Internal Revenue Service Policy on Medical Practice Groups

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IN 1969 the Internal Revenue Service (IRS) announced that, in response to recent decisions of the Federal courts, "it is conceding that organizations of physicians, lawyers and other professional people organized under state professional association acts will, generally, be treated as corporations for tax purposes" (*1*). Since many of these professional people were also organized under State professional corporation acts, the reasonable assumption based on the context of the ruling in which this statement appeared is that the Internal Revenue Service also intended to cover organizations established under such acts.

On the surface, this decision is a great victory for the taxpaying professionals who in the past have been denied equality of treatment, under the Federal income tax laws, with others who have had the advantage of the corporate form of organization. But, it must be pointed out, this ruling does not entirely close the book on the matter. In the first place, the Government has stated that this decision will hold true generally. It then adds that, obviously, the Government must reserve the right to conclude differently in any case that reflects special circumstances not present in the court decisions (see *O'Neill* or *Kurzner* cases) which led to its change of attitude. This statement should serve as a strong warning to all who plan to incorporate to follow carefully the organizational patterns outlined in these two decisions. In addition, the trouble spots stressed in this paper are still pertinent since it may be anticipated that, this ruling notwithstanding, the Internal Revenue Service will not readily relinquish revenue. This attitude will become apparent when the changes made in the Subchapter S provisions by the Tax Reform Act of 1969 are pointed to later in my discussion.

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In any event, because the trend is toward encouraging the provision of medical care through the group practice of medicine, the decision as to whether to use the corporate form becomes extremely important. In making this decision, some knowledge concerning the history of the controversy may be helpful; but even more important is familiarity with the advantages and disadvantages of incorporation. These matters will be discussed later.

Historical Controversy

From the time of the 1954 decision in the case of *Kintner* v. *United States* (*2*) until its most recent policy statement, the Internal Revenue Service has steadfastly maintained that such organizations could not meet the tests for corporate status and therefore had to be taxed as partnerships.

In the case of *Morrissey* v. *Commissioner* (*3*), the IRS attempted to have a trust taxed as a corporation. In holding that the trust was a corporation for Federal income tax purposes, the court formulated four tests or standards of corporate status. These tests are continuity of life, centralized management, limited liability, and free transferability of interests. To qualify, an organization had to meet most of these tests.

Not until corporate owner employees began taking advantage of employee retirement plan benefits available to them and IRS revenue began to decline as a result did the IRS reverse its position. Then, following the adverse *Kintner* decision in 1954, the Internal Revenue Service issued Revenue Ruling 56–23, 1956–1 CB 598, stating in effect that it would not follow *Kintner*. However, the Internal Revenue Service reversed itself the next year and issued a ruling in which it stated that the "usual tests will be applied in determining whether a particular organization of physicians or other professional groups has more of the characteristics of a corporation than a partnership" (Revenue Ruling 57–546, 1957–2 CB 886). In 1960 the Internal Revenue Service again did an about-face and promulgated the "Kintner" regulations.

The Kintner regulations were designed to insure that no unincorporated organization could achieve corporate tax status. When the States adopted enabling legislation in response to these discriminatory regulations, the IRS countered with even more stringent regulations. The 1965 amendments, in effect, denied the possibility that professional corporations could ever meet the requisite tests for corporate status.

Despite these regulations, professional corporations were established. Then, when deficiencies were assessed against individual members as though they were members of partnerships rather than corporate employees, suits to obtain refunds were started. The results to date have been unanimously in favor of the taxpayers.

Three 1969 decisions by U.S. Circuit Courts of Appeals held that all or part of the 1965 amendments to the 1960 regulations were invalid: *United States* v. *Empey* (*4*), *O'Neill* v. *United States* (*5*), and *Kurzner* v. *United States* (*6*).

The court in the case of *Empey* held that the regulations were inconsistent with the definitions of the terms "corporation" and "partnership" in the Internal Revenue Code. It said, "To treat as a partnership for Federal income tax purposes a corporation organized and chartered under state laws as a corporation and operated as such in good faith, does violence to the statutory definitions of the terms. . . ." The court also held that these regulations were invalid because they represented an attempt by an administrative body to legislate, which is not permitted by the Constitution.

The court in the *O'Neill* case said that legislative history constituted convincing proof that Congress intended that corporations created under State law be treated as corporations for Federal tax purposes. It therefore held that the amended sections were invalid insofar as they require a corporation created under State law to be treated as something other than a corporation for Federal income tax purposes.

The court in the *Kurzner* case said that the 1965 amendments were "patently and radically arbitrary." They discriminate against the professional corporation (by forcing it to meet different standards) when these corporations are organized with no major differences from nonprofessional corporations, and they constitute an attempt to legislate and for these reasons are invalid. The court concluded that there was no statutory precedent for the 1965 amendments and that the professional association to which Dr. Kurzner belonged qualified as a corporation for Federal income tax purposes, based on the pre-1965 regulations.

