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THE PROFESSIONAL SERVICE CORPORATION — A NEW BUSINESS ENTITY

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INTRODUCTION

During the year 1961 many states have created a new business entity known as either the professional association or the professional service corporation. The professional association partakes of many of the characteristics of a partnership and yet has some corporate attributes. The professional service corporation partakes of many of the corporate characteristics of a general corporation and yet has certain restrictions or limitations imposed.

Because this is an uncharted sea upon which many attorneys and tax consultants are reluctant to embark, it is most timely that an article be written which would attempt to shed some light upon both the legal and tax problems arising under this new legislation. In order to keep the article from being too broad in its scope, the specific comments will be limited to the Florida professional service corporation.

The Florida Legislature, on May 25th, 1961 enacted the Professional

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Service Corporation Act, with an effective date of September first. In commenting on this act, an attempt will be made to anticipate the problems arising in Florida, but most of the comments should have general application to all of the various states, regardless of whether these states provide for professional associations or professional service corporations. This will be particularly true when the subject matter enters into the area of taxes under the Internal Revenue Code.

The content of this article could be expanded into several volumes, and one of the problems facing the writers was to limit their material to a presentation of the general nature and effect of legislation of this kind. Brief references will be made to many specific tax problems which, in themselves, have been treated elsewhere at great length. The references to pension plans and profit-sharing plans will be made with the recognition that each topic is a very broad field and that there is material available to the practitioner who wishes to broaden his knowledge of the subject. The same is true of the various tax aspects under the Internal Revenue Code which are briefly mentioned here.

To put the professional service corporation of Florida in its proper perspective, it is best to comment at the outset that there is no radical difference, from a tax standpoint, between the professional service corporation and any corporation under the general corporation laws of Florida. This new legislation simply provides a means whereby certain professionals, who previously have been forbidden to assume a corporate veil, may now obtain the favorable tax treatment that previously was available only to corporations dealing in general business. Once the reader can assume this viewpoint, then many of the difficulties vanish.

It is sufficient to say that the forgotten man—the self-employed professional—is now in a position to enjoy all of the tax benefits which previously were unavailable to him because of the regulation of his profession. Now that a means has been devised for legally preserving personal liability between the professional man and his client or patient, there should be no valid objection from any professional regulatory group to the use of the corporation.

8. CCH Pension Plan Guide.
10. From the language used in the act it is clear that the legislative intent is to correlate the act to the general corporation law (Fla. Stat. ch. 608 (1959)), as a supplement thereto.
11. See note 16 infra.
12. However, see note 94 infra.
Ever since income tax laws came into being tax consultants and attorneys have been devising various means of obtaining tax benefits for business people operating in corporate form. The professional people who were prohibited from incorporating have been trying to obtain these same benefits. Members of these professions, because of the nature of the personal services involved, have been forbidden by law, regulation, or codes of ethics to practice in corporate form. Primarily, these regulated professions took in the medical, legal and accounting fields although there are others. The reason for the rule is quite obvious. A professional person must not be permitted to shield himself from personal liability to his patients or clients for any malfeasance, misfeasance, or nonfeasance. No doubt there would have been a continued stringent application of the rule had not the question of the disparities between professional and nonprofessional type endeavors arisen in relation to the Internal Revenue Code.

For many years lobbying groups have attempted to obtain some type of legislation by Congress which would permit a self-employed person in a profession to set aside a certain amount of his income for retirement and to delay the payment of taxes on the amount so set aside until such time as the fruits are reaped during the later years of life. The 87th Congress had a bill before it concerning this question, but never passed on it.

In another area, members of the medical profession have been successful in forming a hybrid association which the courts have forced the Internal Revenue Service to treat as a corporation for federal income taxation purposes. Under this type of association, many corporate characteristics are established for what would otherwise be a joint venture taxed as a partnership. This has come to be known as the "Kintner-type" association.

13. A general federal income tax was not imposed in modern times until after the adoption of the 16th amendment to the Constitution of the United States in 1913. Prior to that time Congress assessed income taxes during the Civil War which were subsequently repealed. In 1894 Congress again imposed a general income tax without apportionment and it was held unconstitutional. Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429 (1895). However, income taxes were imposed by several of the states at or shortly after the adoption of the federal constitution. Shaffer v. Carter, 252 U.S. 37 (1920); 27 AM. JUR. Income Taxes § 16 (1940).


16. 5 AM. JUR. Attorneys-At-Law § 25 (1936). Traditionally, the so-called learned professions have not been permitted to practice as corporate entities. 13 AM. JUR. Corporations § 837 (1938).


20. Ibid.
As an outgrowth of the *Kintner* case and similar cases, the Internal Revenue Service adopted regulations clarifying the distinction between these associations and partnerships for federal income taxation purposes. Under these regulations, to meet the test for classification as an "association taxable as a corporation," an organization must have more corporate than non-corporate characteristics.

Because these regulations provide that local law shall determine whether or not the legal relationships which have been established in the formation of an organization meet the regulations' standards, the mandatory classification of these associations as partnerships under the Uniform Partnership Act would result in their disqualification. The result of this was that the 39 states which had enacted the Uniform Partnership Act precluded their professionals from qualifying as "Kintner-type" associations.

Before 1961 some states had statutes permitting certain categories of professional persons to form corporations. These exceptions have been quietly existing without challenge and with no apparent detriment to the high standards of professional ethics. The personal relationship of the doctor to his patient has not been adversely affected by incorporation according to one reported account of a five-year experiment in Connecticut. Also, the most heartening fact is that the pension plan involved had been approved by the Internal Revenue Service.

Immediately following the issuance of the *Kintner* regulations in November 1960, by the Internal Revenue Service, there was a flurry of activity under the leadership, if not the sponsorship, of the American Medical Association. In 1961, various state legislatures enacted laws which would circumvent the Uniform Partnership Act thereby paving the way for

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25. The *Uniform Partnership Act* § 6 defines as a partnership any association of two or more persons joining to conduct a business for profit unless that association is formed under some other statutory authority.

