir. 1969).

[3] 296 U.S. 344 (1935).

substantially those of a corporation, it would be classified as an "association," associations being taxed as though they are in fact corporations. The Court posed four questions in *Morrissey,* the answers to which should be used to determine whether or not an organization should be treated as an association for tax purposes: (1) whether or not an organization has a centralized management; (2) whether or not there is a continuity of enterprise; (3) whether or not there is a means of transferability of interests without ending continuity; and (4) whether or not limited liability exists. The Court, however, did not limit the test to these four attributes. It thought inquiry should be made as to who held title to the property — was title held by an entity separate from the principals of the organization?[4] In a close case, the Court seemed to think that an important factor to consider would be how the organization represented itself to the public.[5]

In 1936 the Commissioner of Internal Revenue argued in *Pelton v. Commissioner*[6] that a clinic formed by a group of Illinois physicians should be taxed as a corporation rather than as a partnership, even though physicians could not form a corporation under Illinois law. The court agreed with the argument that the clinic was carrying on business for a profit and had substantial similarities to a corporate organization sufficient to qualify the organization as a corporation for tax purposes. To determine whether or not it substantially resembled a corporation the court used the test set up in *Morrissey.*[7] The court also held that national uniformity required that the title a state gave to an organization was not conclusive, but that the court must examine actual form and characteristics in determining how the organization should be treated under federal tax law.[8]

Some professional service taxpayers, however, wanted the benefit of some of the tax advantages of the corporate form. Health, retirement, and death benefits were far greater, at lower tax rates, and the corporation was able to deduct payments into these funds or plans as a proper business expense. In response to these taxpayers, the government seemed to change its position. In *United States v. Kintner,*[9] it has argued that a group of Montana physicians should be taxed as a partnership and not as a corporation. However, the court found that although the physicians could not incorporate

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[4] *Id.* at 345.

[5] *Id.* at 360.

[6] 82 F.2d 473 (7th Cir. 1936).

[7] *Id.* at 476.

[8] *Id. See also* Helvering v. Combs, 296 U.S. 365 (1935).

[9] 216 F.2d 418 (9th Cir. 1954).

under Montana law, their organization more closely resembled a corporation than any other type or form of organization. The organization was run by some rather than all of the former partners, it incurred debts in the name of the association, it paid federal and state corporate taxes, its members received their compensation from the association and not from individual clients and death or retirement of one or more members would not cause dissolution of the organization. The resemblance hence was substantially that of a corporation, even though the interest of a member was not assignable as is the normal corporate interest.

A few years later, in *Galt v. United States*,[10] a group of Texas physicians won corporate tax treatment even though they could not legally incorporate under Texas law. The court said:

> We think the association was entitled to be treated for tax purposes as though it was a corporation and the act of a state can neither raise nor lower the federal taxes that may be due by the association by whatever name it may be called under the laws of the particular state.[11]

On December 23, 1959, the Treasury announced newly proposed regulations to show its position on professional associations. In 1956, as expected, the Department had announced that it would not follow the *Kintner* decision.[12] However, in 1960 the Department adopted the strongly protested "Kintner Regulations."[13] Under the "Kintner Regulations" an organization had to have the following characteristics in order to qualify for corporate tax treatment: (1) associates; (2) the objective of carrying on business for profit with subsequent division of that profit; (3) continuity of life; (4) limited liability; (5) centralization of management; and (6) free transferability of ownership interests. The regulations go on to say that items (1) and (2) are of lesser importance because they are common to both corporations and partnerships and that to be treated as a corporation for tax purposes an organization must have more corporate characteristics than noncorporate characteristics.

These new regulations ignored previous case law which held that general partnerships could be taxed as corporations even though they were treated as general partnerships under local law[14] and

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[10] 175 F. Supp. 360 (N.D. Tex. 1959).

[11] *Id.* at 362.

[12] Rev. Rul. 56-23, 1956-1 CUM. BULL. 598.

[13] Treas. Reg. § 301.7701-2 (1960).

[14] Burke-Waggoner Oil Ass'n. v. Hopkins, 269 U.S. 110 (1925); United States v. Kintner, 216 F.2d 418 (9th Cir. 1954); Wabash Oil & Gas Ass'n. v. Commissioner, 160 F.2d 658 (1st Cir. 1947), *cert. denied*, 331 U.S. 843 (1947); Popular Bluff Printing Co. v. Commissioner, 149 F.2d 1016 (8th Cir. 1945); Bert v. Helvering, 92 F.2d 491 (D.C. Cir. 1937); Wholesalers Adjustment Co. v. Commissioner, 88 F.2d 156 (8th Cir. 1937); Cincinnati Stamping Co., 45,258 P-H Mem. T.C. (1945).

that local law did not control how an organization was treated for federal tax purposes.[15] The "Kintner Regulations" also seemed inconsistent or more strict than previous regulations which did not even mention limited liability or free transferability of ownership interests.[16] In fact, these regulations specifically state that a partnership lacks one of the essential requirements of a corporation:

> Accordingly, a general partnership subject to a statute corresponding to the Uniform Partnership Act and a limited partnership subject to a statute corresponding to the Uniform Limited Partnership Act both lack continuity of life.[17]

When it became apparent that to qualify for corporate tax treatment a general partnership must incorporate under state law, states sympathetic to professional taxpayers acted quickly. In 1961 and 1962 alone 18 states enacted laws to allow professional associations or corporations.[18]

While the Treasury and professional service taxpayers were battling, Congress was attempting to solve the root of the problem — tax inequality between self-employed individuals and corporate employees. The Keogh Bill, known as H.R. 10 or the Self-Employed Individuals Tax Retirement Act of 1962 was delayed time and again in the Senate Finance Committee before it was finally passed in 1962. The Treasury was strongly against the Keogh Bill in its original form and it was only with Treasury sponsored changes that the bill passed at all.[19]

Because of its amended form and the delay in its approval the Keogh Bill only partially bridged the gap in tax treatment between corporate and professional service taxpayers. Professional service taxpayers had their expectations raised during the debates and were severely disheartened by the result. One effect was an increased desire on their part to achieve corporate tax status, which led ultimately to an amendment to the Bill in 1966 which narrowed the gap, but did not close it completely.[20]

This amendment altered one of the features of the original act, that the self-employed could deduct only half of the amount

[15] *See* Galt v. United States, 175 F. Supp. 360 (N.D. Tex. 1959).

[16] For an excellent discussion of the history of this problem, *see* Bye & Young, *Law Firm Incorporation in Colorado,* 34 ROCKY MT. L. REV. 427 (1962).

[17] Treas. Reg. § 301.7701-2(1)(3) (1960).

[18] *See* Bye & Young, *supra* note 16, at 434.

[19] For an interesting discussion on H.R. 10's problems and battles, *see* Rapp, *The Quest for Tax Equality for Private Pension Plans: A Short History of the Jenkins-Keogh Bill,* 14 TAX L. REV. 55 (1958). The new law was to take effect for taxable years after December 31, 1962.

[20] The amendment was by a rider on the Foreign Investors Tax Act of 1966. Act of November 13, 1966, Pub. L. No. 89-809, § 204, 80 Stat. 1577. It still gives an inferior treatment to professional service and other self-employed taxpayers when compared to corporate benefits. Incorporation should be given serious consideration by all professional service-self-employed taxpayers.

contributed to retirement and profit-sharing plans with a maximum of \$1,250 being deductible.[21] The amendment provides that for those years beginning after December 31, 1967, the entire contribution for a self-employed person is deductible up to \$2,500 or 10 percent of earned income, whichever is less.[22] Contributions for employees are deductible in full up to a standard limitation of 15 percent of their compensation. If both pension and profit sharing plans are in effect, then the standard limitation is 25 percent. The corporation has no limit to how much more it may want to contribute to the plans as long as the contribution is the *reasonable* actuarial cost of funding benefits. If the 15 percent limitation is not reached in any year the remaining contribution deduction may be carried forward indefinitely. However, an employer cannot deduct in any year more than 30 percent of participating employees' compensation.[23]

Distribution of the benefits of an H.R. 10 plan cannot be made to a self-employed person who is an owner-employee before he reaches the age of 59½ unless he is permanently disabled, but benefits must start before he reaches the age of 70½.[24] This limitation is applicable evn if the plan is terminated.[25] The only restriction on when benefits can be distributed to an employee, defined as one who is less than a 10 percent partner, is that payments must start before the age of 70½.[26] Thus, an employee may receive benefits if he retires, is disabilitated, dies, is discharged, or quits before he reaches the age of 70½. Total distribution of the benefits must be made within five years of death or can be used to buy an immediate annuity payable on the life of a beneficiary.[27]

H.R. 10 plans may be pension, profit sharing, or annuity plans and are in the forms of Trusteed plans,[28] Annuity plans,[29] Custodial Account plans,[30] U.S. Government Bond plan,[31] and Face-Amount Certificate plans.[32] H.R. 10 originally amended twenty sections of the *Internal Revenue Code* of 1954 relating to corporate retirement arrangements and provided one additional section,[33] which

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21 INT. REV. CODE OF 1954, §§ 404(a)(10), 404(e)(1).
22 *Id.* § 404(e)(1).
23 *Id.* § 404(a)(3)(7).
24 *Id.* § 401(d)(4)(B).
25 Rev. Rul. 65-21, 1965-1 CUM. BULL. 174.
26 INT. REV. CODE OF 1954, § 401(a)(9).
27 *Id.* § 401(d)(7).
28 *Id.* § 401(d)(1).
29 *Id.* §§ 401(g), 403.
30 *Id.* § 401(f).
31 *Id.* § 405.
32 *Id.* §§ 401(g), 403.
33 *Id.* § 405.

described newly created bonds for investments for H.R. 10 plans. The key sections to H.R. 10 are the sections governing qualification[34] and deductions.[35] H.R. 10 plans are more restricted in types of investments that can be made than are corporate plans. The earnings from H.R. 10 funds are tax free like corporate fund earnings,[36] and both have the advantage of distributing the benefits when the beneficiary is in a lower income tax bracket than he was when he made the contributions.

