Pension Plans and Associations Taxable as Corporations for Professional Persons

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AN area in which professional persons are at a disadvantage under present tax laws is in the pension and profit sharing fields. Whether the professional men are partners or sole proprietors is immaterial.

There have been several recent attempts by professional men, especially physicians, to devise means whereby they would be put on an equal footing tax-wise with corporate executives and corporate stockholders who are employees of a corporation. At the present time officers and shareholders may be among employees covered by a pension or profit sharing plan for their company.¹ Even the chairman of a board of directors may be classified as an employee and become eligible to participate in a pension plan.²

If a pension plan is not designed as a subterfuge for distribution of profits to shareholders, shareholders who are bona fide employees of a corporation may participate in the corporation's pension plan to the same extent as other employees.³

On the other hand, a general partner is not considered an employee of a partnership and therefore may not participate in the partnership's pension plan.⁴ Limited and special partners are placed in the same category as general partners.⁵ If a partnership is succeeded by a corporation, the former partners cannot be credited for services rendered to the partnership in order to accumulate prior service credits under the successor corporation's pension or profit sharing plan.⁶ An individual may establish a pension plan for his employees, but since he is the employer he cannot participate in it.⁷

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² Holmes v. Republic Steel Corp., 84 N.E.2d 508 (Ohio Ct. App. 1948).
⁴ I.T. 3350, 1940-1 Cum. Bull. 64.
⁵ Elwin S. Bentley, 14 T. C. 228 (1950).
⁷ P. S. 23 (1944).
Is it possible for a doctor, an attorney, an accountant, an engineer, or other professional person to be an employee and participate in a pension plan? This depends upon the source of his income and the control of his activities. If a professional person is an employee for all purposes, then he may be included in a pension plan after becoming an employee even though he rendered services to the organization on a fee basis prior to that time.\(^8\)

A quasi-professional person, the full-time life insurance agent, may be deemed an employee for pension, profit sharing, stock bonus and annuity plans if he is an employee as defined in the Code.\(^9\) For Social Security purposes, a full-time life insurance salesman or agent is an employee.\(^10\) Insurance agents and brokers who are not full-time agents are not eligible for inclusion in a plan.\(^11\)

There are only two cases in the field today on the problem of having unincorporated organizations taxable as corporations for professional persons— one is *Kintner v. United States*\(^12\) and the other is *Pelton v. Commissioner*.\(^13\)

**THE KINTNER CASE**

Dr. Kintner and several other doctors were engaged in the practice of medicine in the State of Montana as a partnership. In 1947, the doctor and his partners formed an unincorporated association as a successor organization to the partnership. Shortly thereafter, or in conjunction therewith, a pension plan was set up to cover the employees of the new association. Included among the employees of the association were the former partners, made eligible by the trust agreement as participants. Articles of association, with a structure similar to a corporation, were drawn, with shares of stock or "certificate notes" being issued.

The new association set up a contingency reserve, made a contribution to the pension trust fund, began operation as an association, and later filed a corporate income tax return.

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\(^9\) Int. Rev. Code of 1939, § 3797 (a) (20), added by 65 Stat. 516 (1951) (now Int. Rev. Code of 1954, § 7701 (a) (20)).

\(^10\) Int. Rev. Code of 1939, § 1426 (d) (3) (B), as amended by 64 Stat. 536 (1950) (now Int. Rev. Code of 1954, § 3121(d) (3) (b)).


\(^12\) 216 F.2d 418 (9th Cir. 1954), affirming 107 F. Supp. 976 (D. Montana 1952).

\(^13\) 82 F.2d 473 (7th Cir. 1936).
The Commissioner of Internal Revenue refused to give an advance ruling on the qualification of the association's pension plan, stating that the association was not taxable as a corporation since a corporation could not be formed in Montana for the purpose of practicing medicine. An assessment was made against Dr. Kintner for his allocable share of the contingency reserve and the contributions to the pension fund by the association, based upon the old percentage of ownership in the partnership. The doctor paid the deficiency and immediately instituted suit in the District Court for refund of the taxes paid.

The District Court found that the association was governed by a board of directors representing all of the associates; that the association would continue even though any associate died or withdrew; that the association held title to the property used by the association; and that there was centralization of authority in conducting the operation of the enterprise. The court compared the association to a corporation and to a partnership. It found that the association, both in structure and in operation, more nearly resembled a corporation than a partnership, and therefore should be taxable as a corporation for all federal income tax purposes.