26. Associations of this type cannot be endowed with the necessary corporate characteristics due to conflict with provisions of the Uniform Partnership Act. See note 143 infra.


29. Medical Economics, supra note 28, at 69.

30. Note 22 supra.

31. The American Medical Association Law Department makes copies of a model act for professional service corporations available to state medical societies and counsels them.

32. *Supra* note 1. A bill is pending presently in Alabama, and others are proposed in California, Indiana, Iowa, New York, North Carolina, Oregon and Rhode Island.
"Kintner Associations." Other states went a step further and adopted legislation which provided for special professional corporations under their corporate codes. Some of these legislative enactments covered only one professional category such as medical doctors. In other instances, the laws applied to a variety of professional classifications.

One factor that all the state laws have in common is that the members or shareholders of the professional group are required to be persons licensed by state law to practice in that specific profession. Mixing of various professions in one business entity or having ownership participation by nonprofessionals is prohibited. Another characteristic which is found in all the corporate acts is that personal liability to the person receiving professional services is imposed by statute. In at least one instance, this personal liability is imposed with respect to all of the shareholders of the professional corporation, but in Florida the act seems to impose the personal liability on the one rendering the services to the person receiving them, with no carryover to the other shareholders.

Now that the laws have been passed which enable these self-employed professionals to set aside tax-free dollars for their future retirement programs, and to obtain other fringe benefits available to private corporations, there is a great interest among the people who can benefit. There is also a great doubt in the minds of many as to whether or not the Internal Revenue Service will recognize this new type of business entity. Because of the hurried enactment of much of this legislation, there are many voids to be filled by later amendments, or by court decisions. The Florida statute leaves much to be desired, but the legislators are to be commended for taking rapid action rather than stalling the matter for years through committees. As the matter stands presently, the writers are of the opinion that a professional man can take advantage of the Florida act and be assured that later amendments to the statute, and the court decisions which may be expected to follow, will cure the deficiencies. He can be confident that the Internal

33. Supra note 2. Some of the pending and proposed legislation in note 32 supra, may relate to incorporation rather than associations.
34. Arkansas, doctors and dentists; Minnesota, doctors; South Dakota, doctors.
40. Legislative action was taken after promulgation of T.D. 6503, 1960-2 Cum. Bull. 409 and bills are still pending in many states, note 32 supra.
Revenue Service must face up to the fact that it has at last reached a position
of having to accord to the professional man the same tax benefits enjoyed
by nonprofessionals who incorporate.

LEGAL PROBLEMS UNDER THE FLORIDA ACT

The act, is a supplement to Chapter 608 of the Florida Statutes dealing
with general corporations for profit. In some respects, it extends the pro-
visions of the corporate code, and in others it makes exceptions thereto for
this particular type of corporation.

Who May Incorporate?

Under the act, it is possible for one professional man to form a corpora-
tion for the rendition of professional services. In this respect, the act differs
from that of many other states which require three or more incorporators.
This is a major departure from the general corporation law requiring a
minimum of three persons subscribing to the articles of incorporation.

The Florida act provides that the individual or group of individuals join-
ing together to form a professional service corporation may do so for the
sole and specific purpose of rendering the same professional service they
rendered previously. The professions involved are named in the definition
with the provision that it has application only to those groups which pre-
viously could not render personal services as a corporation. It goes on to
provide that the act shall not apply to any individual or groups of individuals
who, prior to its passage, were permitted to organize and perform personal
services to the public by means of a corporation. It then states somewhat
inconsistently that any such corporation may, however, bring itself under
this statute by amending its articles of incorporation so as to be consistent
with the provisions of the act. These statements would seem to be incompat-
ible, but they might have application, for example, to groups composed
of engineers.

The term “professional services” as defined by the act refers to those
personal services for which the state of Florida requires the obtaining of a
license or some other legal authorization. The named examples make the in-

42. Fla. Stat. §§ 621.01,.05 (1961).
ch. 1, § 3.
47. Ibid.
49. Ibid.
tent of the legislature clear. To the extent that the different professions render the same or similar services, a question might be raised as to whether or not, for example, engineers and architects might associate together to form a professional corporation. It is submitted that a strict interpretation of the statute would preclude this because it seems clear that the legislative intent was to determine the qualification of shareholders by looking to the licensing requirements of their respective professions. Since there is a difference in licensing requirements for architects and engineers, or for medical doctors and osteopaths, it would be asking for trouble to attempt to put these two professions into the same corporation, despite the fact that they might render the same or similar services. This situation is much clearer in some of the other states where legislation specifically requires a license for the corporation from the regulatory group administering the profession as a condition precedent to issuing the articles of incorporation.

Officers and Directors

The Florida act requires all shareholders to be licensed members of the profession involved, but it is silent as to whether or not the officers and directors of the corporation must be members of the profession represented by the corporation. The Florida act is deficient in this regard, and it is hoped that it will be amended to clarify the point. Several of the other states specifically provide that the officers and directors must also be members of the profession, licensed to render the professional services which the corporation is to perform. Public policy and professional dignity would seem to require this. It is predictable that the courts, if called upon to interpret the Florida law, would rule that the legislative intent to limit participation in the corporation to licensed individuals, should be construed to require that the officers and directors also be members of the same profession. This area of doubt must remain unresolved until court decision or legislative amendment answers the question. As the matter presently stands, the Florida act says specifically that when not in conflict with the general corporation code, the law of the general corporation code shall be followed. Since the general corporation code does not require that the directors or officers be stockholders, it can be argued that nonprofessionals may fill offices in the corporation or serve as directors. Serving as an officer

51. FLA. STAT. § 621.03 (1961).
53. FLA. STAT. § 621.09 (1961).
54. However, see Fla. Att'y Gen. Op. 061-139 stating that officers and directors must be licensed in the profession.
56. FLA. STAT. § 621.13 (1961).
or director would not, of course, extend to them the privilege of rendering professional services to the client or patient. However, ordinary prudence should direct anyone forming a professional service corporation to have officers and directors who are members of the profession, even though they need not be stockholders.