Another difference between H.R. 10, even after amendment, and corporate plans is in discrimination (discriminatory in giving favored treatment to shareholders, officers, persons who are high in management, and highly paid employees). A corporation may discriminate to a far greater extent than H.R. 10 plans can.[37] Health and accident, wage contribution plans, insurance plans, and death benefits, for instance, do not come under corporate discrimination prohibitions; and those prohibitions against discrimination that do, can be easily avoided in a close corporation. H.R. 10 plans must include all employees with three or more years of continuous service, while a corporate plan has no such limitation.[38] The benefits going to a corporate executive, limited only by the prohibition against discrimination in favor of stockholders, officers, and highly salaried employees,[39] can be far better and more complete in coverage. H.R. 10 plans can not get capital gains treatment for lump sum distributions, estate tax exclusions on death benefits,[40] gift tax exclusions[41] nor the $5000 tax-free death benefit[42] which are all available under corporate plans. Thus, H.R. 10, even in its

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[34] *Id.* § 401.

[35] *Id.* § 404.

[36] *Id.* § 501(a).

[37] *Id.* §§ 401(a), 401(d)(3).

[38] *Id.*

[39] *Id.* § 401(a).

[40] *Id.* §§ 2039(c), 2039(c)(2), 2037, 2038.

[41] *Id.* §§ 2517, 2517(b).

[42] *Id.* §§ 101(b), 101(b)(3). There are other less important differences. H.R. 10 plans vest immediately while it may be possible for corporate plans not to vest at all. Corporate profit sharing plans may take up to 10 years before vesting and 20 years or more for pension plans. When the corporate employee leaves the corporation he receives the percentage of his contribution vested. Contributions for self-employed can't exceed one-third of the total contribution to social security. There is no such restriction for corporate plans. A self-employed cannot borrow from trust plans, cannot buy from or sell to trusts and cannot charge for his services for the trust. Corporate employees can borrow from the trust if adequate security is given and a reasonable interest rate is charged, employees can buy from or sell to trusts if adequate consideration is given, and employees can charge for reasonable value of services to the trust. The trustee for an H.R. 10 plan must be a bank, while corporate plans have no such trustee restrictions. As mentioned before, the distribution of benefits under corporate plans is free from restriction and has much broader limitations on amount of deductions, providing the requirements of *Int. Rev. Code of 1954.* §§ 162, 212 are complied with *See Id.* §§ 404(a)(1), 404(a)(3).

amended form, does not put the self-employed on equal ground with corporate employees.[43]

Before H.R. 10 was amended in 1966, some interesting developments occurred that probably gave some extra incentive to pass the amendment. In 1964, it was held in *Foreman v. United States*[44] that a group of Florida physicians should be allowed corporate status for tax purposes. As in the *Kintner*[45] and *Galt*[46] cases, the organization met all the *Morrissey*[47] requirements except limited liability. Therefore, the court held that the organization's characteristics were substantially those of a corporation.

At this time more and more states were making it possible for professional service corporations to incorporate. This response by states and the current of cases against the I.R.S. caused the Treasury to promulgate a change in the regulations in 1965.[48] The regulations published by the Treasury in 1960, showing its position on professional associations, had as its first example[49] a situation quite similar to the *Kintner* facts except that it set forth a modified form of transferability of interests of its members. The example also had a striking resemblance to the *Galt* factual situation. However, the new regulations deleted this example and added an additional requirement for professional service organizations[50] that made it

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[43] INT. REV. CODE OF 1954, §§ 402(a)(2), 403(a)(2), 403(a)(2)(A).

[44] 232 F. Supp. 134 (S.D. Fla. 1964).

[45] United States v. Kintner, 216 F.2d 418 (9th Cir. 1954).

[46] Galt v. United States, 175 F.Supp. 360 (N.D. Tex. 1959).

[47] Morrissey v. Commissioner, 296 U.S. 344 (1935).

[48] Treas. Reg. § 301.7701-2(h) (1965).

[49] *Id.* § 301.7701-2(g) (1960), Example 1.