Since the association was taxable as a corporation, it was entitled to deduct the contribution to the pension plan fund, and that the doctor was not taxable on an allocable portion of this contribution. Further, Dr. Kintner was held not taxable on any portion of the contingency reserve.

Insofar as the pension plan was concerned, the court ruled that the plan qualified under Section 165 (a) of the Internal Revenue Code of 1939 (Section 401 of the 1954 Code), this section permitting the establishment of a pension plan without the approval of the Commissioner of Internal Revenue so long as a certain percentage of the employees are covered, and no discrimination exists against the lower paid employees.

The Internal Revenue Service originally ruled that it would not give a ruling on the qualification of the pension plan since the association was not taxable as a corporation inasmuch as formation of a corporation presupposes a right under state law to incorporate the business involved, and that since the practice of medicine is not one of the purposes for which a corporation could be formed in Montana, the new association could not be treated
as a corporation for any purposes of the Internal Revenue Code.

In this, the Commissioner appears to be proposing a new and additional test for the taxability of associations as corporations: that state law controls as to the purpose for which an association may be formed. It is submitted that the Commissioner errs in this contention since such question has been resolved by many courts, including the Supreme Court of the United States, and the Commissioner's own Regulations.

The term "association" is not used in the Internal Revenue Code in any narrow or technical sense. It includes any organization, created for the transaction of designated affairs, or the attainment of some object, which, like a corporation, continues notwithstanding that its members or participants change, and the affairs of which, like corporate affairs, are conducted by a single individual, a committee, a board, or some other group, acting in a representative capacity. It is immaterial whether such organization is created by agreement, a declaration of trust, a statute, or otherwise. It includes a voluntary association, a joint-stock association or company... and any other type of organization (by whatever name known) which is not, within the meaning of the Code, a trust or an estate, or a partnership.14

The Commissioner then distinguishes the association from the ordinary trust, and in the Regulations sets forth further characteristics of the association and corporation forms:

...[T]he trust form affords the advantages of unity of management and continuity of existence which are characteristic of both associations and corporations. This trust form also affords the advantages of capacity, as a unit, to acquire, hold and dispose of property and the ability to sue and be sued by strangers or members, which are characteristic of a corporation; and also frequently affords the limitation of liability and other advantages characteristic of a corporation. These advantages which the trust form provides are frequently referred to as resemblance to the general form, mode of procedure, or effectiveness in action, of an association or a corporation, or a "quasi-corporate form." The effectiveness in action in the case of a trust or of a corporation does not depend upon technical arrangements or devices such as the appointment or election of a president, secretary, treasurer, or other "officer," the use of a "seal," the issuance of certificates to the beneficiaries, the holding of meetings by managers or beneficiaries, the use of a "charter" or "by-laws," the existence of "control" by the beneficiaries over the affairs of the organization, or upon other minor elements. They serve to emphasize the fact that an organization possessing

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them should be treated as a corporation, but they are not essential to such classification....

... The distinction is that between the activity or purpose for which an ordinary strict trust of the traditional type would be created, and the activity or purpose for which a corporation for profit might have been formed.\textsuperscript{15}

This is the first and only time the Commissioner mentions the "purpose" for which an organization is formed. Here, of course, he refers to the purpose of conservation or protection of income or property as distinguished from the purpose of engaging in a business activity. What he mentions here has no connection with his ruling in the \textit{Kintner} case that formation of a corporation "presupposes" that a corporation may engage in some type of business. It is submitted that Dr. Kintner did not intend to form a corporation for the practice of medicine and surgery, but he did intend to form an \textit{association} for the practice of medicine. The association form for the practice of medicine is apparently permissible in all states since it is a partnership, and some states permit corporations to furnish medical services through employee physicians,\textsuperscript{16} while Wisconsin and Mississippi have several clinics operating in the corporate form for the practice of medicine.

Local law is not important in classification for federal income tax purposes, and therefore whether the association is classed as a corporation or as a partnership under state law becomes of no consequence. There are many court decisions to this effect, but Regulations 118, Section 39.3797-1 (1953) states it best:

Classification of taxables:
For the purpose of taxation the Internal Revenue Code makes its own classification and prescribes its own standards of classification. Local law is of no importance in this connection. Thus, a trust may be classed

as a trust or as an association (and, therefore, as a corporation), de-
pending upon its nature or its activities.... The term "corporation"
is not limited to the artificial entity usually known as a corporation, but
includes also an association, a trust classed as an association because
of its nature or its activities, a joint-stock company, an insurance com-
pany, and certain kinds of partnerships.