Since the provisions of the general corporation code must be followed when not in conflict with the Professional Service Corporation Act, another area of doubt exists as to the number of directors which will be required for the professional service corporation. The general corporation code provides that there must be at least three incorporators and also provides that there must be at least three directors. However, since the Professional Service Corporation Act requires only one subscriber, the single incorporator would be forced to go outside of the corporation to obtain the two additional directors required under the general corporation code. The Attorney General of Florida has issued an opinion which, although lacking the force of law, would be persuasive upon the courts. He has stated that the legislative intent must have been that where less than three incorporators are required the act should be interpreted to require no more directors than there are incorporators. Accordingly, one can rely upon this opinion or, in the alternative, can avoid conflict with the general corporate laws by naming directors who are not stockholders of the corporation but are licensed practitioners in the profession involved. There is no requirement that directors be stockholders of the corporation.

Another provision in the general corporation code which creates a seeming conflict is that there must be at least two officers for any corporation. Once again, the one-man corporation is stymied. Although no specific requirement is made by the act that the officers must be members of the profession, it is still desirable and may later be construed by the courts to be mandatory. The safest thing is, once again, to find an officer for the corporation who is licensed in the profession even though he is not a shareholder in the one-man corporation and put him on record as the secretary. Although this will impose a practical problem, as is the case with having nonshareholders for directors, it is perhaps the safest route. It is hoped that the legislature will study the matter further and will adopt a provision to meet this situation similar to that in effect in Wisconsin.

57. Note 54 supra.
58. Note 56 supra.
61. This is an informal unnumbered opinion to the authors dated July 31, 1961. A formal opinion is expected to be issued as this article goes to press.
64. Note 54 supra.
65. Wis. Stat. § 180.99(7) (1959), as amended 1961, provides that where in-
Corporate Powers and Purposes

It is to be noted that the primary corporate purpose of a professional service corporation must be the rendition of professional services of the type which the stockholders are licensed to render.\textsuperscript{66} No other business may be engaged in,\textsuperscript{67} but the corporation may invest its funds in real estate, mortgages, bonds, or any other types of investments, or may own real or personal property necessary for the rendition of the professional services.\textsuperscript{68} A question may arise as to whether or not the ownership and operation of a professional building is within the scope of this corporate purpose if a part of the building is leased and becomes income property. This corporate purpose also has implications which will be touched upon in the tax section of this article. It is a possibility that at some time in the future the courts will be called upon to interpret the difference between investing within the meaning of the act, and operating a business. This problem may arise in a situation where the professional service corporation acquires real estate for investment purposes and later finds itself in the position of actually operating income-producing property. At this time the property might not be properly classified as an investment.

Transferability of Stock

Florida has burdened the corporate stock of the professional service corporation with limitations on transferability not found in the other states. As previously mentioned, it is provided in all states that ownership of the stock is limited to members of a particular profession involved, but Florida has taken additional steps which appear to be for the protection of minority stockholders. To take a new stockholder in a corporation, the person proposing to sell or transfer his stock may do so only after approval of the proposed new stockholder by a majority of the outstanding stock entitled to vote at a special meeting called for this purpose.\textsuperscript{69} There is also a provision that the person who proposes to sell may not vote his stock at this special meeting.\textsuperscript{70} The question then arises—how can there be a majority vote of the outstanding stock if the person proposing to sell is the only stockholder or holds the majority of the stock? This slight ambiguity in the act can be resolved readily by an examination of another provision in the same section which states that the stock of the one proposing to sell cannot be voted or counted.

corporation is by one person and there is only one shareholder, the corporation need only have one director and this same shareholder shall also serve as president and treasurer of the corporation. Other officers of the corporation in such a situation need not be licensed, certified or registered in the same field of endeavor as the president. A corporation having two shareholders need have only two directors and the two shareholders shall fill all of the offices of the corporation between them.

\textsuperscript{66} Fla. Stat. § 621.05 (1961).
\textsuperscript{67} Fla. Stat. § 621.08 (1961).
\textsuperscript{68} Ibid.
\textsuperscript{69} Fla. Stat. § 621.11 (1961).
\textsuperscript{70} Ibid.
for any purpose at this special meeting.\textsuperscript{71} Another doubt left to be resolved is the situation where you have only one stockholder who proposes to take in a new stockholder and transfer some of his stock to that person. It is suggested that the courts will follow historical precedent and apply the rule only where the purpose of the rule is to be served.\textsuperscript{72} Since the obvious purpose is to protect minority stockholders from having an undesirable associate thrust upon them, the rule should not apply where there is only one stockholder and he wishes to sell some of his stock.\textsuperscript{73} We have many laws which are for the protection of persons but which, unless invoked by the persons for whom they are enacted, have no application.\textsuperscript{74} Since, in the example of a sole stockholder selling some of his stock to a new participant, there is no one to be protected, the provision requiring a vote of approval of a new participant should not apply. It would be illogical for the courts to assume any other position.

When a stockholder dies or for some other reason becomes disqualified to serve in his profession, another question arises.\textsuperscript{75} Since nonmembers of the profession are prohibited from owning stock in the corporation, in the event of death does the personal representative have a legal right to deal with the decedent’s stock? It is submitted that this is an unwritten exception to the provisions of the statute. To rule otherwise would serve no useful purpose, and would impose an unnecessary hardship. The personal representative of the decedent could and should be permitted to convey the corporate stock of the deceased stockholder to some other member of the profession subject to the approval of the other stockholders.\textsuperscript{76} The personal representative would be holding the stock merely in a fiduciary capacity and would have no power to vote the stock\textsuperscript{77} or to participate in the corporate management. The exception to this might be participation by the estate in any dividends of the corporation during the period it held the stock.