[50] On February 2, 1965, Treas. Reg. § 301.7701-2(h) (1965) was added. The following are the parts of 2(h) that the *Empey* court thought pertinent:

> (h) Classification of professional service organizations. (1) (i) A professional service organization is treated as a corporation (or as an association and, therefore, taxable as a corporation) only if it has sufficient corporate characteristics to be classifiable as a corporation under paragraph (a) of this section, rather than as a partnership or proprietorship. For purposes of determining the classification of an organization under these regulations, the term "professional service organization," as used in this paragraph, means an organization formed by one or more persons to engage in a business involving the performance of professional services for profit which under local law, may not be organized and operated in the form of an ordinary business corporation having the usual characteristics of such a corporation. Thus, even if a professional service organization is organized as an ordinary business corporation, this paragraph applies if such corporation is subject to local regulatory rules which deprive such corporation of the usual characteristics of an ordinary business corporation. . . .
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> (2) . . . A business corporation has a continuing identity as an entity which is not dependent upon a shareholder's active participation in any capacity in the production of the income of the corporation. Furthermore, the interest of a shareholder in an ordinary business corporation includes a right to share in the profits of the corporation, and such right is not legally dependent (determined without regard to any agreement among the share-

almost impossible for a professional service organization to qualify for corporate tax treatment. This set the stage for the *Empey* court battle between the Treasury and the professional service organizations.[51]

The judicial challenge of the 1965 regulations by a legal organization in Denver culminated in 1967 in *Empey v. United States.* The district court held for Empey and the Treasury Department appealed to the United States Court of Appeals, Tenth Circuit.[52] In

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holders) upon his participation in the production of the corporation's income. However, the interest of a member of a professional service organization generally is inextricably bound to the establishment and continuance of an employment relationship with the organization, and he cannot share in the profits of a professional service organization unless he also shares in the performance of the services rendered by the organization. For purposes of this paragraph, the term "employment relationship" is used to describe such active participation by the member and is not restricted to the common law meaning of such term. If local law, [or] applicable regulations . . . 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. . . .

. . . .

(5) (i) If the right of a member of a professional service organization to share in its profits is dependent upon the existence of an employment relationship between him and the organization, free transferability of interests within the meaning of paragraph (e) of this section exists only if the member, without the consent of other members, may transfer both the right to share in the profits of the organization and the right to an employment relationship with the organization.

(ii) . . . [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. The possession by other members of the power to determine, in connection with the transfer of the power to determine, in connection with the transfer of such an interest, whom the organization is to employ is so substantial a hindrance upon the free transferability of interests in the organization that such power precludes the existence of a modified form of free transferability of interests. Therefore, if 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.

Many anticipated that the new regulations would not change the court positions already established.

Few if any new style professional organizations will be able to meet the standards of the 1965 regulations, but since they are "interpretive" rather than "legislative" regulations and were issued long after the statutory provision they interpret, they will probably not weigh very heavily with the flood of litigated cases that can be anticipated.

B. BITTKER & S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 38 (2d ed. 1966) [hereinafter cited as BITTKER].

[51] 272 F.Supp. 851 (D. Colo. 1967).

[52] *See* 81 HARV. L. REV. 1356 (1968) for initial comments.

the 1968 November term, the circuit court affirmed the district court's invalidation of Treas. Reg § 301.7701-2(h).[53]

To provide a background for the *Empey* case, it should be stated that prior to 1962, the Treasury Department prohibited corporate employees from practicing before it; but in that year, the Department amended its requirements concerning those qualified to engage in such practice.[54] The amendment allows professional service corporation employees to carry on their tax practice before the Treasury Department. In response to this amendment and due to the fact that in Colorado lawyers are permitted to incorporate under the General Business Corporation Act,[55] a group of Denver attorneys who specialized in tax matters decided to incorporate.

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[53] 406 F.2d 157 (10th Cir. 1969). A review of the opposing arguments is informative. The Treasury Department argued in *Empey,* as stated in its appellant brief, that *Int. Rev. Code of* 1954, § 7701(a)(2) clearly permits an organization incorporated under state law to be classified as a partnership for federal tax purposes, and that if an organization more closely resembles a partnership than a corporation in its essential and relevant characteristics it must be taxed as a partnership even though it is incorporated under state law. The Treasury further argued that Drexler and Wald Professional Company more closely resembled a partnership since: (1) it did not have free transferability of interests because the stock had to be offered first to the company and if refused permission had to be obtained to sell to an outside lawyer; (2) lacked continuity of life since the state supreme court could cause the corporation to cease being one; (3) lacked limited liability because members were jointly and severally liable; and (4) lacked centralized management in the manner that they actually operated. Finally the Treasury argued that if the regulations were invalid, Drexler and Wald still did not qualify under the 1960 regulations and by the standards stated in *Morissey.*

