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The Professional Corporation—Has the Death Knell Been Sounded?

Forest J. Bowman*

The favorable tax reasons for incorporating a professional practice have been substantially reduced by the Tax Equity and Fiscal Responsibility Act. The retirement benefits of the professional corporation have effectively been eliminated by TEFRA. In addition, the new allocation of income powers provided by TEFRA may have eliminated the tax incentive for forming a professional corporation. The professional's decision whether to incorporate his practice will now rest with his desires as to how he wishes to carry out that practice. This article discusses the changes that TEFRA has wrought, and its impact on the professionals' decision to incorporate.

I. INTRODUCTION

In the lexicon of purely fictional legal devices, nothing quite compares with the professional corporation.¹ A fairly recent creature of the law, it has been molded, hammered, and shaped for

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1. A "professional corporation" is a corporation, organized pursuant to state law for the purpose of rendering a specific kind of professional service for profit. The professional corporation is available to most professions as an alternative form of practice. Some state professional corporation laws permit incorporation by specifically named professions (such as S.D. Comp. Laws Ann. § 47-11 (1967)), while other states permit incorporation by all persons render "professional services" (such as Maine, Ne. R.S. Title 13, Ch. 22, §§ 701-716). "Professional services" is defined in such a fashion as to include professional services of physicians, attorneys, dentists, and the like. See, e.g., Me. R.S. Title 13, Ch. 22, § 703(2).

one purpose—tax-avoidance. To be sure, there are justifications other than tax savings advanced in defense of the professional corporation. It remains, at bottom, a creature of the aberrations of the Internal Revenue Code, a totally artificial device resorted to almost entirely for the purpose of avoiding taxes—a symptom, not the source, of the real problem.

The problem has consistently been the federal income tax law. Despite deceptively modest beginnings,² the federal income tax has risen to the level of a substantial burden, especially for taxpayers of moderately high income, a classification which would include many professional persons.³ Until the introduction of “income indexing” in the Economic Recovery Tax Act of 1981 [hereinafter ERTA],⁴ this tax burden was further aggravated by the fact that in inflationary times the tax “take” continued to rise against incomes declining in real dollars. Motives of tax avoidance took on a new and enhanced significance as inflation hacked its cruel path across the American economy.

At the same time, tax-burdened professionals were dealing with clients and patients who worked for corporations and who spun tales of the various tax-free fringe benefits offered by their corporate employers. The message was clear: there were tax advantages afforded to corporate employees that were available nowhere else. As a result, prodded by their memberships, representatives of professional organizations throughout the United States began lobbying for the right of professional people to practice under the umbrella of a “professional corporation.” Today every state has some statutory provision for the incorporation of professionals.⁵ The state professional association acts vary

2. The sixteenth amendment, which became effective on February 25, 1913, empowered Congress “to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration.” U.S. CONST. amend. XVI. For the year 1913, a married couple with two children paid \$60 federal income tax on a net income of \$10,000, \$260 on a net income of \$25,000, and \$25,010 on a net income of \$500,000. B. BITTKEY & L. STONE, *FEDERAL INCOME TAXATION* 1 (5th ed. 1980); Revenue Act, 1916, ch. 463, 39 Stat. 756 (1916).

3. While exact comparison of the 1913 and 1981 federal income tax burdens is not possible because of the impact of inflation and differences in exemptions and deductions, a tax bill for 1981 would be \$373 on a net income of \$10,000, \$3,460 on a net income of \$25,000 and \$186,031.20 on a net income of \$500,000.

4. Pub. L. No. 97-34, 26 U.S.C. § 1 (1981). Income indexing was introduced in § 104(a), 104(b) & 104(c)(2) of the 1982 act by providing that after 1984 the tax-rate table, zero-bracket amounts, and amounts allowable as exemptions for dependents will be adjusted upward each year to reflect the rate of inflation. I.R.C. §§ 1(f), 63(d), 151(e) (West 1981). This adjustment will prevent tax increases caused solely by inflation.

5. CHASEMAN, *PROFESSIONAL CORPORATIONS*, in *ADVANCED ESTATE PLANNING READINGS* 9.9 (S. Limberg ed. 1980).

greatly, particularly as to which professionals are permitted to incorporate, but the Internal Revenue Service has conceded that professional corporations which are formed in compliance with such acts will be recognized as corporations for federal tax purposes.⁶

Since the recognition of professional corporations by the Internal Revenue Service, increasing numbers of professional people have established professional corporations. Indeed, so many professionals have adopted the corporate form in recent years that a legitimate question for the professional person today is whether the professional corporation is *really* that good. There is nothing wrong with seeking to avoid taxes by any legitimate and lawful means. The question is whether something is wrong with a system that affords substantial tax relief to those who adopt a purely

6. Technical Information Release (TIR), August 8, 1969, 1969-2 C.B., superceded by Rev. Rul. 70-101, 1970-1 C.F. 278. The IRS did not come to this point willingly. In 1935 the United States Supreme Court held, in *Morrissey v. Commissioner*, 296 U.S. 344 (1935), that a trust organized as a medium for the conduct of a business for profit merited taxation as a corporation where the trust "resembled" a corporation. The attributes of a trust which the court said would render it analogous to a corporation for tax purposes included: 1) centralized management, 2) continuity of life, 3) limitation of personal liability of participants, and 4) ease of transferability of interests. *Morrissey*, 296 U.S. at 359. That same year the Seventh Circuit held, in *Pelton v. Commissioner*, 82 F.2d 473 (7th Cir. 1975), that a medical clinic operated by a trust was taxable as a corporation on the theory that the clinic more closely resembled a corporation than a trust. Thereafter, however, the IRS reversed itself and opposed corporate tax treatment of professional associations. The rush towards incorporation of professional practices was slowed until the Internal Revenue Code of 1954 provided certain tax benefits to corporate employees (such as the § 101 exclusion of employees' death benefits from gross income, the § 105 exclusion from an employee's gross income of amounts received under accident and health plans paid for by the employer, and the §§ 401 through 404 advantages offered to corporate employees under qualified pension, profit-sharing, and stock bonus plans).

As the drive to incorporate professional corporations began to increase again, the Commissioner, in contradiction of *Pelton*, contended that state law controlled whether an organization would be considered a corporation for tax purposes. The Ninth Circuit, in *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954), rejected this argument and held that only the *Morrissey* test need be met. Widespread litigation followed as the IRS handed down the so-called "Kintner Regulation" (Treas. Reg. § 301.7701 (1960)), which followed *Morrissey's* criteria but added that corporate tax treatment would be denied to a professional service association organized under the Uniform Partnership Act, and later, the "Kintner Amendment" (Treas. Reg. § 301.8801-1(a), and -2(h)(1)(i); T.D. 6797, 1965-1 C.B. 553), which reaffirmed the *Morrissey* criteria and denied corporate status to professional service associations which would not meet these tests regardless of state levels.

The Commissioner lost every case brought contesting the amendments and the validity of the professional corporation was established. Rev. Rul. 70-101, 1970-1 C.B. 278.

artificial device merely for its tax-avoidance characteristics, and whether motives of tax-avoidance are not blinding professionals to other reasons which mitigate against incorporation of a professional practice.

This article will analyze where the professional corporation stands in light of the passage of ERTA and the Tax Equity and Fiscal Responsibility Act of 1982 [hereinafter TEFRA].

II. FORMS OF PROFESSIONAL PRACTICE

There are four basic forms for conducting a professional practice. These are the sole proprietorship, the partnership, the partnership of professional corporations, and the professional corporation.

A. *The Sole Proprietorship*

The sole proprietorship is the simplest of these business forms since only one owner is involved. A sole proprietor has complete control over his own business operations—and full liability for his actions. Many of the fringe benefit programs available to corporate employees are not available to the sole proprietor, although since 1960, the sole proprietor has been able to establish a Keogh or HR-10 “retirement plan” and thus defer paying taxes on his contributions to a corporate retirement plan.⁷

B. *The Partnership*

The partnership is a very common practice arrangement for professionals, but possesses certain dangers. Each partner is liable, not only for his own negligence, but for the negligence of each of his partners and employees as well.⁸ (A partner’s lack of limited liability cannot be avoided although adequate insurance can protect the professional from catastrophe.) Each partner has an equal voice in the management of the business,⁹ and may bind the partnership by his decisions. As in the sole proprietorship, few tax-favored fringe benefits are available to partners although a Keogh or HR-10 plan could be established for the partnership.

