Income Tax: Corporations–Incorporated Professional Service Organization Taxable as a Corporation; Kintner Regulations Held Invalid–*Empey v. United States*

Michigan Law Review

INCOME TAX: CORPORATIONS—Incorporated Professional Service Organization Taxable as a Corporation; Kintner Regulations Held Invalid—*Empey v. United States**

Lawrence G. Empey, a lawyer, was employed by the Drexler and Wald Professional Company, an association of attorneys that had incorporated in 1961 pursuant to the Colorado Corporation Code[1] and rule 265 of the Colorado Rules of Civil Procedure.[2] Empey began his employment with Drexler and Wald in March 1965, and in

---

* 372 F. Supp. 851 (D. Colo. Aug. 31, 1967), *government appeal authorized,* 16 P-H FED. TAXES at 61,002 (1968) (hereinafter cited as the principal case).

1. COLO. REV. STAT. ANN. ch. 31 (1963).

2. COLO. R. CIV. P. 265 (1963) provides in pertinent part:

I. Lawyers may form professional service corporations for the practice of law under the Colorado Corporation Code. . . . The articles of incorporation of

November of the same year he acquired ten shares (ten per cent) of the outstanding capital stock of the corporation. On his 1965 federal income tax return, he reported income consisting of his salary as an employee of the company for ten months and ten per cent of the undistributed net income of the company for the two-month period in 1965 in which he had been a stockholder. After paying his taxes, Empey sued in federal district court for a refund of the taxes attributable to his share of the undistributed net income. The government maintained that under the tests of the Kintner regulations[3] Drexler

---

such corporations shall contain provisions complying with the following requirements:

. . .

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

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

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

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

F. . . . Lay directors and officers shall not exercise any authority whatsoever over professional matters.

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

II. . . .

B. The corporation shall do nothing which if done by an attorney employed by it would violate the standards of professional conduct established for such attorney by this Court. The corporation shall at all times comply with the standards of professional conduct established by this Court and the provisions of this Rule. Any violation of this Rule by the corporation shall be grounds to terminate or suspend its right to practice law.

C. Nothing in this Rule shall be deemed to diminish or change the obligation of each attorney employed by the corporation to conduct his practice in accordance with the standards of professional conduct promulgated by this Court; any attorney who by act or omission causes the corporation to act or fail to act in a way which violates such standards of professional conduct shall be deemed personally responsible for such act or omission and shall be subject to discipline therefor.

D. Nothing in this Rule shall be deemed to modify the attorney-client privilege specified in C.R.S. 1963, 154-1-7(2) and any comparable common-law privilege.

3. Treas. Reg. § 301.7701-2 (1965). Although technically the term "Kintner regulations" has been used to refer to the regulations promulgated in 1960 in response to *United States v. Kintner*, which did not include the current subparagraph (h), the term "Kintner regulations," as used herein, shall refer to the amended Treas. Reg. § 301.7701-2, with specific reference to subparagraph (h) on professional service organizations. For a detailed discussion of the history and the development of the regulations which have defined "corporations" and "associations," *see* Scallen, *Federal Income Taxation of Professional Associations and Corporations*, 49 MINN. L. REV. 603, 633-66 (1965).

and Wald was a partnership, rather than a corporation, for federal tax purposes, and therefore that Empey was not entitled to the refund.[4] The United States District Court for Colorado held that Drexler and Wald was a corporation for federal tax purposes, and thus that Empey was entitled to a refund.[5] The Kintner regulations are invalid, and, even if the regulations were valid, Drexler and Wald possessed all of the characteristics necessary for taxation as a corporation under the regulations.[6]

The court's alternative holding that Drexler and Wald qualified as a corporation under the tests embodied in the Kintner regulations is open to question. When an organization is incorporated under state law, the regulations provide that it may qualify for taxation as

4. If Drexler and Wald Professional Company is a "corporation" for federal tax purposes, any income retained by the corporation generally will not be taxed to the shareholders until distributed. INT. REV. CODE OF 1954, §§ 11, 301. If, however, Drexler and Wald is a "partnership" for federal tax purposes, the entire earnings of the firm are taxed to each partner according to his respective share, whether or not some or all of the income is retained by the partnership. INT. REV. CODE OF 1954, § 701-08.

The importance of a determination that Drexler and Wald is a "corporation" is not limited to the taxation of retained earnings involved in the principal case; also at stake are the many tax benefits available to stockholders who are employees of their own corporation but unavailable to partners. The primary of these is the opportunity for "income splitting" through deferred compensation, pension plans, profit sharing, or stock options (INT. REV. CODE OF 1954 §§ 401-08, 421-25) which allows taxpayers in high brackets to avoid the full impact of the progressive rate structure by spreading their income out over a period of years and/or realizing such income as capital gain at a maximum rate of twenty-five per cent. In addition, certain *employee* benefits are deductible by the business organization and/or are not taxable to the employees. Examples of such benefits are employee group-term life insurance, medical and hospital insurance and benefits, and meals and lodging. INT. REV. CODE OF 1954, §§ 79, 105-06, 119.