Ellis J. Sobol, of Drexler and Wald Professional Company, argued in the appellee's brief that the Treasury's 1965 regulations were unreasonable, plainly inconsistent with the statute, and amounted to administrative legislation and thus should be void; and if the 1965 regulations were not void, the professional company still possessed the attributes of corporate resemblance as set forth in the regulations and the decided cases. The amicus curiae brief filed by the Colorado Bar Association argued that corporations validly chartered under state law are included in the term "corporation" as used in the *Int. Rev. Code of 1954,* § 7701(a)(3), and are excluded from the term "partnership" as used in *Int. Rev. Code of 1954,* § 7701(a)(2); that the resemblance test had no application to corporations that were incorporated under state statutes since they inevitably resemble corporations more than partnerships; that if the 1960 regulations were applicable, Drexler and Wald would qualify to be taxed as a corporation since it has more corporate than partnership characteristics; and finally, that Treas. Reg. § 301.7701-2(h), which deals with professional service organizations, is an unreasonable and improper interpretation of the statute. (These two briefs should be read together to get *Empey's* full argument, since Drexler and Wald Professional Company and the Colorado Bar Association purposely worked together in order that they wouldn't be redundant.)

[54] Circular No. 230, 1962-2 CUM. BULL. 394, 31 C.F.R. § 10.460 (1959) *amended* Oct. 3, 1962, by CUM. BULL. 394.

[55] Colorado is unique in that it is the only state where lawyers are permitted to incorporate under the General Business Corporation Act by virtue of a rule of the state supreme court. *Supra* note 1. The rule authorizes attorneys to form professional service corporations under the *Colorado Corporation Code.* The pertinent parts of the rule as as viewed by the 10th Circuit are as follows:

> 265. Professional Service Corporations and Joint Stock Companies. Lawyers may form professional service corporations for the practice of law under the Colorado Corporation Code, providing that such corporations are organized and operated in accordance with the provisions of this Rule. The articles of incorporation of such corporations shall contain provisions complying with the following requirements:
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> A. The name of the corporation shall contain the words "professional company" or "professional corporation" or abbreviations thereof . . . .

The new corporation, called Drexler and Wald Professional Company elected officers and began practicing law on November 1, 1962. Its shareholders signed employment contracts, as did its nonshareholder lawyer employees. On the same date each shareholder entered into a stock redemption contract. Cases were usually referred to individual lawyer employees from outside sources. Routine cases were normally handled by the individual to whom they were referred and he would also set the fee to be paid by the client. If the case was not a routine one or involved a major client, the board of directors would decide what lawyer employee would handle the case, and the board would set the fee to be paid by the client.

The Corporation performed all activities in the corporate name. For example, it obtained short term loans in the corporate name, entered into a ten-year lease for offices, had its corporate name put on all stationery, office doors, and had its corporate name listed in Martindale-Hubbell Law Directory.

In August 1963, one of the original stockholders left the corporation and the corporation redeemed his stock. On November 1, 1965, one of the nonstockholder employees, Empey, purchased the 10 percent stock interest that had been redeemed. When Empey filed his 1965 tax return he reported the salary he had received for the first ten months before he purchased the stock and also reported

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B. The corporation shall be organized solely for the purpose of conducting the practice of law only through persons qualified to practice law in the State of Colorado.

C. The corporation may exercise the powers and privileges conferred upon corporations by the laws of Colorado only in furtherance of and subject to its corporate purpose.

D. All shareholders of the corporation shall be persons duly licensed by the Supreme Court of the State of Colorado to practice law in the State of Colorado, and who at all times own their shares in their own right. They shall be individuals who . . . are actively engaged in the practice of law in the offices of the corporation.

E. Provisions shall be made requiring any shareholder who ceases to be eligible to be a shareholder to dispose of all his shares forthwith either to the corporation or to any person having the qualifications described in paragraph D above.

F. The president shall be a shareholder and a director, and to the extent possible all other directors and officers shall be persons having the qualifications described in paragraph D above. . . .

G. The articles of incorporation shall provide and all shareholders of the corporation shall agree (a) that all shareholders of the corporation shall be jointly and severally liable for all acts, errors and omissions of the the employees of the corporation . . . except during periods of time when the corporation shall maintain in good standing lawyers' professional liability insurance which shall meet the following minimum standards:

1. The insurance shall insure the corporation against liability imposed upon the corporation by law for damages resulting from any claim made against the corporation arising out of the performance of professional services for others by attorneys employed by the corporation in their capacities as lawyers.

2. Such policy shall insure the corporation liability imposed upon it by law for damages arising out of the acts, errors and omissions of all non-professional employees.

10 percent of the corporation's income for the two months of 1965 that he held the stock, even though he did not receive this percentage of the corporation's income in any way or form. Empey then filed his claim for refund for the tax difference between the 10 percent of corporate income he reported and his salary that he actually received. After waiting six months with no action from the Commissioner, Empey sued in the Federal District Court for the District of Colorado.