7. “Keogh” or “HR-10” retirement plans are retirement plans for self-employed individuals. They take their name from the sponsor of the Self-Employed Individuals Tax Retirement Act of 1962, Pub. L. No. 87-792, 76 Stat. 809 (1962), United States Representative Eugene James Keogh of New York, who introduced the legislation to the Congress as House Resolution 10. The terms “Keogh” or “HR-10” are used interchangeably.

8. Uniform Partnership Act §§ 13-15, 17 & 18 (West 1969).

9. Uniform Partnership Act § 18(e) (West 1969).

C. Partnership of Professional Corporations

The partnership of professional corporations is, as the name implies, a partnership in which some or all of the partners form separate professional corporations and those corporations join in as partners in a new partnership. This device was created for two major reasons. First, practicing in the form of a partnership of professional corporations may minimize the conflict between older and younger partners with respect to spendable income. In a professional corporation with more than one shareholder it is often difficult to meet the diverse needs and goals of individuals of differing ages, financial situations, and personal interests. A partnership of professional corporations will permit each individual to make his or her own decision regarding the allocation of income between current, spendable income and income which is to be accumulated for retirement. Secondly, utilizing the partnership of professional corporations was thought to be a device to permit the exclusion of lower paid employees from coverage in corporate fringe benefits. The professionals in a practice could form individual professional corporations having no employees and provide extensive fringe benefits for themselves without the necessity of covering anyone else. These professional corporations could then join together in a partnership, but if the partnership hired the lower paid employees, they would be effectively excluded from the benefits of the professional corporations.

Legislation enacted by Congress on December 28, 1980, limited the ability of a partnership of professional corporations to exclude partnership employees from qualified plan coverage.¹⁰ The law now requires that all employees of members of an "affiliated service group" are to be treated as though employed by one employer. Thus the advantages of qualified retirement plans and other fringe benefits will not be fully available to shareholder employees of a professional corporation unless all employees of the "affiliated service group," i.e., the partnership of professional corporations, to which the professional corporation belongs are also covered.

D. The Professional Corporation

The professional corporation itself, like any other corporation,

10. I.R.C. § 414 (West 1982).

is a separate legal entity. Historically a wide variety of fringe benefit programs were available to the employees of a corporation which were not otherwise available. These benefits will be reviewed in detail later in this article.

III. ADVANTAGES AND DISADVANTAGES IN FORMING A PROFESSIONAL CORPORATION

Deciding whether to adopt the professional corporation as a vehicle to carry out a professional practice should be a matter of answering the following questions:

(1) What are the *tax advantages* of the professional corporation?

(2) What are the *tax disadvantages* of the professional corporation?

(3) What are the *non-tax advantages* of the professional corporation? and

(4) What are the *non-tax disadvantages* of the professional corporation?

Unfortunately, given the enormous tax advantages of professional corporations, in recent years many professionals have tended to ignore the non-tax considerations inherent in the decision to incorporate and have concentrated only on the tax effects of this decision.¹¹ But the matter of tax savings, while important, is only *one* aspect of the important question of whether to incorporate a professional practice. And, depending on such factors as the nature of the practice, the age, health, marital status, and personality of the practitioners, the tax questions may be less important than the non-tax questions.

A. *Non-Tax Advantages of the Professional Corporation*

What are the major non-tax advantages of the professional corporation? First, there is the limitation of liability, an advantage of some significance in light of the epidemic of malpractice claims which most professions are now facing.¹² Liability is governed by the laws of the several states but, generally speaking, a corporate

11. Banoff, *Reducing the Income Tax Burden of Professional Persons by Use of Corporations, Joint Ventures, Subpartnerships and Trusts*, 58 TAXES 968 (1980); Comment, *Unreasonable Compensation in the Professional Corporation*, 13 AKRON L. REV. 540 (1980). The major reason for incorporating a professional practice since the Internal Revenue Service began recognizing such corporations as legitimate for tax purposes has been the opportunity to set aside a greater sum of money for retirement that would otherwise be possible. Strictly speaking, this is a *tax* decision since the non-taxation of contributions to retirement in times of high income is the major advantage of such contributions.

12. Comment, *Medical Malpractice*, 4 AM. J. OF TRIAL ADVOC. 816 (1981);

shareholder's loss is limited to his investment in the corporation's debt and stock while the members of a partnership, at least under the Uniform Partnership Act, are jointly and severally liable for the wrongful acts of every other partner committed in the course of the partnership business, and for the misapplication of the property of third persons.¹³

Depending upon state law, a professional who incorporates will continue to be liable for his own negligence and for the negligence of those under his control,¹⁴ but will not be personally liable for another professional's negligent acts. Therefore, limitation of liability is a *major* non-tax advantage of the professional corporation, even though the limitation of liability has some restrictions.

1. Centrality of Management

Management is centralized in a professional corporation. The Uniform Partnership Act provides every partner with an equal voice in the management of the business.¹⁵ As firm size grows, this can become an administrative nightmare. Unanimous consent may become difficult or impossible to obtain, resulting in a deadlock which could impair the ability of the partnership to function.¹⁶

The corporation, on the other hand, provides for centralized management through the election of officers and a board of directors who manage the corporation with authority delegated to them by the shareholders. Under this form, a few of the "business-oriented" shareholder-professionals can manage the business of the practice while the remaining shareholder-professionals concentrate their time on their professional practice. This format is especially useful where the practice group includes a professional who has no "business sense" and who interferes with the routine business operation of the practice.

Weiss, *The Rising Tide of Legal Malpractice: Spitting Into the Wind?* 4 AM. J. OF TRIAL ADVOC. 637 (1981).

13. Uniform Partnership Act §§ 13, 17 (West 1969). As of September 1, 1981, all states except Louisiana and Georgia had enacted legislation substantially similar to the Uniform Partnership Act. 1981-82 REFERENCE BOOK OF THE NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, table 1.

14. Note, *Professional Corporations: Analysis Under the Tax Reform Act and Survey of State Statutes*, 58 GEO. L.J. 487, 521 (1970).

15. Uniform Partnership Act § 18(e) (West 1982). "All partners have equal rights in the management and conduct of the partnership business." *Id.*

16. The members of the partnership could, however, vest specific management functions in named partners.

This professional can be isolated from the business management of the professional corporation without the need for personal confrontation which might accompany the same sort of action in a partnership.¹⁷

2. Continuity of Life

The corporation has greater continuity of life than a partnership. By operation of law a partnership is dissolved by the death¹⁸ or withdrawal¹⁹ of a partner, and any remaining partners who wish to continue the professional practice of the partnership must form a new partnership to continue practicing together in a partnership.

On the other hand, a professional corporation, and the practice carried on under the corporate umbrella, has a perpetual life regardless of the death, retirement, expulsion, resignation or bankruptcy of an individual owner. While most statutes require that only licensed members of the profession be permitted to own shares in a professional corporation,²⁰ except during a brief settlement period following the death of a shareholder-professional, there is virtually no limit on the transfer of such shares to persons who are permitted to own them.

Continuity of existence is an important feature for a group practice that experiences frequent turnover of members. Moreover, since ownership interests are represented by shares of stock in a professional corporation, these interests can be rearranged simply by transferring shares of stock among the shareholder-professionals with no effect on the existence of the corporation.

3. Transferability of Ownership

Ease of transferability of ownership is another important non-tax advantage of the professional corporation. The Uniform Part-

17. Centralization of management is of no consequence to the sole practitioner since he or she has already has "centralized" the management of the practice.

18. Uniform Partnership Act § 31(4) (West 1982). "Dissolution is caused: . . . (4) By the death of any partner." *Id.*

19. *Medd v. Medd*, 291 N.W.2d 29 (Iowa 1980) (dissolution of partnerships caused by partner's withdrawal).