Another hurdle facing the one-man corporation is the provision in the statute providing for automatic dissolution of the corporation in the event that there is no stockholder in the corporation authorized and licensed to

\begin{footnotes}
\item \textsuperscript{71} Ibid.
\item \textsuperscript{72} See 19 Am. Jur. Equity § 21 (1939).
\item \textsuperscript{73} In this situation there would be no one else who would have any standing to object to the transaction or to institute legal action to enjoin the transfer.
\item \textsuperscript{74} See Fla. Stat. § 608.15 (1959) which provides shares of stock shall be nonassessable. Notwithstanding this provision, assessments could be made and if all stockholders participated voluntarily, the statute would be of no effect. Similarly, Fla. Stat. § 95.11 (1959) prescribes statutes of limitation. However, even though an action is barred by a statute of limitation, if the statute is not invoked and affirmatively pleaded by the defendant, then it is of no effect. Abbandanolo v. Vonella, 88 So.2d 282 (Fla. 1956). This is true even though the complaint shows on its face that the statute of limitation has run. Akin v. Miami, 65 So.2d 54 (Fla. 1953).
\item \textsuperscript{75} Fla. Stat. § 621.10 (1961).
\item \textsuperscript{77} Fla. Stat. § 621.09 (1961) implies that no one other than the shareholder of record may vote the stock.
\end{footnotes}
practice the profession. What then happens to the one-man corporation in this event? In all probability, the disqualified professional would be permitted to sell his stock to someone having the necessary qualifications, in the manner suggested above. An alternative procedure would be to amend the articles of incorporation to make it a general corporation and thereby permit the corporate existence to continue until a disposition of the corporate assets could be made. Since the professional corporation act permits investments as well as the practice of a profession, a situation might well arise where it would be desirable to continue the corporation solely for the purpose of preserving and continuing the investments. In the case of a professional corporation having more than one shareholder, to meet the problem of disability or disqualification of one of the stockholders, provision should be made by the articles of incorporation or in the bylaws to enforce an involuntary surrender of the disqualified person's stock.

The refusal of the minority interests to approve the contemplated transfer of stock by a majority stockholder could be very oppressive from a practical standpoint and might result in a severe pecuniary loss. To combat this it is recommended that some very strong provision be made in the form of a buy-and-sell agreement, or a bylaw provision for redemption of this person's stock by the corporation, or by a forced sale to the remaining stockholders. A provision should be made for some fair valuation of the stock to be surrendered in this eventuality. Some states have provided that this stock will be surrendered at book value to the corporation unless some alternative provision is incorporated in the articles or the bylaws of the corporation; the Florida act fails to provide for this.

There is no reason to presume that the laws regulating the transfer of corporate stock are in any way abrogated or amended by the Professional Service Corporation Act. The "Blue Sky Laws" of the State of Florida will apply, and care should be taken that no transactions involving a transfer of stock take place which would violate the Florida Securities and Exchange Act.

The Uniform Stock Transfer Act also has certain provisions that should be considered. The limitations on the transferability of the corporate stock should be noted on the stock certificates used in order to comply with

79. This possibility is suggested in Fla. Att'y Gen. Op. 061-139.
80. Fl. Stat. § 621.11 (1961) makes it permissive for the bylaws to provide for the purchase or redemption of its shares by the corporation.
these laws,\textsuperscript{86} even though the limitations are spelled out by the language of the Professional Service Corporation Act.\textsuperscript{87}

**Personal Liability**

As is previously mentioned, the provisions for personal liability of the professional man to the person for whom he is rendering services has been specifically perpetuated so that the professional man cannot hide behind the corporate veil.\textsuperscript{88} In Florida this provision is limited by its language to impose liability for negligent or wrongful acts or misconduct committed by the individual and those persons under his direct supervision and control while rendering the professional services.\textsuperscript{89} In Wisconsin this personal liability extends to all shareholders, and is, therefore, broader than the Florida provision.\textsuperscript{90} As a natural consequence, the corporation is also liable to the full extent of its assets.\textsuperscript{91}

Insofar as personal liability to general creditors, or for any claims arising against the corporation other than as a direct result of misconduct or negligence not connected with the rendition of professional services is concerned, the personal liability of the corporation and of the individuals involved would follow common law principles. To this extent the professionals now have the insulation of the corporate veil, at least where the business debts of the corporation are concerned. And in Florida, there is the additional shield for the individual from liability for the acts of his professional associates.

**Nonstatutory Prohibitions Against Corporate Practice**

The Professional Service Corporation Act concludes with the provision that all laws or parts of laws in conflict with the act are repealed.\textsuperscript{92} From this it would seem clear that any statutory limitations which prohibit the various professions from practicing in corporate form are repealed.\textsuperscript{93} Logi-

\textsuperscript{86} FLA. STAT. § 614.17 (1959).
\textsuperscript{87} FLA. STAT. § 621.11 (1961).
\textsuperscript{88} Note 36 supra.
\textsuperscript{89} FLA. STAT. § 621.07 (1961).

\textsuperscript{90} WIS. STAT. § 180.99(8) (1959), as amended 1961.
\textsuperscript{91} 13 AM. JUR. Corporations §§ 1118 et seq. (1938).
\textsuperscript{92} FLA. STAT. § 621.15 (1961).
\textsuperscript{93} E.g., accountants, FLA. STAT. § 473.23 (1959); dentists, FLA. STAT. § 466.36
cally, this would also extend to the rules and regulations of any regulatory board of a governmental or semi-governmental nature. Thus, any prior prohibitions against corporate practice directed against the various professions are repealed with the exception of the attorneys. The legal profession has been taken outside of the jurisdiction of the legislature, its government and regulation being in the hands of the supreme court. Recently, the court ruled that lawyers could incorporate under the act.