The trial court held that the Treasury regulation which had denied professional corporations corporate tax treatment[56] constituted an inconsistent position with the *Code,* with the previous administrative position, and with previous case law, and was an exercise of a nondelegable legislative function by an administrative agency. The trial court further stated that even if the new regulations were valid, the organization met the requirements and therefore could be taxed as a corporation.[57] As previously stated, the appellate court agreed with the trial court, affirming the decision.[58]

Since the landmark *Empey* decision, there have been other cases in accord with the *Empey* interpretation of the 1965 regulation. A group of physicians in Ohio obtained corporate tax treatment in *O'Neill v. United States.*[59] In that case, the court held that the same regulation considered in *Empey* was an interpretive regulation, not binding upon the court, and invalid. The court stated that the only time that a corporation was not allowed to be taxed as a corporation was when it failed to meet the "business purpose" test.[60] The court found that the physicians had the non-tax business purpose of controlling a sizeable and unwieldy organization.[61] The court cited *Empey* as support for invalidating the new regulation.

In *Kurzner v. United States,*[62] a Florida medical association won in its challenge to the validity of the new regulation. The court held that it was unreasonable, discriminatory, and invalid and cited *Empey* and *O'Neill* in support. In *Holder v. United States,*[63] a group of Georgia physicians had like success challenging the same 1965

[56] Treas. Reg. § 301.7701-2(h) (1965).

[57] Empey v. United States, 272 F. Supp. 851 (D. Colo. 1967).

[58] 406 F.2d 157 (10th Cir. 1969).

[59] 281 F. Supp. 359 (N.D. Ohio 1968), *aff'd,* P.H. 60,262 (6th Cir. 1969). The Sixth Circuit said that the new regulation declared invalid in *Empey* was invalid only to the extent it failed to follow the state's label of "corporation."

[60] The "business purpose" test requires an organization to have a legitimate business purpose or purposes to incorporate besides obtaining better tax consequences.

[61] O'Neill v. United States, 281 F. Supp. 359, 361 (N.D. Ohio 1968).

[62] 286 F. Supp. 839 (S.D. Fla. 1968), *aff'd* P.H. 60,262 (5th Cir. 1969). The Fifth Circuit based its invalidation of the new regulation on the ground that it was discriminatory, not on the ground that it was inconsistent with the *Code.*

[63] 289 F. Supp. 160 (N.D. Ga. 1968).

regulation. The court reached the same conclusions as in the previously mentioned cases and found that the organization had complied with the proper qualification procedure optional to the taxpayer.[64] It was held in *Wallace v. United States*[65] that the same regulations were unreasonable, discriminatory, and in conflict with the previously decided cases. Thus, the Treasury seems to have lost its battle with professional service organizations under the present statutes. If, however, cases go against the professional service corporations, it will probably be because they failed to incorporate with full knowledge and understanding of the proper procedures to follow and thus failed to "dot all the i's and cross all the t's."

For a professional service organization to qualify for corporate tax treatment after *Empey,* it must incorporate under state incorporation or association law, *substantially* meeting the requirements of having continuity of life, centralized management, transferability of interests, and limited liability. Under *Empey,* it is wise to have articles of association, setting forth a clear agreement of incorporation; the board of directors should meet regularly and minutes of the meetings should be taken; there should be written employment contracts with the employees paid by the corporation; individual clients should pay the corporation; the corporation should pay corporate income taxes; the corporation's property and debts should be in the corporate name; all business forms should be captioned with the corporation's name; and the organization should hold itself out to the public as being a corporation.

Since H.R. 10 has failed to close the gap completely between professional service taxpayers and corporate employees, incorporation might very well provide the equalizer for professional service people. However, incorporation may be the answer for some and not for others; it should not be automatic. It is felt that for most, incorporation is the answer for the self-employed since he has far superior benefits than those offered by H.R. 10.

The first problem that the professional group must face is whether or not it would be ethical to incorporate.[66] On November

[64] Rev. Proc. 61-11, 1961-1 CUM. BULL. 897, states that Articles of Association, By-Laws, Employment Contracts, a copy of the state professional association incorporation law, and the Profit Sharing Plan, Pension Plan, etc., may be filed with the District Director of Internal Revenue so that a determination of tax treatment can be made.

[65] 22 Am. Fed. Tax R.2d 5880 (D. Ark. 1968).

[66] One leading case where the court refused to permit lawyers to incorporate is *In the Matter of Co-op Law Co.,* 198 N.Y. 479, 92 N.E. 15 (1910). Ellis J. Sobol, stockholder in Drexler and Wald Professional Company and also the attorney who argued Empey's case, disagrees strongly with the position that it is unethical for either a large or small law firm to incorporate. Mr. Sobol contends that reasons for incorporation are limitation of liability, convenient transferability of shares, greater ease in handling a large organization, and to attract and keep qualified employees through retirement plans, and other increased fringe benefits. The weight of decisions and the ABA are on Mr. Sobol's side.

27, 1961, the American Bar Association expressed the view that it would not be unethical to incorporate if the lawyer is (1) still personally responsible to the client and (2) if the client is made personally aware of the restrictions on liability as to the other lawyers in the organization.[67] In states having similar requirements to Colorado's, this would not be a problem since the members are either subject to joint and several liability or must provide a large amount of insurance.