20. "A professional association may issue its capital stock only to personnel who are duly licensed or otherwise legally authorized to render the same professional service as that for which the association was organized." OHIO REV. CODE ANN. § 1785.05. "A professional corporation may issue shares of its capital stock only to a qualified person. . . . No shares may be transferred upon the books of the professional corporation or issues by the professional corporation until there is presented to and filed with the corporation a certificate by the regulating board stating that the person to whom the transfer is to be made or the shares issued is duly licensed to render the same type of professional services as that for which the corporation was organized" KAN. STAT. ANN. § 17-2712(a) (1981).

nership Act²¹ prohibits a partner from transferring his partnership interest to another person (making the purchaser a partner) without the consent of all the partners. In theory, such a transfer of partnership interest without consent of all partners, dissolves a partnership entity.²²

4. Increased Efficiency

Another significant, but often overlooked non-tax benefit of a professional corporation is the enhancement of efficiency that often accompanies adoption of the corporate form of business. The process of incorporation requires that the professional carefully analyze his or her business practice, an inquiry that the unincorporated professional will often ignore. The reporting requirements that accompany the corporate form of practice enforce the same sort of introspection. Such periodic reviews can result in enhanced efficiency and a careful budgeting of profits from the professional practice.²³ These non-tax advantages must be weighed carefully against the non-tax disadvantages of a professional corporation.

B. Non-Tax Disadvantages of the Professional Corporation

1. Intangible Aspects

First, there is the human factor—some personalities are simply not compatible with the corporate form. Some professionals may be reluctant to “submerge” their identities in a corporation: to have their office telephone answered “Legal Corporation” or have their professional return address read “Medical Group, Incorporated.” Many professionals want to practice under their own names for psychological reasons that have much to do with why they entered their profession in the first place. Others will not want to practice within the confines of a corporation because of the financial restraints it imposes. They may be relatively young

21. Uniform Partnership Act § 18(g) (West 1969). “No person can become a member of a partnership without the consent of all the partners.” *Id.*

22. Treas. Reg. § 301.7701-2(e)(1) (1982). Uniform Partnership Act §§ 27, 30 (West 1969) provide that such a conveyance “does not of itself dissolve the partnership.” *Id.* But § 29 defines the dissolution of a partnership as “the change in the relation of the partners caused by any partner ceasing to be associated in the carrying on [of the business] as distinguished from the winding up of the business.” *Id.*

23. Rosley, *Incorporation Is More Than Just Cutting Taxes*, 65 MEDICAL ECON. 227 (1979).

and unwilling to begin to save toward retirement at this early date. Individuals may not feel they can afford to set money aside in a retirement plan because of other debts or, especially in the case of young professionals recently out of school, simply because they are tired of "being poor." Whatever the reason, the corporate structure is too financially confining for some professionals.²⁴

2. Costs

The increased cost of the corporate form is another disadvantage. The formation and operation of a professional corporation can be a moderately expensive undertaking. With the exception of lawyers who specialize in organizing professional corporations, there will be attorney's fees and accountant's fees.²⁵ Initial and annual filing fees, expenses of establishing the books of the corporation, and the cost of accounting and legal fees are some of the additional costs.²⁶ Moreover, employment taxes will likely be higher since the professional will be an employee of his or her corporation, and the corporation will be required to pay social security, employment insurance taxes, and worker's compensation premiums on both professional and non-professional employees.²⁷

3. Government Regulation

Another non-tax disadvantage of the professional corporation, closely related to increased cost disadvantages, is increased governmental regulation, both federal and state, with resulting increased complexity of operation.²⁸ Despite recurring efforts to reduce the burden of red tape, the headache of governmental regulation never seems to recede.

4. Patients' and Clients' Concerns

Finally, there may be some concern over the adverse reactions of patients and clients to the incorporation of a professional practice. However, this is seldom a problem today given the growing number of professional corporations and an increasingly sophisticated public.

24. M. MORLEY & P. DIMATTEO, *PROFESSIONAL PRACTICE ALTERNATIVES* 35 (1978).

25. While practically any lawyer can set up a corporation, retirement plans are highly specialized and have elaborate filing and reporting requirements. Only a lawyer who specializes in this sort of work should undertake to establish a professional corporation.

26. Housen, *Professional Corporation*, 59 ILL. BAR J. 196, 203 (1970).

27. Schmukler, *Partnership, Corporation, Sole Proprietorship or Other Forms; How Should I Conduct My Practice?*, WIS. BAR BULL. (June 1979) at 8, 10.

28. Warren & Dunkle, *Professional Corporations — Organization and Operation*, 334 TAX MGNM'T (BNA) A-3 (1980).

C. Tax Advantages of the Professional Corporation

The tax advantages afforded professional corporations have prompted most of the decisions to incorporate. These advantages have been significant in the past, but whether they remain of any consequence is yet another question.

Initially, there are no unique tax advantages to the professional corporation. The tax advantages that result from the decision to practice a profession within the corporate structure are those which would accrue to any closely-held business organized as a corporation rather than a partnership. The major tax advantages stem from the fact that a shareholder-employee of a corporation is, by virtue of his or her status as an "employee," eligible for all of the the tax-favored fringe benefit programs of the corporation.²⁹

1. Retirement Plan

The most significant employee fringe benefit is the qualified retirement plan of the corporation,³⁰ which, until the two most recent tax acts, was clearly superior to similar plans for partnerships. There are three income tax benefits to a qualified retirement plan, regardless of whether the plan is corporate or non-corporate. First, the employer may deduct from gross income all contributions to the plan.³¹ Second, the assets which are placed in the plan are allowed to accumulate tax-free until they are withdrawn. Third, the individual on whose behalf contributions have been made is not taxed on the contributions to the plan until they are distributed.³²

29. With the adoption of the Keogh legislation, 26 U.S.C. § 401 (1978 and Supp. 1982), the Internal Revenue Code now treats a partner as an employee for purposes of participating in the qualified retirement plan of his unincorporated business on a tax-favored basis. But Keogh plans are much less attractive tax shelters for high-income professionals than qualified retirement plans for corporate employees. Moreover, there are other significant tax-favored fringe benefits available to corporate employees that are unavailable to partners.

30. Generally speaking, a qualified retirement plan is one which meets the requirements of I.R.C. § 401(a) (West 1982). Basically, the plan must be written, the benefits and eligibility requirements must not discriminate between shareholders and employees, the plan can only be for the benefit of employees and their beneficiaries, and, once in operation, the plan must continue to meet the qualifications of § 401. Only four types of qualified plans are recognized for special treatment under the Code: (1) trustee pensions, (2) profit sharing, (3) stock bonus, and (4) non-trustee annuity plans. I.R.C. §§ 402, 404(a)(1), 404(1)(3), 2039(c)(1), 2517(a)(1), 101(b)(2)(B)(ii), 403(a), 404(a)(2), 2039(c)(2), 2516(a)(2) (West 1982).

31. I.R.C. § 202 (a)(1), (3) (West 1982).

32. I.R.C. §§ 402(a)(1), 501(a) (West 1982).

There are two kinds of retirement plans recognized by the Internal Revenue Service. First, there are defined *contribution* plans (popularly known as "profit-sharing plans"), and second, there are defined *benefit* plans (commonly referred to as "pension plans"). All other types of retirement plans are variations of these two basic plans.

A defined *contribution* plan is an "input" plan. Each year a contribution is made to the plan on behalf of each participant based on a percentage of the participant's salary. Upon retirement, the participant receives the amount deposited in his account, plus the income and capital growth, if any, which has been earned by the contributions of the plan over the years.

A defined *benefit* plan, on the other hand, is an "output" plan under which the employer determines the amount of retirement benefits he wants his employees to receive. (In the case of a professional corporation, the "employer" will usually be the same person or persons as the "employee," so the professional decides how much he or she wants to receive in retirement income.) It is then left to an actuary to determine the amount which must be contributed each year to produce the retirement goal. The limitation in a defined benefit plan is placed on the "output" — the benefit paid at retirement.