In distinguishing and defining partnerships 17 and limited part-
nerships, 18 the Commissioner lists the Code classification for an
association which is taxable as a corporation. An example he gives
is this:

A, B, and C contribute $10,000 each for the purpose of buying and
selling real estate. If A, B, C, or D, an outside party (or any combina-
tion of them as long as the approval of each participant is not required
for syndicate action), takes control of the money, property, and busi-
ness of the enterprise, and the syndicate is not terminated on the death
of any of the participants, the syndicate is classified as an association.

The Commissioner goes even further in outlining taxation of
partnership associations:

A partnership association of the type authorized by the Statutes of
several states, such, for instance, as those of the State of Pennsylvania
virtue of the statutory provisions under which it was organized, the
characteristics essential to an association within the meaning of the
Internal Revenue Code, is taxable as a corporation. 19

The Pennsylvania statute mentioned in the above Regulation
gives these elements: capital stock and capital, a lengthy period
of time of existence, dividends, limited liability, managers and
officers, by-laws, and election of officers.

- TESTS FOR ASSOCIATIONS TAXABLE AS CORPORATIONS

Code and Regulations

Under the Internal Revenue Code and the Commissioner's Reg-
ulations as they are presently written without interpretation by
court cases, the following are the items which will make an asso-
ciation, trust, partnership, syndicate, or other type of organiza-
tion, taxable as a corporation for federal income tax purposes:

1. The organization must be created for the transaction of business.
2. The death of a member or a change in membership must not affect the continuity of the organization.
3. The organization must resemble a corporation in structure and in operation.
4. It does not have to be created under statutory authority or with statutory privileges; a common law organization created with or without a written agreement may be taxable as a corporation.
5. The affairs of the organization must be run by a representative group or an individual.
6. It is not necessary to have formal evidence of a corporation, such as officers, directors, seal, minutes, etc.

Modification of Tests By Courts

In Hecht v. Malley, the United States Supreme Court discussed the difference between an association for income tax and for excise tax purposes. Under the 1916 statute for excise taxes, the franchise or license fee was to apply to all corporations or associations "organized under the laws of the United States, or State or Territory." The income tax statute used the phrase "no matter how created or organized." This particular phrase was incorporated into the excise tax statute in 1918. The Court stated: "... [T]he intention of Congress is plainly shown to extend the tax from one imposed solely upon organizations exercising statutory privileges, as theretofore, to include also organizations exercising the privilege of doing business as associations at the common law." Thus, associations which have "quasi-corporate" organizations through which they operate a business, are taxable as corporations. The court approved the definition of an association as "a body of persons united without a charter, but upon the methods and forms used by incorporated bodies for the prosecution of some common enterprise." 

Under Hecht v. Malley and the present Code, an association to be taxable as a corporation does not have to be a "corporation" created under the laws of a state, the United States, or a territory. Most tax cases in the association field have been on trusts taxable as corporations, and some few partnership cases.

20 265 U.S. 144 (1924).
21 1 BOUVIER, LAW DICTIONARY 269 (Rawle's 3rd Rev.).
In 1925, the Supreme Court held that Congress has the constitutional power to tax as a corporation an unincorporated association which transacts its business as if it were incorporated, and the power of Congress is not affected by the fact that, under the law of a particular state, the association cannot hold title to property. Even though its stockholders are individually liable for an association's debts, or even though it is not recognized as a legal entity under the local law, an association may still be deemed a corporation for tax purposes.

A key line of cases began with *Morrissey v. Commissioner*, all of them establishing landmarks along the way for distinguishing an association or other unincorporated entity taxable as a corporation from one taxable as a partnership. In the *Morrissey* case, a trust was formed to sell lots and to construct a golf course and club house. The trust, to represent the beneficiaries, had a quasi-corporate form. The beneficiaries did not hold meetings nor elect representatives to run the trust. However, since the trust was created as a medium for carrying on a business enterprise with the “beneficiaries” sharing in its gains according to their proportionate interests in the trust, and the form of the trust was sufficiently analogous to corporate organization, the court found that Congress intended the income to be taxed in the same manner as that of a corporation. The court added that the trust method permits continuity, centralized management, limited liability, facilitation of transfer of beneficial interests, and introduction of large numbers of participants. The term “association,” the court said, in income tax statutory interpretation, embraces an association as it may have existed or does exist at common law. There is no requirement for organization under a statute or with statutory privileges.