A practical problem still exists with regard to many groups. The various professional societies and organizations, although lacking the force of law, do prescribe standards of conduct and ethics as a condition of membership. Because he is no longer prohibited by law from incorporating, the professional man may find that he has to make a choice between incorporation or retaining his membership in the various professional societies which he so highly prizes. Remedial steps are being taken, or are

(1959); funeral directors, Fla. Stat. § 470.10(5) (1959). Fla. Atty Gen. Op. 061-117 states that the prohibition against funeral directors practicing in corporate form has been repealed to the extent that Fla. Stat. ch. 621 (1961) permits incorporation, and that funeral directors are among the professions not specifically named but included in the coverage of the Professional Service Corporation Act.

It is a generally accepted rule in construing statutes that two acts relating to the same subject matter should be interpreted so as to preserve the force and effect of each without destroying their evident intent. Ellis v. City of Winter Haven, 60 So.2d 620 (Fla. 1952). However, to the extent that there is an irreconcilable repugnancy, the later general act should supersede the earlier act. International Paper Co. v. Merchant, 77 So.2d 622 (Fla. 1955); De Coningh v. City of Daytona Beach, 103 So.2d 233 (Fla. App. 1958).

94. E.g., accountants are regulated by the State Board of Accountancy, which derives its powers from Fla. Stat. § 473.04 (1959). Under this statute the board has the right to "prescribe a standard of professional conduct and formulate reasonable rules defining unethical practices for persons holding certificates." Under this authority the State Board of Accountancy has adopted "Rules Relating to the Practice of Accountancy." Section C of the rules, para. 16 prohibits an accountant from being "an officer, director, stockholder, representative or agent of any corporation engaged in the practice of public accounting ...." Since the State Board of Accountancy derives its authority from the Legislature under statute then it should logically yield to subsequent legislation and be consistent therewith. See note 93 supra. However, the authors are informed that the State Board of Accountancy met on September 15, 1961, to discuss the matter of the Professional Service Corporation Act and decided that they shall continue in effect the prohibition against the practice of public accountancy by a corporation. Cf. Fla. Atty Gen. Op. 061-117, supra note 93.

95. Fla. Const. art. V, § 23 confers exclusive jurisdiction over attorneys-at-law to the Florida Supreme Court, thereby denying the legislature power to permit incorporation if the supreme court does not rescind the prohibition against corporate practice of law.

96. See Fuller v. Watts, 74 So.2d 676 (Fla. 1954); State ex rel. Florida Bar v. Evans, 94 So.2d 730 (Fla. 1957).

97. In re Florida Bar, case No. 31073, Fla. Sup. Ct., October 11, 1961. This opinion has given the court's stamp of approval to the idea of professional incorporation under Fla. Stat. ch. 621 (1961). The Integration Rule of the Florida Bar, Article 2 was amended and Article 15 was added pertaining to professional service corporations. Canon 33 of Rule B was revised and Canon 35 of Rule B, Ethics Governing Attorneys, was supplemented to cover attorneys under this new law. Rule 10 of the Rules Governing the Conduct of Attorneys in Florida was also amended to avoid any conflict with the act.

98. E.g., the American Institute of Certified Public Accountants and the Florida Institute of Certified Public Accountants prohibit members from practicing in corporate form.
expected to be taken in the immediate future, by these various societies and organizations to remove from their codes of ethics the limitations and restrictions against corporate practice.

Another practical consideration which presently exists for certified public accountants and attorneys who practice federal taxation law is that an Internal Revenue Service regulation prohibits a corporation from practicing in the tax courts or before the Internal Revenue Service. A ruling has been requested by the District Director of Internal Revenue from the Treasury Department in Washington as to whether or not attorneys and accountants will be permitted to practice before the Internal Revenue Service if they incorporate. Perhaps by the time this article is published a decision will have been rendered, but those concerned with this area of tax practice should be cautious.

POSSIBLE TAX PROBLEMS

Transfer of Assets to Corporation

It is almost inevitable that the practicing professional who plans to incorporate will have on his books a number of accounts receivable. When he merges his activities into the corporation he will usually want to transfer all of his assets to that corporation. With respect to the monies due him for personal services rendered, he must take care to make provisions for his protection in the event he transfers this asset to the corporation. Under the Internal Revenue Code, assignment of income of this type will be taxed to the one who earned it, even though he assigns it under a legally enforceable contract. In the event the incorporator finds it desirable to transfer his accounts receivable to the corporate books, it is recommended that he transfer them for notes payable to himself so that when the accounts are collected he may have the funds with which to pay the tax assessed against him on this assigned income.

Other than the problem of dealing with the accounts receivable at the time of incorporation, there should be no tax problem involved in transferring the other assets to the corporation at the transferor's basis with no gain or loss ensuing therefrom.

Personal Holding Company Income

Since a professional service corporation will be engaged in rendering personal service under which the individual who is to receive the services can designate the person who is to perform them, the income of the corporation would almost certainly be classified as personal holding company.

100. As yet no ruling has been handed down.
102. INT. REV. CODE OF 1954, § 351.
income under the Internal Revenue Code. Taking this a step further, the professional service corporation will in all probability fall within the definition of a personal holding company under the Internal Revenue Code in that, in most instances, fifty percent of the value of its outstanding stock is likely to be owned by not more than five individuals.

Because there is a great likelihood that the average professional service corporation will be classified as a personal holding company, severe tax penalties could result from filing a regular corporate return and holding the corporate income. It would be possible for taxes, penalties, and interest caused by failing to recognize personal holding company income to aggregate up to 150 per cent of the actual income received. This danger will always be present when there is a small close corporation and the recipient of the services can designate who is to perform the particular professional services desired.