The advantage of a corporate retirement plan over the Keogh plan of a self-employed individual, prior to the enactment of TEFRA, can readily be seen from the following comparisons:

a. Limitations on tax-deductible contributions to a defined contribution plan. By January 1, 1982, the maximum annual tax-deductible contribution permitted to a corporate defined contribution plan for any one participant, was the lesser of \$45,475 or 25% of salary. For example, on an \$80,000 salary, the maximum annual contribution could not exceed \$20,000. On an annual salary of \$181,900 or more, the 1982 limit was \$45,475. This dollar limit was adjusted annually by a cost-of-living feature similar to that used to adjust primary insurance amounts under the Social Security Act.³³ At the same time, contributions to a Keogh defined contribution plan were limited to the lesser of 15% of net practice income or \$15,000.³⁴

b. Limitations on tax-deductible contributions to a defined benefit plan. As of January 1, 1982, the maximum tax-deductible contribution to a corporate defined benefit plan was an actuarially determined amount necessary to fund an annual retirement benefit that could be as great as 100% of an employee's average salary

33. News Release I.R. 82-18; I.R.C. §§ 415(c)(1) and (d)(1)(A) (amended 1982).

34. I.R.C. § 404 (e)(1) (West 1981).

for the three highest-paid consecutive years, up to a dollar limit of \$136,425. This dollar limit, like the limit on contributions to a defined contribution plan, was adjusted annually for inflation.³⁵ Depending on the employee's age at entry into the plan, his salary and the retirement income sought, the defined benefit formula would usually produce annual tax-deductible contributions in excess of the \$45,475 contribution permitted under defined contribution plans.

The maximum annual benefit payable under a Keogh defined benefit plan also varied depending on the participant's age at entry into the plan, income, and retirement income goals. This formula usually resulted in deductions in excess of \$15,000 per year, but not as high as the deductions permitted under a corporate defined benefit plan.³⁶

c. Distribution of benefits under retirement plans. Distribution of benefits under corporate plans before retirement was permitted without penalty.³⁷ In a Keogh plan, however, distribution of benefits to an owner-employee was not permitted before age fifty-nine years and six months, except in the event of death or disability. Otherwise, a ten percent penalty tax was assessed.³⁸

d. Participation in a retirement plan. Under a corporate plan, all full-time employees with one year (or three years if 100% immediate vesting was provided) of service were required to be included in the plan. However, a minimum age requirement of twenty-five could be imposed, and for a defined benefit plan, employees who were within five years of normal retirement when hired could be excluded.³⁹ In a Keogh plan, on the other hand, all full-time employees with three years of service had to be included, regardless of age.⁴⁰

e. Vesting of interest in a retirement plan. In a corporate plan, vesting could be contingent on the length of service with the employer.⁴¹ In a Keogh plan, however, interests of participating

35. News Release I.R. 82-18, I.R.C. §§ 415(b)(1) and (d)((1)(A) (amended 1982).

36. I.R.C. § 401(a)(17)(B)(ii) (West 1981) (repealed 1982).

37. O'Connor, *Selection of the Form of Business or Professional Organization: A Need for Clairvoyance*, 56 TAXES 880, 895 (1978).

38. I.R.C. § 401(d)(4)(B) (West 1981).

39. I.R.C. §§ 410(a)(1)(A), (a)(2) (West 1982).

40. I.R.C. § 410(d)(3)(A) (West 1981) (repealed 1982).

41. I.R.C. § 411(e)(2) (West 1982).

employees were required to vest immediately.⁴²

f. Loans made from retirement plans. Loans from corporate plans were subject to reasonable rules, but loans were not permitted from Keogh plans without a tax penalty.⁴³

Finally, a corporate retirement plan could be integrated with Social Security, either to restrict benefits to, or provide higher benefits for, persons whose benefits exceeded a stated Social Security compensation level.⁴⁴ The integration of a Keogh plan with Social Security was much more limited and, indeed, unavailable under certain circumstances.⁴⁵

The corporation offered a better opportunity for tax-favored funding of employee/owner retirement plans than the Keogh or HR-10 plan offered for unincorporated individuals. It was this enormous advantage of the corporation, more than any other factor, that led professionals to adopt the corporate form.⁴⁶

2. Health and Insurance Plans

a. Group term life insurance. Other tax advantages to the professional corporation include those flowing from the availability of certain welfare plans which could be enjoyed by employees on a tax-excluded basis, but were unavailable to self-employed individuals. One such advantage is group term life insurance. The professional corporation may provide group term life insurance benefits to all of its employees, including its shareholder-employees. The cost of the premium is deductible by the corporation as a business expense, and the cost of the premium for the first \$50,000 of group term life insurance is not taxable as income to the employee.⁴⁷ In a partnership, on the other hand, the premium

42. Treas. Reg. § 1.401-12(g) (West 1982).

43. I.R.C. § 72 (m)(4)(B) (West 1981).

44. Treas. Reg. § 1.401-3(e)(32)(i)(c) (West 1982).

45. A Keogh profit-sharing (i.e., defined contribution) retirement plan may be integrated with social security only if not more than one-third of the deductible contributions made under the plan (exclusive of social security) "is deductible by reason of contributions by the employer on behalf of owner-employees" I.R.C. § 401(d)(6)(A) (West 1981). This provision was repealed for years beginning after 1983 by §§ 237(b)(1) and 141(a), Pub. L. No. 97-248, Sept. 3, 1982. A Keogh pension plan (i.e., defined benefit plan) could not be an integrated plan. I.R.C. § 401(j)(4) (West 1981) (repealed 1982).

46. Battle, *The Use of Corporations by Persons Who Perform Services to Gain Tax Advantages*, 57 TAXES 797 (1979).

47. Rev. Rul. 56-400, 1956-1 C.B. 116 states:

Insurance premiums paid by a taxpayer for group life and hospitalization insurance policies, the benefits of which accrue to its commission salesmen, constitute allowable deductions from gross income as ordinary and necessary business expenses under section 162 of the Internal Revenue Code of 1954, whether or not an employer-employee relationship exists between the taxpayer and the insured, provided that the total commissions, together with the premiums for insurance coverage and any

cost for any life insurance provided for employees must be included in the employees' personal income.⁴⁸ (The TEFRA change in this area will be discussed in a subsequent section, but the change does not relate to the basic corporate advantage outlined above.)

b. Employee health plans. Employee health plans also provide tax advantages to the professional corporation. The professional corporation may adopt a plan to reimburse employees, including shareholder-employees, for medical and dental expenses incurred, and the cost of this reimbursement, or the cost of the premium to pay medical or dental insurance plans under which the reimbursement is made, is a deductible expense to the corporation. So long as the reimbursement amounts received by the employee do not exceed the expenses incurred for the medical or dental care of himself, his spouse, and dependents, the reimbursed expenses are not includible in the employee's income.⁴⁹

An unincorporated professional may, of course, deduct the cost of medical insurance plus other unreimbursed medical expenses to the extent the total exceeds five percent of his adjusted gross income, if he itemizes his deductions on his income tax return. The professional will usually lose those deductions.⁵⁰ This advantage of the corporation remains unaffected by ERTA and TEFRA.

c. Disability income plan. Another tax advantage is the disability income plan. A professional corporation can establish a plan to provide disability income benefits for employees during periods when they are unable to work due to injury or sickness. The cost of providing this protection, by insurance premium or otherwise, is a deductible business expense of the corporation and does not represent taxable income to the employee.⁵¹ No such

other remuneration attributable to their services, paid to and in behalf of such salesmen are reasonable in amount, and provided further that the taxpayer is not a beneficiary under such life insurance policies.

Id. I.R.C. § 79(a) (West 1982).

48. Treas. Reg. § 1.79-1(d)(1) (West 1982).

49. I.R.C. §§ 105(d)(1), 106 (West 1982), Treas. Reg. 1.162-10(a) (West 1982).

50. I.R.C. § 213(a) (West 1982). In order to be deductible, the expenses must exceed five percent of adjusted gross income (as of January 1, 1983). In any event, no matter how high the medical expenses of a self-employed professional may be, the first five percent may not be deducted.

51. There must be a finding of permanent and total disability to qualify for the exclusion, and it is phased out to the extent that an employee's adjusted gross income exceeds \$15,000. I.R.C. § 105(d) (West 1982). Finally, if a professional employee pays for his or her own disability insurance with after-tax dollars, any disability benefits paid under the policy will be entirely free from the income tax.

opportunity exists for the self-employed. This advantage of the corporation also remains unaffected by the recent tax laws.

d. Death benefit plans. Death benefits can also be viewed as a tax advantage of the professional corporation. Death benefit payments to widows and widowers, up to a maximum of \$5,000, are exempt from the estate tax and the payments are deductible business expenses of the corporation.⁵² Until TEFRA, there was no similar advantage for the self-employed individual.

D. Tax Disadvantages of the Professional Corporation

Despite the attractive tax advantages of the professional corporation which existed until recently, there were also a number of tax disadvantages that accompanied adoption of this business form.