Upon the authority of the *Morrissey* case, two circuit courts held that an organization need not meet all the tests of a corporation or of a partnership, but rather that the organization be examined to determine whether it resembles a corporation more

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23 Hecht v. Malley, supra note 20.
closely than a partnership and its status declared in accordance with the "balance of resemblance." 26

The Sixth Circuit 27 requires "the consideration of each case as a special, individual and separate problem." There must be a number of persons (associates) entering into a joint enterprise for the transaction of business.

In Estate of Hermann Becker v. Commissioner, 28 the Tax Court summarized the Morrissey prerequisites of an association as: (a) associates, (b) business purpose, and (c) a combination of characteristics resulting in a closer resemblance to a corporation than to an ordinary trust.

Most principles in these trust cases are analogous to partnership and other unincorporated organization situations, insofar as taxability as a corporation is involved.

What is the effect of variations from the usual corporate procedure? In Alexander Trust Property, 29 the Tax Court said:

The provisions of the instrument, even considered in connection with what was actually done under the instrument, indicate to us that the points of similarity to a corporation are so numerous in this proceeding that we must hold it to be so taxable. The variations from usual corporate procedure pointed out by petitioner, such as conferences between all the interested parties respecting any important action, are no more than the departures from usual procedure by a family or closely held corporation, the affairs of which are often loosely conducted. Nor does the fact that a corporation could not be organized in Illinois for the principal purpose of dealing in real estate, prevent this petitioner from being taxable as an unincorporated association under the Federal law.

Where there are fixed powers for an agent, even though those powers are extensive, the organization is not an association. 30 Delegation of ministerial powers only does not make a taxable association entity. 31 The "management trust" has been held taxable as an association. 32 However, a family trust for the conservation

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26 Bert v. Helvering, 92 F.2d 491 (D.C. Cir. 1937); Comm'r v. Brouillard, 70 F.2d 154 (10th Cir. 1934).
27 United States v. Davidson, 115 F.2d 799 (6th Cir. 1940).
28 2 T.C.M. 341 (1943).
29 2 B.T.A. 1226 (1928).
30 A. A. Lewis & Co. v. Comm'r, 301 U.S. 385 (1937).
31 Comm'r v. Gibbs-Preyer Trusts Nos. 1 & 2, 117 F.2d 619 (6th Cir. 1941).
and protection of income is not taxable as an association even though it carries on a business.\textsuperscript{38}

In partnership cases, resemblance to a corporation results in taxation as an association,\textsuperscript{34} while lack of resemblance prevents classification as an association taxable as a corporation.\textsuperscript{35} Where a partner's liability to creditors of a firm only becomes operative after exhaustion of partnership assets, taxability as an association has been found.\textsuperscript{36} The \textit{Cincinnati Stamping Company} case had a similar form of hybrid liability.\textsuperscript{37} A partnership has even been penalized for failure to file a corporate return, even though a partnership return apparently was filed in good faith.\textsuperscript{38}

Thus, it is seen that court decisions have followed and clarified the rules previously observed arising from the Code and Regulations. For convenience, the following listing is adapted from \textit{Morrissey v. Commissioner}.\textsuperscript{39}

1. Ownership by the entity of property embarked in the undertaking.
2. Centralization of management through representatives of members.
3. Control of management through selection of managers by the members.
4. Continuity of enterprise without interruption by death of a member or a transfer of membership.
5. Limitation of personal liability of members to property embarked in the undertaking.

\textbf{The Commissioner's Objections}

The Commissioner has asserted three objections to having associations taxable as corporations for professional persons in the practice of their professions.

The first, and probably a specious argument, is the claim that professional persons practicing their professions, that is, attorneys, doctors, dentists, engineers, accountants, architects and others, are not engaged "in business",\textsuperscript{40} since the profits of such an association, if formed, would be solely from professional services, not