The public image of lawyers and the legal profession might be tarnished should there be a great stampede (there has been none, yet) to incorporate to simply obtain tax benefits.[68] While many may pass this area over lightly, it was not taken lightly by the CPA profession. The Council of the American Institute of Certified Public Accountants was so concerned with the image of their profession and the members in it that it adopted a resolution condemning CPA's for even supporting this type of "tax gimmick."[69]

The ethical problems are not the only things to be considered. Forming the corporation involves the trouble, time, and expense of filing for qualification and approval of health and retirement plans. In addition it may be quite expensive for one member to withdraw as the market for the members share may be quite limited. Even if there is a right to have the organization repurchase the interest, the fair market value or price would probably be small and the cash might not be available. Also, one might have to forfeit his pension-plan rights if he withdraws.

All tax problems are not solved by incorporation. The organization might have to contend with the extremely high personal holding company tax rates.[70] Generally, a personal holding company is one controlled by a limited number of shareholders and receives most of its income from sources specified in the *Code*. Amounts received from personal service contracts are personal holding company income, according to *Code* § 543(a)(7), if "some person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or if the individual who is to perform the services is designated (by name or by description) in the ocntract . . . ." Drexler and Wald Professional Company had clients execute a standard form of fee agreement which solved the problem by having the corporation reserve

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[67] *ABA Comment on Professional Ethics, Opinion 303, Nov. 27, 1961*, 48 A.B.A.J. 159 (1962).

[68] Note, *Professional Corporations and Associations*, 75 HARV. L. REV. 776, 789 (1962).

[69] *Editorial: Professional Association or Incorporation*, J. ACCOUNTANCY 39-40 (Nov. 1961).

[70] Note, *supra* note 69 at 791. *See* INT. REV. CODE OF 1954, §§ 542(a), 543(a)(7); § 541 imposes the high personal holding company tax rate.

the right to designate who would perform the services and not having the contract specify who would perform the services.

Another tax problem that the organization might meet is the problem of reasonableness of compensation; compensation must be reasonable in order to qualify as a deduction.[71] To avoid as much double taxation as it possibly can, the organization will attempt to distribute as much of its earnings as it possibly can. Also, a law firm needs only a small cash reserve to operate. Partners of large, well known law firms normally receive greater salaries than can be supported by their billing time to clients. This is not to imply that these partners are not worth what they are paid. These partners surely draw clients to the firm and keep clients simply by their name and reputation. Also, they fulfill administrative duties and other services that cannot be billed to clients. Their name and reputation may allow the organization to charge higher fees. The Commissioner might label some of these attributes *good will*, and good will, if purchased, must be capitalized[72] and is not subject to depreciation or amortization. Upon liquidation, the Commissioner could claim an additional value for good will.

Concurrent with the problem of the Treasury arguing that some salaries are unreasonable is the problem with the assignment of income theory.[73] The Treasury may attempt to attribute income received by the corporation to the stockholder-employee who earned it. The fact that he did not receive such income makes no difference.

If a legal corporation accumulates earnings for a reserve for redemption of any withdrawing member's stock, that accumulation may be subject to the accumulated earnings tax[74] (an unsettled point at this time). Unlike physicians and dentists, who could argue that the reserve is needed for purchase of new or more equipment, lawyers have little reason for such a large accumulation. It can be argued that the business purpose for keeping a large amount of accumulated earnings is in fact the constant, real threat or pos-

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[71] INT. REV. CODE OF 1954, § 162(a)(1).

[72] Welch v. Helvering, 290 U.S. 111, 113 (1933).

[73] *See* Lucas v. Earl, 281 U.S. 111 (1930); Victor Borge, 23 Am. Fed. Tax R.2d § 69-320 (2nd Cir. 1968).

[74] INT. REV. CODE OF 1954, § 531-37. The accumulated earnings tax on a corporation's "accumulated taxable income" is at the rate of 27½ percent of the first $100,000 of accumulated taxable income and 38½ percent of any accumulated taxable income in excess of $100,000. This tax is in addition to the usual corporate tax and is aimed at preventing corporations from accumulating income so that stockholders won't be taxed on dividends. *Int. Rev. Code of 1954*, § 535(c) allows an accumulated earnings credit in "an amount equal to such part of the earnings and profits for the taxable year as are retained for the reasonable needs of the business." Section 535(c)(2) says the credit allowed to accumulation "shall in no case be less than the amount by which $100,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year." Thus the first $100,000 accumulated won't be subject to the accumulated earnings tax.

sibility that one or more members will withdraw from the organization. Many of the smaller firms that would incorporate may not have to worry about the accumulated earnings tax, since they would not need to accumulate earnings in excess of $100,000, and probably could not if they wanted to. Large and small professional service corporations can also argue that it is reasonable to accumulate earnings to buy an outside business for investment purposes, and could point out that office equipment and furnishings are not cheap and replacements will not be any cheaper.