In addition to these cases, eight other cases were heard at the district court level, two of which, *Holder* v. *United States* (*7*) and *Wallace* v. *United States* (*8*), were on appeal in U.S. Circuit Courts. Although the Internal Revenue Service said in a release that it would not press these appeals (*1*), it is interesting to note that the Fifth Circuit Court of the United States had issued a per curiam decision in the *Holder* case, affirming it in favor of the taxpayer on the basis of its decision in the *Kurzner* case.

The Internal Revenue Service added in its release that no appeal would be prosecuted in any other pending cases decided adversely to it on the same issue involving similar facts. The

Internal Revenue Service also said that all similar cases now under litigation or audit would be reviewed to see if they should be conceded. For the record, the other six cases, all in 1969, are *Cochran* v. *United States* (*9*), *First National Bank & Trust Company of Tulsa* v. *United States* (*10*), *Smith* v. *United States* (*11*), *Van Epps* v. *United States* (*12*), *Williams* v. *United States* (*13*), and *Ahola* v. *United States* (*14*). All of these cases are substantially in agreement that either all or part of the amended regulations are invalid because they set standards for professional service corporations that are more difficult to meet than those for nonprofessional corporations. According to the Internal Revenue Service, these regulations will be amended.

Decision to Incorporate

The decision to incorporate must take a number of very complex factors into consideration. It is not, by definition, necessarily advantageous to incorporate. A brief discussion of some of the major considerations follows.

Fringe benefits—employee retirement plans. One of the most important tax benefits offered by the corporate form is the opportunity to participate in an employee retirement plan qualified for tax deferral. Solo practitioners and members of partnerships are not employees for the purpose of coverage under such plans. An employee of a corporation who is also a shareholder is entitled to coverage since a corporation may set up a retirement plan for the benefit of all its employees. Under such plans, funds usually are set aside in a trust established for corporate employees to be paid at a future date, usually at retirement or termination of employment. These funds are provided either by corporate employer contributions on behalf of employees or by joint employer-employee contributions.

The advantage of these qualified retirement plans is that the contributions to the plan are tax deductible to the corporation as a business expense and at the same time are not currently taxable to the employee on whose behalf the contributions have been made. In a corporation this contribution has the effect of reducing the taxable income of employees by the amount of the corporate contribution. When highly paid employees such as physicians are involved, the effect is to reduce the current taxable income that is otherwise taxable to them. Thus less income is taxable to them at current high rates and is deferred until the retirement years, when income is presumably lower and subject to lower tax rates.

Solo practitioners and members of partnerships may adopt the Keogh law plans for self-employed persons, but the tax-deferred benefits are much lower. For example, deductible contributions to a regular pension plan may be as high as 25 percent of an employee's compensation if actuarially required to fund his benefits. Under the Keogh law, contributions on behalf of owner-employees are limited to 10 percent of earned income or $2,500, whichever is lower.

Employee insurance programs. Another fringe benefit for the corporate member employee is the ability to establish employee insurance programs at tax savings. A corporation may establish one of these programs to cover any one or all of the three main areas of insurance. A group term life insurance program may be set up for 10 or more employees. The corporation pays the premiums and then deducts them as a business expense. At the same time the employee is not taxed for any of this coverage up to $50,000. The corporation may also purchase insurance policies to cover hospitalization and other major medical costs. In the event of disability the corporation may either continue to pay the employee or take out some form of disability insurance for him. In either instance, the cost to the corporation is tax deductible. The employee is also free from taxation on any amount up to $100 per week paid as sick pay in lieu of wages for absence from work due to sickness or injury. For a partner or solo practitioner, the cost of similar coverage comes out of after-tax dollars.

Subchapter S corporations. Professional corporations with 10 or fewer stockholders may elect to be taxed as Subchapter S corporations. The major difference between the standard corporation and the Subchapter S corporation is that the standard corporation is taxed on its income and accounts for its own losses. That is, the individual stockholder is not personally responsible for any more than the amount of his corporate share. On the other hand, a Subchapter S corporation pays no income tax, but its stockholders pay a personal income tax on the corporation's income allocable to them or take into account any losses suffered by the corporation. Thus the Subchapter S corporation resembles a partnership more than a corporation.

The advantage of electing Subchapter S status is that the corporation is still entitled to a standard corporation's deductions for contributions to qualified retirement plans and the other fringe benefits referred to previously. A Subchapter S corporation may also avoid some potential disadvantages that a standard corporation faces, such as the personal holding company penalty tax or the accumulated earnings tax. In addition, compensation received by a Subchapter S employee may be treated as distributable partnership income. In this connection, see the subsequent discussion of unreasonable compensation.