**Tax Option Corporations**

The safest way to avert the danger of being penalized with taxes on personal holding company income is for the corporation to elect to be taxed as an individual or partnership. This election might be detrimental in some isolated instances, particularly when the stockholder has income other than from his profession which puts him in a high tax bracket. However, taking the bitter with the sweet, he is still in a better tax position, even if he uses the election, than he is presently where his full income from his practice is taxable to him as ordinary income.

It is to be noted, that there is a provision in the code that personal holding company income when received by a corporation terminates the election to be taxed as described above, and, in that event, the corporation would go back to being taxed in regular corporate form. However, personal holding company income, as defined in the section of the code relating to tax option corporations, does not include income from personal services even though the one performing the services can be designed by

the person receiving the services. From this it must be concluded that the definition of personal holding company income for the purpose of terminating the election is not the same as the definition of personal holding company income for the purpose of imposing penalties on this type income. Therefore, although there seem to be inconsistent definitions, the logical conclusion to reach is that the tax-option election by the professional service corporation would not be terminated by receiving personal holding company income of the type involving personal services. Under most circumstances, the tax-option corporation would be the recommended step for professional service corporations. The election to be so taxed should be filed during the first month of corporate business.

Accumulated Earnings Tax

The Internal Revenue Code provides for a tax on improperly accumulated earnings of a corporation. It also provides for a minimum 100,000 dollar exemption on accumulated earnings, after which earnings still can be accumulated for the reasonable needs of the business.

In drafting the corporate charter of the professional service corporation, it would be well to consider authorizing the corporation to render professional services and to make investments as authorized by the statute, giving equal dignity to both types of authorized corporate purposes. Then the danger of being taxed on accumulated earnings would be applicable only if the excess earnings were held as uninvested cash. If the business of the corporation is to make investments as well as practice professionally, it is believed that the corporation's accumulated earnings can be invested in stocks, mutual funds, or other securities, and so long as there is not a substantial amount of uninvested cash for a long period of time, the accumulated earnings tax would not be applicable. However, this is a controversial area and it would not be unreasonable to expect a considerable amount of litigation on this point.

Of course, the comments with regard to the accumulated earnings tax would not be applicable in the event that the professional service corporation elects to proceed as a tax-option corporation and is thereby taxed as a partnership or sole proprietorship.

Acquiring Corporation to Obtain Tax Credit

The Internal Revenue Code prohibits a person from acquiring a corporation solely for the purpose of obtaining a tax credit benefit. How-

110. Ibid.
111. INT. REV. CODE OF 1954, compare $ 1372(c) with $ 543(5).
112. INT. REV. CODE OF 1954, $ 1372(c).
114. INT. REV. CODE OF 1954, § 535(c)(2).
115. See note 107 supra.
116. INT. REV. CODE OF 1954, § 269. This states that any person or persons
ever, in view of the advantages given the incorporators under the Professional Service Corporation Act, it can be shown that there are sufficient business considerations to mitigate any arguments which might be presented by the Treasury Department that the corporation was acquired solely for tax purposes. The incorporators can point to the limitation of liability which they gain and to the creation of pension plans and profit-sharing plans, which are recognized incentive programs for employees, to offset any of the government's arguments.

**Disallowance of Salary Deductions as Excessive**

The Internal Revenue Code permits the allowance of any deductions for salaries which are reasonable and realistic. The question of reasonable salaries is one of judgment, and there have been court cases where substantial salaries have been allowed. Elements to be considered in the reasonableness of the salary are the earning capacity of the individual prior to incorporation, the earning capacity of similar individuals practicing in the same area and the local labor market and salaries paid therein. By considering these tests, it is obvious that salaries paid to professional practitioners would be comparable with salaries paid high level corporate executives, and salaries of employees of the professional service corporation should not fall into difficulty in this area. As a matter of fact, the salaries paid to the professional employees of the corporation would not exceed what they would have received as income for themselves had they not incorporated, and therefore this could hardly be deemed unreasonable.

**Benefits to be Derived by Incorporation**

It has been previously stated that there are certain legal benefits to be derived from incorporation, such as an insulation to some extent from personal liability. In addition to this, there are innumerable tax benefits to be gained for the professional. An attempt to go into detail on the mechanics and method of achieving all of these various tax benefits would acquiring control of a corporation, the principal purpose of which is the acquisition for the evasion or avoidance of federal income tax by securing the benefit of a deduction, credit, or other allowance which such person would not otherwise enjoy, will not be allowed the deduction, credit or other allowance. Cases under this section concern themselves primarily with the question of buying "loss corporations" to obtain a carryover of losses against successful new operations. However, by interpretation of the code, the Internal Revenue Service may attempt to argue that the professional service corporation's primary purpose is to obtain tax benefits which the incorporators could not otherwise obtain. No cases specifically in point on the present question were found.

118. See extensive notes in 1 CCH 1960 STAND. FED. TAX. REP. ¶ 1369 et seq. See also Wolder, How the Tax Court Treats Reasonable Compensation, 39 TAXES 473 (1961).
involve too lengthy a discussion for the purpose of this article. However, the writers intend to touch briefly on these points.

Pensions and/or Profit-Sharing Programs

Heretofore, if the self-employed professional man wished to set aside some of the fruits of his labor, he must have done so after first paying an income tax on the money set aside. With the advent of the Professional Service Corporation Act, the self-employed practitioner after incorporation under the act becomes the employee of his own corporation. As an employee his corporation can set aside for him, before taxes, a portion of his income in a qualified pension or profit-sharing plan. To do this, he must have a plan which will qualify under the provisions of the Internal Revenue Code. The amount which may be set aside is determined by the type of plan and by the total payroll of the corporation. The plan must take in virtually all employees of the corporation, including the nonprofessionals, and must not be discriminatory in favor of the officers, stockholders, and higher administrative officials of the corporation. The Internal Revenue Code does permit the plan to contain certain restrictions and limitations upon who may participate in the plan and to what extent they may participate.