1. Double taxation.

The first such disadvantage is "double" taxation. This so-called "second tax" is the tax applied to the dividends a corporation pays. The corporation will already have paid income tax at corporate rates on the profit from which the dividend has been declared after the payment of a dividend. The dividend, which represents income to the shareholders, is subject to tax again at personal rates in the tax returns of the shareholders.

In reality, the matter of double taxation is a "red-herring." After the deduction of corporate expenses, including compensation of all employees and employee fringe benefits, most professional corporations will not have sufficient income remaining to cause dividends of any substantial amount to be declared. So this disadvantage, which is very real with ordinary corporations, is largely illusory with respect to the majority of professional corporations.⁵³

I.R.C. § 105(a) (West 1982). But the corporation and the employee will be unable to take a tax deduction for the premiums paid.

It can be argued that a disabled professional will need all the income he can accumulate. If the professional foregoes the income tax deduction on disability insurance premiums while making a decent income, then the professional can assure that if he ever needs to collect from the disability policy, all of the proceeds will be tax-free. On the other hand, a disabled professional will probably be in a substantially lower tax bracket, and this fact, together with the savings that can be made from current income by corporate financed disability income insurance premiums, may provide justification for taking the tax deduction immediately.

52. I.R.C. §§ 101(b)(1), 101(b)(2)(A) (West 1982). See also Rev. Rul. 55-212, 1955-1 C.B. 299.

53. MORLEY & DIMATTEO, *supra* note 24, at 33.

2. Fiscal Insurance Contributions Act (FICA) tax.

An unquestionable tax disadvantage of a professional corporation is the fact that a professional, practicing within a professional corporation, will pay more FICA taxes than a self-employed professional.⁵⁴ This is because, in 1982 terms, the corporation will pay 6.70% FICA tax on the employee, and the employee himself will pay 6.70% tax, for a total of 13.40% on the first \$32,400 of salary, or \$4,341.60 in total FICA tax. The self-employed professional, on the other hand, will pay only 9.35% FICA tax on the first \$32,400 of income for a total FICA tax of \$3,029.40.⁵⁵

3. Personal holding company tax.

There is a slight possibility that a professional corporation, especially a one-person corporation, could be classified as a "personal holding company" by the IRS and subject to a tax of fifty percent on its undistributed personal holding company income.

A personal holding company is one in which more than half of its stock is held by five individuals or less, and sixty percent of its adjusted ordinary gross income comes from within one of the categories designated as personal company income.⁵⁶ The personal holding company test is purely mechanical and motives of tax avoidance are irrelevant, so it is possible for an unincorporated professional to find himself unwittingly characterized as a professional holding company.

Fortunately, however, this is a remote possibility if certain precautions are taken. A 1975 revenue ruling⁵⁷ indicates that a professional corporation which observes the following precautions will not be considered a personal holding company. First the corporation should not contract with the patient or client for a specific individual to perform particular services. Second, the corporation should not enter into a contract which forbids the substitution of another professional to perform the promised services. Finally, the corporation should not agree to perform any type of service so unique that no other professional could possibly be substituted. These requirements, on reflection, merely as-

54. I.R.C. § 3111 (West 1982).

55. SOCIAL SECURITY ADMINISTRATION, *YOUR SOCIAL SECURITY* 25 (1980).

56. I.R.C. § 542(a) (West 1982).

57. Rev. Rul. 75-67, 1975-1 C.B. 169.

sure that the corporation is in fact a separate entity from an individual professional.

4. Accumulated earnings tax.

Because of the lower tax rate on corporations,⁵⁸ it is often tempting to accumulate income in the corporation and pay the lower tax there, rather than to pass it on to the shareholder-employees as wages or dividends where it will be subjected to higher income tax rates. The accumulated earnings tax and the personal holding company tax are weapons to curtail the accumulation of profits in a corporation to avoid higher individual income tax rates.

Since 1975, the Code has permitted a corporation to accumulate up to \$150,000 before being required to show that the accumulation is necessary for the reasonable needs of the business.⁵⁹ ERTA raised the figure to \$250,000, but the increase does *not* apply to corporations whose principle business consists of the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting.⁶⁰

Both the personal holding company tax and the accumulated earnings tax can be avoided in the same fashion as the so-called "second tax." This can be accomplished by paying adequate salaries, maximizing the contribution to corporate retirement plans, and paying out corporate profits as dividends to shareholders.

5. Unreasonable compensation.

The Internal Revenue Code prohibits payment as salary (which

58. The income tax imposed by I.R.C. § 11(b) (West 1982) on corporations is as follows:

(1) 15% (16% for taxable years beginning in 1982) of so much of the taxable income as does not exceed \$25,000;

(2) 18% (19% for taxable years beginning in 1982) of so much of the taxable income as exceeds \$25,000 but does not exceed \$50,000;

(3) 30% of so much of the taxable income as exceeds \$50,000 but does not exceed \$75,000;

(4) 40% of so much of the taxable income as exceeds \$75,000 but does not exceed \$100,000;

(5) 46% of so much of the taxable income as exceeds \$100,000.

59. I.R.C. § 531 (West 1982) imposes a tax on "accumulated taxable income" of 27.5% of the first \$100,000 of taxable income over \$100,000. I.R.C. § 535 (West 1982) defines accumulated taxable income as "taxable income" after deducting, among other things, the "accumulated earnings credit." I.R.C. § 535(C)(2)(B) (West 1982) provides that "[i]n the case of a corporation the principal function of which is the performance of services in the field of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting," the accumulated earnings credit shall be not less than \$150,000 per year.

60. I.R.C. §§ 232 (a)(2)(B), 535 (c)(2) (West 1982).

would be deductible as an ordinary business expense of the corporation) of unreasonable amounts which in fact represent a return on capital. To the extent that salary is too low, the Internal Revenue Service may add to it.⁶¹ If the salary is so high that it includes a return on capital, part of the salary may be treated as a dividend.⁶²

It can be argued that if the corporate shareholder-professional's salary does not exceed his or her earnings before incorporation, there should not be a presumption of validity to a claim of unreasonable compensation. However, in a corporate setting, a professional would have to attribute at least part of his or her earnings to a return on capital investment. In the *McCandless Tile Service* case,⁶³ a close corporation paid out approximately fifty percent of net profits as salaries to two shareholder-employees but declared no dividend during five years of corporate operation. The court of claims held that the salaries were reasonable, but that they included a distribution of corporate earnings amounting to fifteen percent of net profits which would not be deductible as ordinary business expenses of the corporation.

In 1979,⁶⁴ the IRS rejected the "automatic dividend" rule of *McCandless*, stating that a lack of dividend payments will not be the sole ground for disallowing a deduction for compensation paid to a shareholder-employee if the compensation is reasonable. However, the failure to pay more than an insubstantial portion of earnings as dividends will be considered "a very significant factor" in determining the deductibility of compensation.

IV. THE EFFECT OF ERTA ON THE PROFESSIONAL CORPORATION

Prior to the adoption of ERTA in 1981, the tax advantages of the professional corporation were clearly greater than the tax disadvantages, especially since some of the more important disadvantages, such as the accumulated earnings tax and personal holding company tax, were easily avoided. Moreover, the non-tax advantages of the professional corporation, in balance, appear to outweigh the non-tax disadvantages, thereby making the professional corporation an attractive and desirable vehicle in which to prac-

61. I.R.C. §§ 162(a), 482 (West 1982).

62. I.R.C. § 482 (West 1982).

63. 422 F.2d 1336 (Ct. Cl. 1970).

64. Rev. Rul. 79-8, 1979-1 C.B. 92.

tice a profession. However, ERTA and TEFRA contain a number of provisions which will have significant impact on the decision of whether to incorporate a professional practice.

Strictly speaking, ERTA did not reduce the attractiveness of the professional corporation. The Act merely made an unincorporated professional practice more attractive. The most significant impact of ERTA on the decision to incorporate a professional practice came from the Act's liberalizing of the Keogh, or HR-10 Retirement Plan coverage, and the expansion of IRA coverage to persons already covered by another retirement plan.