\textsuperscript{38} Comm'r v. Guitar Trust Estate, 72 F.2d 544 (5th Cir. 1934).
\textsuperscript{35} Glenside Textile Co., 46 B.T.A. 176 (1942).
\textsuperscript{36} Poplar Bluff Printing Co. v. Comm'r, 149 F.2d 1016 (8th Cir. 1945).
\textsuperscript{37} 4 T.C.M. 806 (1945).
\textsuperscript{38} West Side Tennis Club v. Comm'r, 111 F.2d 6 (2d Cir. 1940).
\textsuperscript{39} Note 25 supra.
\textsuperscript{40} Kinter v. United States, \textit{supra} note 12.
from business, that is, not derived from a combination of capital and labor. In Regulations 118, the Commissioner holds: 41 "For the purpose of the deductions specified in section 22(n) the performance of personal service as an employee does not constitute the carrying on of a trade or business. The practice of a profession, not as an employee, is considered the conduct of a trade or business within the meaning of such section." The Commissioner even lists many major expense items deductible as business expenses by professional persons. 42 The Board of Tax Appeals long ago approved the definition of a "trade or business" found in Bouvier's Law Dictionary — "that which occupies the time, attention, and labor of men for the purpose of livelihood and profit." 43

The Commissioner's second objection, offered for the first time in the Kintner case, asserts a new and additional test to determine whether an association will be taxable as a corporation. The test, injected into the Kintner case, 44 is that the purpose of the association must be a purpose that a corporation could have under local law. Thus, if the association could not have that purpose were it a corporation under state law, then it cannot be treated as a corporation for federal income tax purposes.

The Supreme Court has thrice refuted this contention. In a Texas case, 45 several men formed an association to operate an oil business. The association was a joint-stock association. Under Texas law, this type of association is a partnership and a partnership is not an "artificial entity." The shareholders are individually liable for the association's debts as members of a partnership. The association cannot hold real property except through a trustee. A Texas statute permits an association to sue and be sued in its own name. The United States Supreme Court stated:

...It is true that Congress cannot make a thing income which is not so in fact. But the thing to which the tax was here applied is confessedly income earned in the name of the Association. It is true that Congress cannot convert into a corporation an organization which by the law of its State is deemed to be a partnership. But nothing in the Constitution precludes Congress from taxing as a corporation an association

43 Claudian B. Northrop, 17 B.T.A. 950 (1929).
44 Note 12 supra.
45 Burk-Waggoner Oil Ass'n v. Hopkins, supra note 22.
which, although unincorporated, transacts its business as if it were incorporated. The power of Congress to tax associations is not affected by the fact that, under the law of a particular State, the association cannot hold title to property, or that its shareholders are individually liable for the association's debts, or that it is not recognized as a legal entity. Neither the conception of unincorporated associations prevailing under the local law, nor the relation under that law of the association to its shareholders, nor their relations to each other and to outsiders, is of legal significance as bearing upon the power of Congress as to how and at what rate the income of the joint enterprise shall be taxed.

The second case, Hecht v. Malley, was discussed previously in this article.\(^{46}\) The third case concerns a mail order dental business, wherein the Supreme Court held the practice of dentistry is a "trade or business."\(^{47}\)

The Commissioner's own regulations on the subject are quite specific, but the "purpose" under state law for which the association was formed is significantly absent as one of his tests.\(^{48}\) When the Commissioner rules on partnerships,\(^{49}\) trusts,\(^{50}\) and limited partnerships,\(^{51}\) he does not make local law determinative of whether an association shall or shall not be taxable as a corporation. "For the purpose of Taxation, the Internal Revenue Code makes its own classification and prescribes its own standards of classification. Local law is of no importance in this connection."\(^{52}\)

That the will of Congress may be superimposed upon state law in classifying types of business organizations for federal tax purposes is indisputably established by many cases.\(^{53}\)

The purpose and operation of an association is more important in determining taxable status and classification of the organization than is the form under which it is organized.\(^{54}\) The "purpose" here is the aim, intent or design to carry on a business or trade. No re-

\(^{46}\) Note 20 supra.

\(^{47}\) Comm'r v. Heininger, 320 U.S. 467 (1943).


\(^{50}\) U.S. Treas. Reg. 118, § 39.3797-3 (c) and (d) (1953).


\(^{53}\) Burk-Waggoner Oil Ass'n v. Hopkins, supra note 22; also: Standard Paving Co., 13 T.C. 425 (1949); Francis A. Parker, 6 T.C. 974 (1946); Comm'r v. Fortney Oil Co., 125 F.2d 995 (6th Cir. 1942); Tyrrell v. Comm'r, 91 F.2d 500 (5th Cir. 1937); Willis B. Anderson, 6 T.C. 956 (1946); Comm'r v. Brouillard, supra note 26; Burnet v. Harmel, 287 U.S. 103 (1932).

\(^{54}\) Comm'r v. Vandegrift Realty and Investment Co., 82 F.2d 387 (9th Cir. 1936).
guard is given to whether or not the purpose is in accord with local law.