If a small professional service organization decides to elect under Subchapter S,[75] it will throw itself into a not impossible situation, but a somewhat complicated one. This maze of *Code* and regulations has been tried before by professional service people and has not been found to be very practical.[76] However, it is not as complicated as one might at first think and this election could be an answer to accumulated income and personal holding company problems.

If a sole practitioner decides to incorporate and be a one-man corporation he will have problems of qualification.[77] The *Code*,[78] regulations,[79] and *Morrissey* lean toward requiring more than one person in an "association."[80] The main problem with a one-man association is continuity of life,[81] but *Empey* said that if *incorporated* under state law, continuity of life would not be a problem. The real problem areas are (a) centralized management, (b) assignment of income, and (c) personal holding company treatment if Subchapter S is not elected.[82]

In conclusion, before a professional service organization decides to incorporate it should weigh carefully all the advantages and disadvantages, as well as the ethical problems.

H.R. 10 is a pale substitute for a corporate plan. Incorporation

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[75] *Id.* §§ 1371-77.

[76] *See* Greene, *Practitioners' Experiences with Subchapter S Reveal Many Doubts, Fears; Use Is Limited,* 10 J. TAXATION 130 (1959).

[77] *See* BITTKER, *supra* note 50, at 39.

[78] INT. REV. CODE OF 1954, § 7701(a)(3).

[79] Treas. Reg. § 301.7701-2(a)(2) (1965).

[80] *But see* Lombard Trustees, Ltd. v. Commissioner, 136 F.2d 22 (9th Cir. 1943).

[81] A.A. Lewis & Co. v. Commissioner, 301 U.S. 385 (1937).

[82] There also may be problems in incorporating a cash basis partnership, as shown in *Peter Raich,* 46 T.C. 604 (1966). In this case petitioner tried to fall within the provisions of *Int. Rev. Code of 1954,* § 351 by incorporating with a tax free exchange of his property for stock in the new corporation. Petitioner ran afoul of statute when he received stock *plus* an unsecured promissory note. The court found that the corporation assumed liabilities over the petitioner's adjusted basis of property transferred. Thusly, *Code* § 357(c) was applicable via *Code* § 351(d)(1) and petitioner should be taxed on this excess of liabilities assumed. The court also found that the petitioner should be taxed on the amount of the note received since it was within the meaning of "other property" received besides stock under *Code* § 351(b).

for most professional service taxpayers is the best answer now available. There are professional service people who are now being pushed too quickly and are being ill advised by mutual funds and insurance groups (who are the ones who stand to benefit from the corporate form through retirement plans). Incorporation must take place only after careful investigation and planning. The best answer would be federal legislation that would put self-employed and corporate employees on equal footing and thus end the journey into the unknown regions and pitfalls of professional service people incorporating. This legislation appears to be only a wish as it is fairly safe to say that chances for equalization by legislation are nill.[83]

T. Michael Carrington

CRIMINAL PROCEDURE — BIFURCATED TRIAL — THE RIGHT TO SEPARATE TRIALS ON THE ISSUES OF GUILT AND PUNISHMENT — *People ex rel. McKevitt v. District Court,* 447 P.2d 205 (Colo. 1968).

CLARENCE English was charged, by direct information, with the crime of murder in the first degree. The public defender submitted a "Motion for Bifurcated Trial" on behalf of English, requesting separate trials before separate juries on the issues of guilt and of punishment. The Denver District Court ordered *separate* trials on the issues of guilt and punishment but before the *same* jury. Thereafter, on behalf of the People, the district attorney instituted an original proceeding on a writ of prohibition against the district court and against the judge who issued the order alleging that the Colorado statute concerning trials for murder in the first degree[1] had been misinterpreted.[2] The Supreme Court of Colorado, after issuing to the district court a rule to show cause, *held* the rule absolute and directed the trial court to reverse its order that English be given separate trials before the same jury. The language used

[83] The Commissioner of Internal Revenue, Randolph W. Thrower, has indicated that the I.R.S. might attack professional service corporations through the administration's legislative tax proposals. These proposals could be to force all Subchapter S Corporations to use "Keogh" or H.R. 10 plans rather than corporate plans. *See* P.H. FED. TAX REPORT BULLETIN § 60,293-94.

[1] COLO. REV. STAT. ANN. § 40-2-3(1) (1963) provides:

> The jury before which any person indicted for murder shall be tried, shall, if it find such person guilty thereof, designate by its verdict whether it be murder of the first or second degree, and if murder of the first degree, the jury shall *in its verdict* fix the penalty to be suffered by the person so convicted, either at imprisonment for life at hard labor in the penitentiary, or at death; and the court shall thereupon give sentence accordingly (emphasis added).

[2] People *ex rel.* McKevitt v. District Court, 447 P.2d 205 (Colo. 1968).