Before ERTA, annual contributions to a Keogh plan were limited to the lesser of fifteen percent of earned income or \$7,500. In applying the 15%/\$7,500 limitation, only the first \$100,000 of earned income could be taken into account.⁶⁵ ERTA, however, raised the ceiling on deductible contributions to the lesser of 15% of earned income or \$15,000, and up to \$200,000 of compensation could be taken into account in determining contributions.⁶⁶ ERTA also permitted any person to contribute to an Individual Retirement Account [hereinafter IRA] the lesser of \$2,000 or 100% of gross income.⁶⁷ If the individual is married and the account maintained as a spousal IRA, the annual deductible retirement contribution is raised to \$2,250.⁶⁸

65. I.R.C. § 404(e) (West 1981) had provided that the deductible contributions could not exceed "\$7,500, or 15 percent of the earned income derived by such employee from the trade or business. . . ." I.R.C. § 401(a)(17) (West 1981) had provided that a Keogh plan was a "qualified" plan "only if the annual compensation of each employee taken into account under the plan does not exceed the first \$100,000 of such compensation." *Id.*

66. ERTA § 312(a) (West 1982) amended I.R.C. § 404(e) (West 1981) by striking out \$7,500 and inserting "\$15,000." ERTA § 312(b)(1) (West 1982) amended I.R.C. § 401(a)(17) (West 1981) to permit the first \$200,000 of compensation to be taken into account.

67. I.R.C. § 219(b)(1) (West 1981) had allowed a deduction for contribution to an IRA of "an amount equal to 15 percent of the compensation includible in [an individual's] gross income for such taxable year, or \$1,500, whichever is less." I.R.C. § 219(b)(2) (West 1981) had disallowed deductions for contributions to an IRA for participants in qualified plans (Keogh or corporate). ERTA § 311(a) (West 1982) amended I.R.C. § 219 (West 1981) to permit a deduction of the lesser of \$2,000 or an amount equal to the compensation includible in the individual's gross income for such taxable year (I.R.C. § 219(b)(1) (West 1982)), and repealed the old prohibition against deductions for IRA contributions by taxpayers who were already covered by qualified plans.

68. I.R.C. § 220 (West 1981) had permitted a maximum deduction of \$1,750 for spousal IRAs only if the contribution was evenly split between the spouses. I.R.C. § 311(e) (West 1982) eliminated this requirement by repealing I.R.C. § 220 (West 1981) and providing, at I.R.C. § 219(c) (West 1982), that as long as no more than \$2,000 is contributed to the account of either spouse, the contribution can be divided as the parties wish and the maximum *total* contribution to a spousal IRA is the lesser of \$2,250 or an amount equal to the compensation includible in the individual's gross income for the taxable year, over the amount allowed as a deduction under subsection (a) for the taxable year.

Thus, an unincorporated individual could contribute and deduct \$17,000 per year to a Keogh plan and an IRA. And if a spousal IRA is used, a total of \$17,250 may be contributed and deducted. Moreover, if the spouse had income of at least \$2,000, he or she could contribute to a separate IRA and the total deductible contributions would be \$19,000 — \$15,000 to a Keogh plan, \$2,000 to an IRA, and \$2,000 to the spouse's IRA.

The possibility of contributing and deducting up to \$19,000 per year for retirement amounted to a substantial deterrent to incorporation by those individuals whose only reason for incorporation was to deduct more than the previous Keogh limit of \$7,500. After ERTA, the professional would have to desire deductions of more than \$17,000-\$19,000 per year for retirement purposes before incorporation could be justified on this ground alone.

Other "sweeteners" in the ERTA "pot" for Keogh plan holders provided further incentive for incorporation. Keogh rules prohibit discrimination in contributions or benefits in favor of a self-employed individual, or other highly compensated employees, as against other employees.⁶⁹ Prior to ERTA, for purposes of determining whether there was discrimination, the \$7,500 and 15% limitations were figured on the first \$100,000 of earned income. Generally, if a professional wished to limit contributions on behalf of a secretary to 7.5% of earned income, the same limitation applied to the earned income of the professional. He could contribute on his behalf 7.5% of up to \$100,000 of earned income or a total of \$7,500 per year.

ERTA, however, raised the ceiling on deductible contributions to the lesser of 15% of earned income or \$15,000, and the maximum amount of compensation that could be used to apply discrimination tests was increased from \$100,000 to \$200,000.⁷⁰ Consequently, in the above example, a professional could continue to contribute 7.5% of earned income to a Keogh plan for his secretary. The 7.5% contribution limit would still apply to the professional himself, but could now be applied against \$200,000 of salary, permitting a total of \$15,000 per year in contributions on behalf of the professional.

If the professional's income was less than \$200,000 per year, he could contribute up to 15% of earned income if the maximum con-

69. I.R.C. § 401(a)(4) (West 1982).

70. ERTA § 312 (b) (West 1982), I.R.C. § 401(a)(17) (West 1982).

tribution does not exceed \$15,000 per year, and if the plan does not discriminate against lower-paid employees. ERTA also expanded the anti-discrimination protection by providing that, if annual compensation in excess of \$100,000 were taken into account in a defined contribution Keogh plan, the minimum contribution for each employee covered by the plan could not be less than 7.5% of that participant's compensation.⁷¹

Additionally, ERTA tightened the rule regarding borrowing from a Keogh plan. Formerly, a Keogh plan participant who was not an owner-employee could borrow from a Keogh plan without having the loan treated as a distribution.⁷² ERTA provided that loans to all partner participants in a Keogh plan were automatic distributions,⁷³ and thus subject to ordinary income tax if the recipient was under the age of fifty-nine years and six months.⁷⁴ Since borrowing was not prohibited under corporate plans, Keogh plans became less attractive than their corporate counterparts.

Looking at the overall scheme, ERTA made Keogh, or HR-10 retirement plans, more attractive vis-a-vis corporation plans. Nonetheless, where a professional could afford to place more than

71. ERTA § 312(b) (West 1982) amended I.R.C. § 401(a)(17) (West 1981) to include the following language in defining a "qualified plan:"

In the case of a plan which provides contributions or benefits for employees some or all of whom are employees within the meaning of subsection (c)(1), or are shareholder-employees within the meaning of section 1379(d)

(B) in the case of—

(i) a defined contribution plan with respect to which compensation in excess of \$100,000 is taken into account, contributions on behalf of each employee . . . to the plan or plans are at a rate (expressed as a percentage of compensation) not less than 7.5 percent, or

(ii) a defined benefit plan with respect to which compensation in excess of \$100,000 is taken into account, the annual benefit accrual for each employee . . . is a percentage of compensation which is not less than one-half of the applicable percentage provided by subsection (j)(3).

ERTA § 312 (b) (West 1982).

72. I.R.C. § 72(m)(4)(B) (West 1981) provided:

[i]f during any taxable year, an owner-employee receives, directly or indirectly, any amount from any insurance company as a loan under a contract purchased by a trust described in section 401(a) which is exempt from tax under section 501(a) or purchased as part of a plan described in section 403 (a), and issued by such insurance company, such amount shall be treated as an amount received under the contract.

Only "owner-employee" (i.e., proprietors or more-than-10%) partner Keogh participants were so identified and I.R.C. § 72(m)(5) (West 1982) slapped a 10% premature distribution penalty on such "distributions."

73. ERTA §§ 312(d), 312(e) (West 1982) amended I.R.C. § 72(m) (West 1981) to provide that *all* partners' loans from a Keogh plan are to be treated as distributions. Former I.R.C. § 72(m)(6) (West 1981) had defined "owner-employee" within the meaning of I.R.C. § 401(c)(3) (West 1982) (i.e., more-than-10% partner). ERTA added a sentence to I.R.C. § 72(m)(6) (West 1982) which also defines "owner-employee" within the meaning of I.R.C. § 401(c)(1) (West 1982) which has no 10% ownership requirement.

74. I.R.C. §§ 72(m)(5), 72(m)(8) (West 1982).

\$17,000 per year in a tax-deductible retirement fund, corporate plans remained the only alternative to accomplish that goal. Moreover, while ERTA made self-employed plans more attractive, it did not remove the restrictions against integration with social security, limits on fund payouts prior to age fifty-nine years and six months, restrictions on borrowing from the fund, and the requirement for full and immediate vesting—all unattractive features of Keogh plans when compared with corporate counterparts. Keogh plans were more attractive after ERTA, but the corporate plan was still “the fairest of them all.”

Perhaps the most important aspect of ERTA as it affected professional corporations was not in any specific provision, but in the very fact that significant steps were taken to achieve equality between retirement plans for corporate employees and self-employed individuals. In effect, the dam was broken and self-employed individuals could achieve more with retirement plans.