Congress and the courts have gone far in taxing organizations which cannot be legally formed under state or federal law, even taxing illegitimate businesses. There are also a few cases specifically holding associations or partnerships taxable other than according to state law.

The Commissioner's third objection to use of the association taxable as a corporation device is that the associate professional persons are not employees of the association and therefore are not eligible to qualify for participation in pension or profit sharing plans.

To define and distinguish between employee and employer herein, the Regulations themselves are quoted.

**Employee.** — The term "employee" includes every individual performing services if the relationship between him and the person for whom he performs such services is the legal relationship of employer and employee. Generally the relationship of employer and employee exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done but how it shall be done. In this connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he has the right to do so. The right to discharge is also an important factor indicating that the person possessing that right is an employer. Other factors characteristic of an employer, but not necessarily present in every case, are the furnishing of tools and the furnishing of a place to work, to the individual who performs the services. In general, if an individual is subject to the control or direction of another merely as to the result to be accomplished by the work and not as to the means and methods for accomplishing the result, he is not an employee.

Generally, physicians, lawyers, dentists, veterinarians, contractors,

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55 Comm'r v. Heininger, supra note 45; see also: Cohen, et al v. Comm'r, 176 F.2d 394 (10th Cir. 1949).
56 Johnson et al. v. Comm'r, 56 F.2d 58 (5th Cir. 1932), affirming 19 B.T.A. 840 (1930); see also: Wholesalers Adjustment Co. v. Comm'r, 88 F.2d 156 (8th Cir. 1937), and Pryor and Lockhart Development Co., 70 F.2d 154 (8th Cir. 1934), affirming 26 B.T.A. 1054 (1932).
sub-contractors, public stenographers, auctioneers, and others who follow independent trade, business or profession, in which they offer their services to the public, are not employees.

Whether the relationship of employer and employee exists will in doubtful cases be determined upon an examination of the particular facts of each case.

If the relationship of employer and employee exists, the designation or description of the relationship by the parties as anything other than that of employer and employee is immaterial. Thus, if such relationship exists, it is of no consequence that the employee is designated as a partner, coadventurer, agent, or independent contractor.

Employer. — The term “employer” means any person for whom an individual performs or performed any service, of whatever nature, as the employee of such person. . . . An employer may be an individual, a corporation, a partnership, a trust, an estate, a joint-stock company, an association, or a syndicate, group, pool, joint venture, or other unincorporated organization, group or entity. A trust or estate, rather than the fiduciary acting for or on behalf of the trust or estate, is generally the employer.

Does the form of organization of the employer’s business have any effect on the employee-employer relationship or on qualification of a pension plan? The following Ruling is by the Pension Division of the Internal Revenue Service:

Form of employer’s business. — There is no requirement as to the form of business organization the employer must operate under. Thus, a partnership is not prohibited from installing a pension plan for the exclusive employees or their beneficiaries. A general partner, however, is not an employee of the partnership and may not participate in the benefits of a pension plan which is intended to qualify under Section 165 (a) of the Internal Revenue Code, as amended.58

Thus, the Commissioner had deemed, up until the Kintner case, that bona fide employees, employee-associates, and employee-stockholders, could qualify for participation in pension plans established by their company.

Cases in Field

There are only three cases bearing directly on the subject of unincorporated associations taxable as corporations. Because of their extreme importance in this newly developing field of business, economic and tax life of persons engaged in professions, they

58 P. S. 23 (1944).
will be reviewed more thoroughly than cases previously cited.

The first case, in point of time, was *Pelton v. Commissioner,* wherein the Commissioner was successful in attempting to have a trust established for the practice of medicine by a group of doctors held taxable as a corporation. For seven years, Dr. Pelton, his son and one other doctor were engaged in the practice of medicine in Illinois as a partnership. In 1920, these doctors created a trust to hold title to the office furniture, equipment, instruments, library and x-ray equipment. The trustees were authorized to use this property in any way they saw fit and to operate clinics, to retain professional assistance and generally conduct a medical and surgical business. These trustees were to receive a salary at so much per year. Vacancies among the trustees were to be filled by the beneficiaries. The trust was to last for ten years and could be amended by the holders of 51% of the beneficial interests. These interests were represented by shares, which were transferable. The other trust beneficiaries had first option to purchase. The proportionate share of each doctor was determined by his agreed value to the clinic based upon earning capacity and not on the property contributed. The clinic employed from one to three additional doctors. The doctors claimed that their tax liability was that of a partnership rather than as an unincorporated association taxable as a corporation.