The advisability of electing Subchapter S status after December 31, 1970, is questionable. Effective for taxable years after this date, any officer or employee who owns more than 5 percent of Subchapter S corporation stock must include with income the contributions made by the corporation under a qualified plan on his behalf to the extent the contributions exceed 10 percent of his salary or $2,500, whichever is less. This Keogh law type of limitation was added to the regulations by the Tax Reform Act of 1969.

Lower tax rates. Technically, the physician who engages in the corporate practice of medicine pays a double tax since the corporation is required to pay a tax on income received by it and he pays a tax on income paid to him by the corporation. The current corporate tax rate is 22 percent on the first $25,000 and an additional 26 percent on all undistributed income above $25,000—plus the current surcharge, which has just been extended by Congress. On the face of it, no real savings accrue because, as a stockholder employee, the physician indirectly pays his share of the corporation income tax as well as his personal income tax. However, if the corporation can distribute its total income by deducting the cost of salaries, fringe benefits, and other expenses, it has no taxable income. Then the physician pays income tax only on his salary excluding the cost of fringe benefits which would otherwise be taxable to him if he were not a corporate employee.

Personal holding company. If the corporation fails to distribute its total income and is unfortunate enough to fall within the definition of a personal holding company, it may be subject to a penalty tax of 70 percent. A corporation may be subject to this tax if more than 50 percent of its stock is held by five or fewer persons and if 60 percent of its adjusted gross income is personal holding company income. If any corporation has fewer than 10 members, more than 50 percent of its stock will necessarily be in the possession of five or fewer persons. And, particularly concerning a small professional corporation, the definition of a personal holding company may apply, because included with income are amounts received under general service contracts made with employees of the corporation owning 25 percent or more of the value of the shares. The problem arises whenever a patient is allowed to specify a particular employee of the corporation to perform professional services; that is, which physician in a group practice is "his" physician.

Limited liability. Limited liability is generally available for shareholders of professional corporations, which means that a physician shareholder, unlike a partner in a partnership, will not be held personally liable, beyond his investment in the corporation's stock, for any debts incurred by the corporation. Even for acts of negligence by other physician employees, he incurs no secondary liability as he would under the agency relationship of a partnership. However, most statutes provide that a physician's personal liability to his patients remains unchanged under corporate form and is not limited to his investment.

Unreasonable compensation. If a regular corporation pays compensation that may be considered excessive when compared with salary or wages customarily paid under similar circumstances, the Internal Revenue Service could treat the excess payment as unreasonable compensation. If this happened, part would be treated as deductible wages and part as income taxable to the corporation as well as dividends taxable to the employee. Therefore, double taxation could result to the extent that the compensation would be treated as dividends.

Accumulated earnings tax. A penalty tax of 27½ to 38½ percent is imposed on earnings retained in excess of $100,000 (cumulative) income. Any amount above that limit is subject to this penalty tax unless the corporation can show that the overage is justified by the reasonable needs of the business. Two justifiable reasons for accumulating earnings are to pay for additional business needs or to purchase additional property for use in the business.

Sham corporations. One approach that may be taken by the Internal Revenue Service since it decided to recognize the professional service corporation may be to charge that incorporation had no business purpose. This factor must be considered carefully. If the corporation is unable to show that it was organized for purposes other than tax savings, the IRS probably would take action against it. To avoid such a charge, the corporation should be prepared to prove that the corporate form was adopted for efficiency and economy of operation and not purely for tax advantages.

Anticipated outcome. As a practical matter, the professional service corporation should be utilized only when the facts indicate that a medical practice can be conducted economically and efficiently. Engaging in business as a corporation is not always justified by facts. Were it otherwise, every business conducted as a solo proprietorship or partnership would long since have been incorporated.

The possible impact of a recent U.S. Tax Court decision in a case involving the incorporation of a nonprofessional solo proprietorship (*15*) should not be dismissed. At least the Research Institute of America seems to think that the case could hurt the new professional corporations (*16*). The facts were that a plumbing contractor, operating as a sole proprietor, incorporated and had his corporation set up a plan to pay his medical expenses. He was the only full-time salaried employee.

The tax court found that the purpose of the plan was not to benefit Smithback as an employee but rather as owner of the plumbing business and sole stockholder. "We understand the genesis and the primary purpose of the plan—indeed, of the incorporation of Smithback's business—to have been the avoidance of Federal taxation, a purpose which obviously was to benefit Smithback in his capacity as owner of the business rather than as employee. The plan did not confer any health or medical benefits upon Smithback as employee." The court therefore held that the medical payments were taxable as dividends to Smithback and not deductible by the corporation.