Sensing the need for equality, the Tax Section of the New York State Bar Association sent to the Treasury Department a detailed report recommending the adoption of legislation establishing parity between employee benefit plans for the self-employed and plans for corporate employees.⁷⁵ The existing Tax Section Chairman, Ruth G. Shapiro, stated that “[a]doption of this legislative change would stem a growing move toward incorporation [of law firms and lawyers] and, therefore, would largely render moot the numerous legal issues discussed in the report.”⁷⁶

Congressional response soon followed with House Resolution 6410,⁷⁷ the Pension Equity Tax Bill, introduced by Representative Charles B. Rangel of New York, as a clear-cut proposal to create equity between pension plans available to corporate employees and those available to self-employed individuals. The bill raised the limit on the Keogh defined contribution plan from \$15,000 to \$30,000, and reduced the corporate plan dollar limit for defined contribution plans from the 1982 level of \$45,475 to \$30,000. The 1982 limit of \$136,425 on payout from corporate defined benefit plans was reduced to \$90,000. Cost-of-living increases for both defined contribution plans and defined benefits plans were abolished. Keogh plan rules regarding treatment of certain loans as

75. 15 TAX NOTES 590 (May 17, 1982).

76. *Id.*

77. H.R. 6410, 97th Cong., 2nd Sess. (1982).

automatic distributions were extended to corporate plans.⁷⁸

Much of the testimony of J. Roger Mentz, Ms. Shapiro's successor, as chairman of the New York State Bar Association Tax Section, in an appearance before the House Ways and Means Committee, was in opposition to specific provisions in House Resolution 6410 (although not the provisions outlined above) and he suggested modifications to the bill to conform to his concerns. But the basic position of the Tax Section of the New York State Bar Association was clear: legislative parity of self-employed pension plans with corporate plans.⁷⁹

V. THE EFFECT OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982

The Tax Equity and Fiscal Responsibility Act of 1982 appears to have accomplished the above-mentioned parity by absorbing and enacting into law most of the more substantial provisions of the Pension Equity Tax Bill. Beginning January 1, 1983, annual additions to corporate defined contribution plans may not exceed \$30,000, and the maximum payout that can be funded under a corporate defined benefit plan is \$90,000—a reduction of the 1982 maximum by one-third.⁸⁰ The unincorporated or Keogh plan limits of \$15,000, or 15% of compensation for defined contribution plans, and the old limits on payment benefits under Keogh plan defined benefit plans are abolished, and the maximums of \$30,000 for defined contribution plans, and \$90,000 for defined benefit plans apply to Keogh plans as corporate plans.⁸¹

A. Frozen Cost of Living Adjustments

The annual cost-of-living adjustments to corporate plan benefit limits have been frozen until January 1, 1986, at which time they will take into account only inflation after October 1, 1984. Moreover, future cost-of-living adjustments will be measured by the formula in effect at that time to provide cost-of-living increases in

78. 15 TAX NOTES 771 (May 31, 1982).

79. 15 TAX NOTES 981-82 (June 21, 1982).

80. Tax Equity and Fiscal Responsibility Act of 1982, [hereinafter cited as TEFRA] § 235 (a) (West 1982), I.R.C. §§ 415(b)(1)(A), (c)(1)(A) (West 1982). The I.R.C. §§ 415(b)(1)(A), (c)(1)(A) (West 1981) limitations had been \$5,000 for a defined benefit plan and \$25,000 for a defined contribution plan. But, as noted earlier in this article, annual cost-of-living adjustments permitted under I.R.C. § 415(d)(1) (West 1982) raised these figures to \$136,425 and \$45,475 respectively.

81. TEFRA § 238 (West 1982) abolished the old \$15,000 or 15% of compensation limits set for Keogh defined contribution plans set by I.R.C. § 401(j) (West 1981). Now Keogh and corporate retirement plans alike are subject to the limits of I.R.C. § 415 (West 1982), which are \$30,000 for a defined contribution plan and \$90,000 for a defined benefit plan.

social security benefits.⁸² These future cost-of-living adjustments will be geared to the social security benefit index rather than the social security primary insurance amounts currently used.⁸³

B. Actuarial Adjustments for Early Retirement

TEFRA has put a halt to the practice of increasing contributions to corporate defined plans by making contributions based on a projected retirement age of fifty-five.⁸⁴ TEFRA requires that the dollar limit for benefits in plans beginning before age sixty-two (instead of fifty-five) must be actuarially reduced to the equivalent of the dollar limit for benefits beginning at age sixty-five.⁸⁵ In no event, however, can a benefit be reduced below \$75,000.⁸⁶

C. Limit on Estate Tax Exclusion

TEFRA also placed a ceiling on the heretofore limitless exclusion from the federal estate tax of payments from a professional corporation's retirement plan in the form of annuities. Estates of decedents dying after January 1, 1982, may only exclude \$100,000 of such annuities.⁸⁷

D. Limit on Loans From Plans

Prior to TEFRA, loans from retirement plan funds could be made to participants in corporate plans substantially without restriction, and such loans were not treated as taxable distributions. Under TEFRA, plan loans are considered taxable distributions to the extent that aggregate loans from all plans exceed the lesser of \$50,000, or fifty percent of the present value of the vested accrued

82. TEFRA § 235(b) (West 1982); I.R.C. § 415(d) (West 1982).

83. *Id.* The effect will be to reduce retirement plan accumulation by making retirement benefits inflation protected rather than inflation-proof as previously treated.

84. Until TEFRA, the contribution limitation for a corporate defined benefit plan was actuarially reduced only if retirement was available before age 55. Thus, a retirement could be funded to take place as early as age 55, but the dollar limitation was calculated in terms of a straight-life annuity beginning at age 65.

85. For example, if a retiree takes his benefit at age 60, he is limited to the actuarial equivalent of that payment at age 65. If his benefit is \$95,000 and the actuarial equivalent of that payment at age 65 would be \$83,000, he would receive \$83,000.

86. TEFRA § 235(e) (West 1982); I.R.C. §§ 415(b)(2)(C), (D) (West 1982).

87. TEFRA § 245 (West 1982); I.R.C. § 2039(g) (West 1982).

benefit of the employee.⁸⁸

E. Parity Between Corporate & Keogh Plans

TEFRA has attempted to establish substantial parity between corporate and non-corporate retirement plans by the following means:

(1) Formerly, Keogh plans which included an owner-employer⁸⁹ had to benefit all employees with at least three years of service. TEFRA has repealed this requirement and Keogh plans will henceforth be subject to the same coverage test as are corporate plans.⁹⁰

(2) Owner-employees who participated in Keogh plans in the past were prohibited under the former law from making voluntary contributions to their plans. This prohibition has been eliminated.⁹¹

(3) "Employees" were formerly eligible for an exclusion from their gross estates of up to \$5,000 in death benefits paid by the employer, or on behalf of the employer. Self-employed persons, however, were not considered "employees." TEFRA extends the death benefit exclusion to self-employed persons where the distribution is made in a lump sum.⁹²

(4) Keogh plans were subject to special rules with respect to integration of such plans with social security. Only defined contribution Keogh plans and defined benefit Keogh plans not covering owner-employees could integrate with social security.⁹³ TEFRA provides that the same integration rules apply to corporate and

88. TEFRA § 236(b)(1) (West 1982) repealed I.R.C. § 72(m)(8) (West 1982) which had provided: "if, during any taxable year, an owner-employee receives, directly or indirectly, any amount as a loan from a trust described in section 401(a) which is exempt from tax under section 501(a), such amount shall be treated as having been received by such owner-employee as a distribution from such trust." *Id.* TEFRA added a new subsection 72(p) which provides that plan loans are considered taxable distributions only to the extent that they exceed the lesser of \$50,000 or 50% of the present value of the vested accrued benefit of the owner-employee.

89. "Owner-employee" is defined as "an employee who—(A) owns the entire interest in an unincorporated trade or business, or (B) in the case of a partnership, is a partner who owns more than 10% of either the capital interest or the profit interest in such partnership. . . ." I.R.C. § 401(c)(3) (West 1982).

90. TEFRA § 237(a) (West 1982); I.R.C. § 401(d) (West 1982).

91. Such voluntary contributions are now subject to the limitations on contributions generally. I.R.C. § 415 (West 1982). TEFRA § 237(c) (West 1982) repealed I.R.C. § 4972 (West 1981) which imposed a tax on excess contributions for self-employed individuals.