The Seventh Circuit Court, basing its decision upon the *Morrissey* case and those following it, determined that the trust was an association taxable as a corporation because (a) it was carrying on a business enterprise for profit and (b) it had substantial resemblance to a corporation. In the court’s language:

Here, through the medium of a trust, the parties secured centralized management of their enterprise, and its continuity during the trust term without termination or interruption by death or changes in the ownership of interests, and with limited liability and transferable beneficial interests evidenced by certificates. Entering into a joint undertaking they avoided the characteristic responsibilities of partners and secured advantages analogous to those which pertain to corporate organization. The fact that meetings were not held, or that particular forms of corporate procedure were absent is not controlling.

The doctors called the court’s attention to a then recent decision

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59 Note 13 *supra.*
of the Illinois Supreme Court which had held that a corporation could not practice medicine in Illinois. The Seventh Circuit rejected this argument, stating that the statute and regulations sufficiently covered the situation in providing that “organizations are associations within the meaning of the statute even though under State law such organizations are technically partnerships.”

The second case in the field was *Mobile Bar Pilots Association v. Commissioner*, in which the Commissioner unsuccessfully sought to convince the Fifth Circuit Court that a group of pilots sharing common office expenses should be taxed as a corporation. After this case was decided, the Commissioner asserted that it in effect overruled the *Pelton* case. These were the facts as established in the *Mobile Bar Pilots* case: the pilot was a servant of the vessel, and the owner of the vessel was liable to third persons for the pilot’s negligence or want of skill. The owner of the vessel controlled the working hours, duties, etc. of the pilot engaged by his boat. In the association itself, the association was not liable for acts of the pilot; it collected fee charges made by the pilots in the individual names of the pilots; the association owned no property, had no income and was merely a collection and bookkeeping agency; the organization could not discharge a pilot as a member; policy and control of the association were by joint agreement of all of the pilots while management was by office clerks acting as agents for the pilots; the purpose of the association was to provide a headquarters for the convenience of shippers so that a pilot could be called when needed.

It is submitted that the *Mobile Bar Pilots* case did not have the same fact situation as the *Pelton* case and therefore did not overrule or contradict any portion of the latter. It is apparent that the bar pilots merely had an arrangement for the splitting of common expenses, but entire control over their activities, fees within limits set by law, and power to work or not was retained by the pilots. This organization did not have centralized management, continuity of organization, ownership of property by the entity, ownership of fees or other income by the entity, responsibility for acts of its members, transferable interests, or limited liability.

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60 People v. United Medical Service, 362 Ill. 442, 200 N.E. 157 (1936).
61 97 F.2d 695 (5th Cir. 1938).
The third case in the field is the Kintner case, discussed briefly earlier. These are the basic points established by the evidence: the association was liable for the acts of the members; it owned all of the property embarked in the undertaking and was entitled to receive all fees charged in its own name for its own use; charges for professional services were set by the association rather than the individual doctors performing the services; the association hired and discharged doctors, including doctor-associates; doctors' activities, working time, vacation time, place of business and assignments of work were controlled by the organization. Policy and control of the association was vested in a Board of Directors, the Board being an elective body representing the entire membership. Operation and direction was by a management committee selected by the Board of Directors. Stock was issued by the organization and made transferrable. Continuity of the group was assured despite change in membership due to death, withdrawal or retirement of a member. The purpose of the association was to provide centralized authority and management, to establish continuity of the business, to reduce turnover of personnel, to permit fairly easy transfer of interests within a class, to establish and maintain permanent personnel relations, and to provide relative security for all personnel through planned pension programming.

Several months subsequent to the Ninth Circuit Court decision in the Kintner case, the Commissioner issued Revenue Ruling 56-23. Because of the importance it has had in influencing local enforcement agents of the Internal Revenue Service, it follows in full:

Advice has been requested whether an association of doctors which formerly operated as a partnership may be treated as a corporation for Federal income tax purposes and further whether a doctor-member of the former partnership was an employee of the partnership for the purpose of the requirements for establishing a pension plan under section 401 (a) of the Internal Revenue Code of 1954, corresponding to section 165 (a) of the 1939 Code.