The most recent pronouncement on the subject of professional service organizations formed under State professional association or corporation statutes is that such organizations will generally be treated as corporations for income tax purposes in the same state as, and having facts similar to, the cases cited throughout this article (*17*).

The ruling adds that "a professional service organization must be both organized and operated as a corporation to be classified as such." Therefore, from its inception the corporate form must have reality. Its affairs must be handled like that of any other business corporation. It must have bylaws, keep minutes, enter into contractual agreements in the corporate name, and otherwise deal with customers, clients, and patients in the corporate name. In this connection, many two-man corporations are most vulnerable to attack. The *Kurzner* case involved a two-man corporation, but the facts in that case will have to be adhered to for the same results to apply.

The right of a professional man to enjoy the same retirement benefits that would be available to him if he were a corporate employee has been significant in the drive to incorporate his practice. It is interesting that the Department of the Treasury opposed a proposed Senate amendment to the Tax Reform Act of 1969 that would have restricted professional corporations to limitations of the Keogh law. Opposition was based on the ground that self-employed persons are entitled to the same tax treatment as corporate employees. The Senate amendment in question was defeated on the floor, but the Treasury Department gave assurances that it would present legislative proposals to achieve equality.

Deputy Assistant Secretary for Tax Policy John Nolan, of the Treasury Department, has said: "Self-employed persons who do not choose to move into professional corporations, and now shareholder employees of Subchapter S corporations, will be discriminated against by being subjected to House Report No. 10 limitations unless equal treatment is provided.

"These differences should be eliminated by providing a uniform set of limitations, applicable to corporate employees and self-employed persons alike, regardless of the form of organizations. . . . A uniform limit on contributions on behalf of any corporate employee or self-employed person should be established. As an example, this limit on annual contributions might be 15 percent of earned income or $10,000, whichever is less."

REFERENCES

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(3) *Morrissey* v. *Commissioner* (36–1 USTC 9020) 296 U.S. 344 (1935).
(4) *United States* v. *Empey* (69–1 USTC 9158) — F. 2d —, aff'g D.C. (67–2 USTC 9638) 272 F. supp. 851.
(5) *O'Neill* v. *United States* (69–1 USTC 9372) — F. 2d —, aff'g D.C. (68–1 USTC 9251) 281 F. supp. 359.
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(7) *Holder* v. *United States* (68–2 USTC 9504) 289 F. supp. 160.
(8) *Wallace* v. *United States* (68–2 USTC 9669) 294 F. supp. 1225.
(9) *Cochran* v. *United States* (69–1 USTC 9250).
(10) *First National Bank & Trust Co. of Tulsa* v. *United States* (69–1 USTC 9296).
(11) *Smith* v. *United States* (69–1 USTC 9360).
(12) *Van Epps* v. *United States* (69–1 USTC 9367).
(13) *Williams* v. *United States* (69–2 USTC 9519).
(14) *Ahola* v. *United States* (69–2 USTC 9520).
(15) U.S. Tax Court: Edward D. Smithback. U.S. Tax Court Memorandum Decision 1969–136, June 30, 1969. Reported in Commerce Clearing House, Inc., Chicago, U.S. Tax Court Memorandum Decisions 28 TCM 709.
(16) Research Institute of America: Special reports. Tax Coordinator, New York, July 17, 1969, p. 4.
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Tearsheet Requests

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GRACE Retired to Smithsonian

The National Library of Medicine sponsored the development of the first computer-driven high speed phototypesetter, GRACE (Graphic Arts Composing Equipment). Only 5 years ago, it was the fastest and most sophisticated phototypesetter in the nation. Now it is a historic relic, joining other prototype systems in the antique and historical printing collection of the Smithsonian Institution. A new production model, PHOTON ZIP 901, has replaced GRACE.

In the early 1960's, the National Library of Medicine entered the computer age with the development of MEDLARS (Medical Literature Analysis and Retrieval System). The high speed computers which store biomedical information on tapes were operational by 1964. In 1962, when MEDLARS was still in the planning stage, the library realized that storing references in computers posed the problem of how to compose and distribute this information in legible printed form with the utmost speed. The computer printouts available at that time required many pages because of the single large type size. The library contracted for the development of a computer-driven photocomposition device with various type fonts and print sizes. The result was GRACE, developed by the Photon Corporation and delivered to the library in 1964.

GRACE operated at the rate of 300 characters, or 3,600 words per minute—five times faster than any previous mechanical phototypesetter. Unlike the standard single-font computer printouts, GRACE used three fonts of type in 6, 10, and 14 point size, both upper- and lowercase. The three fonts contained a total of 226 characters, including special characters such as diacritical marks for foreign languages. It was estimated to have the power of 55 linotype operators. GRACE, as a prototype, was almost literally handmade; by mid-1969 it was not economically feasible to maintain it in reliable operating condition.