The first thought that might come to the mind of the professional man who considers incorporation is that, even though he can now have tax-free dollars from his labors to put aside for his old age, he must share these fruits with the other employees to whom he is paying salaries. To evaluate whether the benefits to be derived are greater than the increased cost of the pension and profit-sharing plans, he must have a competent evaluation of his individual situation. The tax bracket in which the man finds himself and the extent of his nonprofessional payroll are factors to be considered. As a general rule of thumb, if he is taxed on his present


122. INT. REV. CODE OF 1954, § 404.

123. INT. REV. CODE OF 1954, § 401(a)(3).


earnings in a bracket of 30 per cent or higher, he will benefit in savings under this plan.126

Once the plan has been qualified—approved by the Internal Revenue Service—the funds deposited in the plan by the corporation for the benefit of employees are not subject to taxation at that time. The funds are placed in some predetermined type of trust,127 and the trust may invest them in any number of different investments.128 There may be split-funding of the plan in that a part of the investment is in insurance and a part in corporate stocks or mutual funds. The kinds of investments are limitless and the varieties of combinations cannot be counted. Numerous plans have been tested by long usage, and have been approved as to form by the Internal Revenue Service.129

The income earned by funds placed in trust under the qualified plan is also tax free during the life of the trust.130 Taxes are not payable on the monies put in the trust or on income of the trust until the time it is distributed to the beneficiaries of the trust.131

The possible negative aspect of bringing all employees of the professional man under the qualified pension or profit-sharing plan is somewhat offset by a recognition that this can form a part of the compensation of the employees and can take the place of raises or bonuses. Also, this added incentive has resulted in many recognized savings by ordinary business corporations, particularly under the profit-sharing plan.132 Employees who have benefits to be derived from producing profits are more diligent in avoiding waste, in providing efficient methods of operation and in collecting unpaid accounts.

Pension or profit-sharing plans, or a combination of the two, are believed to be the major benefit to be derived by the professional man as a result of incorporation. To evaluate the ultimate gains of a tax-free plan for his old age is something for actuarial computation. If we assume that a man is presently in the 50 per cent tax bracket, he would have to earn $5,000 dollars in order to invest $2,500 dollars in some program providing for his retirement. Assuming that this investment would be made at 4 per cent per annum before taxes, his net return on his investment would be

126. Corporate income tax rates begin at 30% of taxable income. INT. REV. CODE OF 1954, § 11(b). Therefore, corporate earnings taxed at 30% on the first $25,000 after deduction of contributions to the plan, would not exceed the individual’s rate of tax. 127. INT. REV. CODE OF 1954, § 501. 128. See INT. REV. CODE OF 1954, § 503(c) for prohibited transactions. See 1 CCH PENSION PLAN GUIDE ¶ 848. 129. At the end of 1958 there were over 36,000 qualified plans filed with the Internal Revenue Service and it is estimated that there are now approximately 50,000. For a complete set of forms see CCH PENSION AND PROFIT-SHARING PLANS AND CLAUSES (1957). 130. INT. REV. CODE OF 1954, § 501. 131. See note 133 infra. 132. P-H INSURANCE GUIDE ¶ 4113.1; 2 CASEY, PAY PLANS ¶ 10,501 et seq., published by Institute for Business Planning, Inc. (1960); 1 CCH PENSION PLAN GUIDE ¶ 461.
2 per cent. Assuming further that he continued this program over a period of 20 years, his $2,500 dollar annual investment with compound interest at 2 per cent would amount to approximately $62,000 dollars. On the other hand, if the corporation earns the same $5,000 dollars and places it in the plan before taxes, the full $5,000 dollars can be invested for future needs. Since the money invested in a qualified pension or profit-sharing plan does not have its income taxed, the same investment would yield a net 4 per cent return which, compounded with principal, would result in a nest egg of almost $150,000 dollars at the end of twenty years. The full amount might then be withdrawn at retirement and 25 per cent capital gains tax paid upon this money or, in the alternative, it might be set up to pay so much annually to the retiring person and would be taxed only as withdrawn. Under the usual circumstances, this pension would be withdrawn at a time after retirement when there would be little or no taxable income from personal efforts of the retiring professional man. Without going further into the mechanics of the qualified pension or profit-sharing plan, it readily can be seen that there are vast benefits to be derived by one who desires to be prudent and set aside funds for his retirement. However, it must be strongly urged that this is a highly technical field, akin to estate planning, which must have the guidance and services of qualified attorneys and competent tax consultants. Also, in arriving at a suitable plan it is to be recommended that the assistance of insurance men and investment counselors who have had training in the field of estate planning be called upon for their advice and counsel.

Deferred Income Tax

Presently, the self-employed professional man usually is taxed on a calendar year basis. Should he incorporate under the Professional Service Corporation Act he may then elect to have a fiscal year different from that of the calendar year. Since he is changing his category from self-employed to employee, he can then defer a portion of the income earned during the year of incorporation to the following year. This can be done by having his salary payable to him on an annual basis. For example, a doctor incorporating on the first of October could pay income tax only on the first three-quarters of the year's income prior to incorporation. The

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135. A corporation may choose a fiscal year other than the calendar year. Int. Rev. Code of 1954, § 441. Thus, an individual incorporating on October first could have the corporate tax year run from October through the following September. Then the income earned by personal services for the last three months of the current year would be corporate income deferred to the following year when the corporate return would be filed.
income he derives from October, November and December of the year of incorporation could be postponed to the following year. It is true that ultimately the tax would have to be paid on the deferred income, but until such time as he leaves the corporation's employ and retires, he can have the benefit of using the money which he would otherwise pay in taxes until the time his employment ends.