These questions are posed because of the decision in United States v. Arthur R. Kintner et ux, 216 F.2d 418. In that case, on the authority of Ora L. Pelton, Sr. et al., Trustees v. Commissioner, 82 F.2d 437, the court held that the association had more of the criteria of a corporation than of a partnership under T. A. Morrissey et al., Trustees, v. Commissioner, 296 U. S. 344, Ct. D. 1064, C.B. XV-1, 264 (1936),

Note 12 supra.
and it distinguished *Mobile Bar Pilots Association v. Commissioner*, 97 F.2d 695, Ct. D. 1417, C.B. 1939-2, 244, relating to the performance of pilotage services by an association of pilots. Having determined that the clinic in the Kintner case is an association which is treated for tax purposes as a corporation, notwithstanding the State does not include the practice of medicine in the listing of purposes for which a corporation may be formed, the court further held that the pension plan established by the association satisfies the requirements of section 165 (a) of the 1939 Code. In reaching this conclusion, the court credited the doctor-members with prior years of service as partners as constituting qualifying years of employment for purposes of the pension plan of the association.

It is held that a group of doctors who adopt the form of an association in order to obtain the benefits of corporate status for purposes of section 401 (a) of the Internal Revenue Code of 1954 is in substance a partnership for all purposes of the Internal Revenue Code. It follows that the doctor-members are employers and therefore not employees. Rev. Rul. 33, Part 2(a) (1), C.B. 1953-1, 267, at 269. Furthermore, any period of service as members of a prior partnership will not be credited as a period of employment for purposes of the above section. The contrary position expressed in the case of *United States v. Arthur R. Kintner et ux.*, 216 F.2d 418, will not be accepted by the Internal Revenue Service as a precedent in the disposition of other cases involving similar fact situations.63

In a letter of clarification on Revenue Ruling 56-23, the Director of the Tax Rulings Division said:64

In declining to accept the decision in *United States v. Kintner, et ux.*, 216 F.2d 418 (9th Cir. 1954), as a precedent in the disposition of similar cases the Internal Revenue Service decided to continue to hold that groups of medical doctors who adopt the form of an association for the practice of their profession will not be treated as a corporation for any purpose of the Internal Revenue Code.... with the exception which follows...

The exception mentioned by the Director is contained in the last paragraph of his letter:

Consistent with Part 2 (b) (1) of Rev. Rul. 33, C. B. 1953-1, 267, the next to last sentence of Rev. Rul. 56-23, supra, was added to make clear our intended position with respect to the prior service of doctors (and others, for that matter) who have operated a partnership and thereafter actually incorporate (in a State permitting such incorporation) for the practice of the medical profession and then have the corporation establish a past and future service pension or other such plan

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64 Letter of Clarification from H. T. Swartz, Director, Tax Rulings Division, Internal Revenue Service, to Richard L. Mackay, Attorney, Dallas, Texas, dated March 7, 1956.
PENSION PLANS FOR PROFESSIONALS

for all employees, including the doctors and other members of the prior partnership. The sentence also makes clear the policy we intend to follow in any case where an individual might change from the status of a partner to that of a bona fide employee of the partnership, or of a successor to the partnership, and thereafter become a participant under the employer's pension or other such plan for employees.

CONCLUSION.

It is submitted that the Commissioner has erred in his continuing stand against precedent established by the courts, and in the clear language of the Internal Revenue Code and his own Regulations in the matter of associations taxable as corporations for persons practicing the learned professions. By apparently intending to accept pension plans, and associate or stockholder-doctors as employees, for professional persons in states where the practice of a profession is listed as a "corporate purpose," he will create and has created discrimination against the vast majority of persons practicing a profession in those states not permitting incorporation. At the present time, the only taxpayers not eligible for coverage under a pension plan set up by their own organization are the professional persons engaged in their professions. Perhaps with sufficient pressure the discrimination will cease in the same way that community property state and non-community property state taxpayers were equalized in division of income for tax purposes.

Does the association form of doing business by professional persons violate public policy? Apparently not, since the association is, in effect, a super-partnership. The associates are still individually and severally liable for debts of the association, while malpractice or misfeasance liability attaches to the wrongdoer. Under common law, and all state laws, the association, as distinguished from the corporate form with limited liability, is a legitimate vehicle for conducting professional practice.

A second major tenet of public policy is preservation of confidential and privileged communications between doctor-patient, attorney-client, etc. A corporate form would prevent this, since a separate legal entity, an "artificial person," would stand between the doctor or attorney and his patient or client, respectively. The association, not being a separate legal entity, could not sever this relationship.
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300