92. TEFRA § 239 (West 1982). I.R.C. § 101(b)(3)(B) (West 1982) now provides: "In the case of any lump-sum distribution . . . the term 'employee' includes a self-employed individual described in section 401(c)(1)." *Id.*

93. TEFRA § 238(b) (West 1982) repealed I.R.C. § 410(j) (West 1981).

non-corporate plans.⁹⁴

(5) Keogh plans are no longer restricted to the use of banks or other approved financial institutions as trustees, but the professionals covered by the plan may opt to serve as trustees themselves and avoid the trustees' fees. This has been the rule only for corporate plans in the past.⁹⁵

(6) Formerly, contributions to Keogh plans could not be made on behalf of an owner-employee who took an early, i.e., before age fifty-nine years and six months, withdrawal from the plan for the five taxable years following the withdrawal. TEFRA has repealed this restriction.⁹⁶

(7) Finally, TEFRA repealed the requirement that owner-employees under a Keogh plan consent to participate in the plan,⁹⁷ and that a Keogh profit-sharing plan provide a definite contribution formula for owners who are not owner-employees.⁹⁸

F. "Top-Heavy" Provisions

TEFRA also adds a new term (albeit not a new *concept*) to retirement planning—"top-heavy plans."⁹⁹ Plans found to be top-heavy are subject to additional rules which eliminate or reduce former advantages of such retirement plans. A plan is top-heavy if it provides more than sixty percent of its aggregate accumulated benefits (or account balances) to key employees.¹⁰⁰ Key employees are employee-participants who, at any time during the plan year or any of the four preceding plan years, is: (a) an of-

94. TEFRA § 239(b) (West 1982) added a new section 401(l) (West 1982), effective for plan years beginning after 1983, which extends to *all* qualified defined benefit plans a rule (formerly applied to Keogh plans), only to insure nondiscriminatory integration with social security.

95. TEFRA § 237(a) (West 1982) amended I.R.C. § 401(d) (West 1981) to remove the paragraph which set forth the requirement that Keogh plans have banks or other approved financial institutions as trustees.

96. TEFRA § 237(a) (West 1982) deleted I.R.C. § 401(d)(5)(C) (West 1981) which prohibited withdrawal before age 59 and 6 months for Keogh participants.

97. TEFRA § 237(a) (West 1982) deleted I.R.C. § 401(d)(4)(A) (West 1981) which required owner-employees to consent to coverage by a Keogh plan.

98. TEFRA § 237(a) (West 1982) deleted I.R.C. § 401(d)(2)(B) (West 1981) which established this requirement.

99. I.R.C. § 401(a)(4) (West 1981) had already prohibited discrimination in favor of officers, shareholders, or highly compensated employees. "Top-heavy" rules added by TEFRA are in a sense another expansion and clarification of the anti-discrimination concept.

100. TEFRA § 240(a) (West 1982) added I.R.C. § 416 (West 1982) which sets out in detail the special rules for top-heavy plans which are discussed in the text of this article. I.R.C. § 416(g) (West 1982) defines the term "top-heavy plan."

ficer, (b) one of the ten employees owning the largest interests in the company, (c) a five percent owner of the employer, or (d) a one percent owner of the employer with annual compensation from the employer in excess of \$150,000.¹⁰¹ Key employees covered by two or more plans must be aggregated, and the sixty percent test is applied against the aggregated plans to determine top-heaviness.¹⁰² Since many professionals' retirement plans will fall within the category of "top-heavy," the special rules applicable to top-heavy plans are of particular interest.

1. Vesting requirements.

Each year a plan is top-heavy it must meet one of two special vesting schedules to qualify for favorable tax treatment. One alternative is three year 100% vesting, and the other is six year graded vesting. Under the first alternative, no vesting at all is required in the first two years but after three years of service the participant must be 100% vested. Under six year graded vesting, participants must vest at least 20% of the accrued benefit by the end of the second year and 20% at the end of each succeeding year, for a total of 100% at the end of six years.¹⁰³

2. Covered compensation.

In top-heavy plans, only the first \$200,000 of an employee's compensation may be taken into account in determining contributions or benefits under the plan. This \$200,000 limit will be adjusted annually for inflation beginning in 1986.¹⁰⁴

3 Minimum Benefits and Contributions.

Top-heavy plans must provide minimum benefits (for defined benefit plans) which may reach as high as twenty percent (computed at two percent per year of service with the top-heavy employer) of the average compensation for the high five years.¹⁰⁵ For defined contribution plans, top-heavy plans must make contributions of at least three percent of the compensation for non-key employees.¹⁰⁶ Top-heavy plans may not consider social security benefits as part of the minimum benefits or contributions they must provide.¹⁰⁷

Plans which are top-heavy and which do not meet the above re-

101. TEFRA § 240(a) (West 1982); I.R.C. § 416(h)(4)(i)(I) (West 1982).

102. TEFRA § 240(a) (West 1982); I.R.C. § 416(g)(2) (West 1982).

103. TEFRA § 240(a) (West 1982); I.R.C. § 416(b) (West 1982).

104. TEFRA § 240(a) (West 1982); I.R.C. § 416(d) (West 1982).

105. TEFRA § 240(a) (West 1982); I.R.C. § 416(c)(1) (West 1982).

106. TEFRA § 240(a) (West 1982); I.R.C. § 416(c)(2) (West 1982).

107. TEFRA § 240(a) (West 1982); I.R.C. § 416(e) (West 1982).

quirements are not considered qualified plans under the Internal Revenue Code.¹⁰⁸

VI. CONCLUSION

Taken together, the effect of the various provisions of TEFRA is to elevate the unincorporated or Keogh retirement plan, and to lower the corporate retirement plan to a level of near equality. In effect, the tax reasons for incorporating a professional practice which have to do with retirement benefits have been effectively eliminated. Moreover, with the new IRS allocation powers provided by TEFRA, the professional corporation may well have been dealt the final blow.

TEFRA gives the IRS the authority to allocate income, deductions, credits, and exclusions between or among a professional corporation and its employee-owners if: (1) a personal service corporation was created for the principal purpose of avoiding or evading federal income tax by securing tax benefits which would otherwise be unavailable; (2) the personal services of the corporation are substantially performed by employee-owners (who are defined as any employees who own more than 10% of the outstanding stock of the corporation); and (3) substantially all of the services of the corporation are performed for another corporation, partnership, or other entity.¹⁰⁹

This grant of allocation power by Congress follows the 1981 opinion of *Keller v. Commissioner*.¹¹⁰ In *Keller*, the United States Tax Court refused to allow an allocation of this type in view of the one-man professional corporation's viability and business purpose. Some commentators have stated that these new powers mark the beginning of the end for professional service corporations.¹¹¹ One problem the IRS will encounter with the new provision is proving that the principal purpose of incorporation was evasion or avoidance of federal income taxes. Nevertheless, the allocation powers serves as a big stick.¹¹²

Given the reallocation power and other provisions of TEFRA,

108. TEFRA § 240(e)(1) (West 1982); I.R.C. § 401(a)(10)(B) (West 1982).

109. TEFRA § 240(a) (West 1982); I.R.C. § 269A (West 1982).

110. 77 T.C. 1014 (1981).

111. Prentice-Hall's handbook on TEFRA headlined the discussion of this subject. PRENTICE-HALL, INC., HANDBOOK ON THE TAX EQUITY AND FISCAL REponsibility ACT OF 1982, 65 (1982).

112. 15 TAX NOTES 909 (June 14, 1982).

the future of the professional corporation is cloudy, at best. Clearly, in light of the new IRS allocation powers, a corporation formed for the sole purpose of avoiding taxes is doomed. In light of this fact, TEFRA has provided a transitional rule that allows professional corporations to complete a one month liquidation during 1983 and 1984 without the risk that the corporation will incur taxes on its unrealized receivables.¹¹³

The discussion has now come full circle. If the professional corporation has a meaning and purpose beyond the mere saving of taxes, then, by all means, professionals should consider it. But if it has no other purpose, it should be avoided. The decision to incorporate a professional practice in the future will be made on grounds that relate to how the professional wishes to carry out his practice, instead of only one or two narrow questions concerned largely with taxes.

113. TEFRA § 247 (West 1982).