Social Security Benefits

Presently doctors are not permitted to have social security benefits if they are self-employed. By going into a professional service corporation doctors would immediately bring themselves under the social security laws. They would contribute, just as their present employees do, toward their social security program. The doctor's contribution would be out of his income after taxes, but the corporation's matching contribution would be made by the corporation before taxes.

Various Fringe Benefits

A corporation is permitted to set up and charge many insurance plans to operating expense. Under this, before taxes, the professional man can provide medical and hospitalization insurance for himself and his employees. He can also obtain for employees, including himself, disability insurance which would continue an employee's salary while he is sick or disabled. "Key man" life insurance plans can be secured to reimburse the corporation for loss of income if any employee should die. Up to 5,000 dollars of this benefit could be passed on without tax to the employee's widow.

An evaluation of the problems and needs of the particular professional man or men desiring to incorporate — analyzing their present income, operating expenses, and other business problems — undoubtedly could disclose other benefits in addition to those mentioned.

Conclusion

Presently, much confusion exists, both in the minds of laymen, attorneys and tax consultants, as to the implications of the Professional Service

136. The Self-Employment Contributions Act, Int. Rev. Code of 1954, § 1401, has not been extended by definition to include doctors of medicine. Accordingly, they can receive the benefits only if employed for wages as defined in Int. Rev. Code of 1954, § 3121.
140. See Pomeroy, Insurance and Other Fringe Benefits, 38 Taxes 865 (1960); Traynor, Nonmonetary Fringe Benefits for Corporate Executives, 38 Taxes 711 (1960); Florey, Fringe Benefits for All, 39 Taxes 870 (1961).
Corporation Act. There is a tendency to relate this new type of corporation to the "Kintner Regulations." While it is true that the Kintner case is the ancestor of the professional service corporation, the regulations of the Internal Revenue Service relating to "Kintner-type" associations do not apply to the professional service corporations. Florida and those other states which have provided for incorporation of professionals have gone a step beyond the Kintner case, and have thereby eliminated the uncertainties plaguing "Kintner-type" associations under the ever changing Internal Revenue Service directives. It is only in those states which have chosen to make an exception to their own Uniform Partnership Act by endowing partnership associations with corporate characteristics that one must still follow the Kintner rules.

Florida and the other states have placed the professionals, through incorporation, in exactly the same category as general business corporations insofar as tax liabilities and benefits are concerned. In those states the only reason that one would have to consider the Kintner regulations would be if, by some unforeseen and difficult to imagine legal maneuver, the corporation was classified as an association for purposes of taxation. However, it should still have sufficient attributes of corporate character so that it could qualify for tax benefits as a "Kintner-type" association. Keeping this in mind, the cautious attorney and tax consultant will take pains to see that the corporate charter and bylaws under the Professional Service Corporation Act are tailored to meet fully the tests of the Internal Revenue Service for "Kintner-type" associations. By so doing, he will assure his client of the dual protection against disallowance of the tax benefits by the Internal Revenue Service at some later date. He will have a pure corporation which if it is found to be impure, can still benefit by falling back on the rule applicable to "Kintner-type" associations. However, the first approach should be that the professional service corporation is not a pseudo corporation.

Despite the shortcomings of Florida's Professional Service Corporation Act which are highlighted in this article, it still presents a very worthwhile

\[141.\text{Treas. Reg. § 301.7701 (1960) constantly refers to unincorporated associations and from this one could infer that unincorporated associations do not have to measure up to the "Kintner regulations." See note 143 infra; see also Eber, Professional Service Corporations—The Answer to the Kintner-Type Organization?, 100 TRUSTS AND ESTATES 758 (1961).}

\[142.\text{Note 1 supra.}

\[143.\text{Treas. Reg. § 301.7701-2(a)(1) (1960) defines an association as an organization having (a) associates, (b) an objective to carry on business and divide the gains therefrom, (c) continuity of life, (d) centralization of management, (e) liability for corporate debts limited to corporate property, and (f) free transferability of interests. Treas. Reg. § 301.7701-2(a)(3) (1960) states: "An unincorporated organization shall not be classified as an association unless such organization has more corporate characteristics than noncorporate characteristics. In determining whether an organization has more corporate characteristics than noncorporate characteristics, all characteristics common to both types of organizations shall not be considered." (Emphasis added.)}
opportunity for the self-employed professional man. The difficulties and confusion surrounding this new business entity are not insurmountable, and it can be predicted that future amendments to the act and court decisions interpreting the legislative intent will rectify any deficiencies.

There are certain tax pitfalls which must be avoided and highly specialized legal and tax advice will be needed by the person or persons electing to form a professional service corporation.

Once a self-employed professional finds himself in the higher income tax bracket, he can achieve greater benefits for himself in tax savings by incorporating under this new enactment. He will be able to accumulate an estate two or three times greater than was formerly possible by availing himself of the tax benefits offered. He will be able to enjoy the benefits of this estate when he reaches retirement age.

The overcautious attorney or tax consultant who counsels clients to adopt a "wait and see" attitude will be depriving his client of many years of benefits that can be gained during the interim period, while the professional service corporation is battling for full recognition from the Internal Revenue Service.

The benefits which are available to the professional service corporation have been time tested over many years by ordinary corporations, and there is no reason to believe that they will not be permitted in the future. The forum whose laws control any test that may be made as to whether or not a particular type of business entity is a corporation is the state where the corporation is formed. The writers believe that it is beyond the province of the federal government, through the Internal Revenue Service and the Treasury Department, to challenge the validity of the professional service corporation.

It is not inconceivable that the Treasury Department may tighten restrictions upon some of the benefits which are presently available to corporations. However, it is inconceivable that this curtailing of benefits can be directed against a specific group such as the professional service corporations. Any belt tightening done by new Internal Revenue Service regulation will have an equal application to general corporations and the professional service corporations, and this action will meet the organized resistance of big business lobbies and pressures.