5. Principal case at 854.

6. *Id. See also* the recent case of O'Neill v. United States, 68 A.F.T.R.2d 405 (1968). In *O'Neill* an organization of doctors was classified as an "association" under the professional service association law of Ohio. The Ohio law incorporated by reference the entire corporation law of the state, except insofar as the corporation law was inconsistent with provisions of the professional service association law. The Ohio federal district court held that subparagraph (h) of the Kintner regulations is invalid because it discriminates unreasonably against professional service organizations, and that the association of doctors qualified for taxation as a corporation according to the tests embodied in subparagraphs (a) through (g), which the court found to be valid. For commentaries on the validity of the Kintner regulations and on the tax status of professional service organizations, *see generally* Anderson, *Tax Aspects of Professional Corporations*, 1963 S. CAL. TAX INST. 309; Bittker, *Professional Associations and Federal Income Taxation: Some Questions and Comments*, 17 TAX L. REV. 1 (1962); Kauffman & Ledley, *Some Comments on the Proposed Kintner Regulations*, 3 AM. BUS. L.J. 36 (1965); Mow, *Professional Associations and Professional Corporations*, 16 SW. L.J. 462 (1962); Ohl, *Corporate Practice of Law in New York*, 40 TAXES 263 (1962); Pearson, *The Professional Corporation*, N.D.L. REV. 309 (1965); Scallen, *Federal Income Taxation of Professional Associations and Corporations*, 49 MINN. L. REV. 603 (1965); Snyder & Weckstein, *Quasi Corporations, Quasi Employees and Quasi Tax Relief for Professional Persons*, 49 CORNELL L.Q. 613 (1963); Note, *Professional Corporations and Associations*, 75 HARV. L. REV. 776 (1962); Comment, *Wisconsin Professional Service Corporations Under the New "Kintner" Regulations*, 49 MARQ. L. REV. 564 (1966).

a corporation if it "more nearly resembles a corporation than a partnership or a trust."[7] For the purposes of this test, the regulations spell out the following basic corporate characteristics which, taken together, distinguish a corporation from other types of organizations: "(i) [a]ssociates, (ii) an objective to carry on business and divide the gains therefrom, (iii) continuity of life, (iv) centralization of management, (v) liability for corporate debts limited to corporate property, and (vi) free transferability of interests."[8] In addition, the regulations leave open the possibility that in some cases other factors may be significant in classifying an organization as a corporation, a partnership, or a trust.[9] The regulations further note that in deciding whether an organization is a corporation or a partnership, the first two factors listed above are not relevant since they are generally common to both types of organization.[10] The court in the principal case thus dealt only with the remaining four corporate characteristics and concluded that Drexler and Wald possessed all of them. It is submitted that the facts do not support such a clear-cut decision, and, indeed, that the company did not have at least two, and possibly three, of these corporate attributes.

The regulations make special provision for the application of the above criteria to professional service organizations.[11] For a professional service organization to have "continuity of life," the right to profits accompanying the ownership of a share in that organization must not be legally dependent upon the owner's participation in the organization as an employee; in other words, if an owner cannot

---

7. Treas. Reg. § 301.7701-2(a)(1) (1960). It should be noted that the regulations are somewhat ambiguous. Treas. Reg. § 301.7701-2(h)(1) (1965) states that "a professional service organization is treated as a corporation (or as an association and, therefore, taxable as a corporation) only if it has sufficient corporate characteristics to be classifiable as a corporation *under paragraph (a)* of this section, rather than as a partnership or proprietorship." (Emphasis added.) Paragraph (a), however, includes two tests for determining the tax status of an organization. Subparagraph (a)(1) speaks in terms of a general resemblance test, whereby an organization will be treated as a corporation for tax purposes if it "more nearly resembles a corporation than a partnership or a trust." Subparagraph (a)(3) states that "an unincorporated organization shall not be classified as an association unless such organization has more corporate characteristics than noncorporate characteristics." It would appear that the most reasonable interpretation of the reference to "paragraph (a)" in paragraph (h) is that with respect to *incorporated* professional service organizations the general resemblance test of paragraph (a)(1) applies, but with respect to *unincorporated* professional service organizations, the specific "more corporate characteristics than non-corporate characteristics" test of paragraph (a)(3) also applies. The principal case purports to be applying the general resemblance test to Drexler and Wald, which was incorporated, but since the court relies on the presence or absence of the various characteristics to determine the resemblance, it is difficult to tell whether they are not confusing the two tests and requiring more corporate characteristics than noncorporate characteristics in addition to resemblance. *See* principal case at 854.

8. Treas. Reg. § 301.7701-2(a)(1) (1960).

9. *Id.*

10. *Id.* § 301.7701-2(a)(2) (1960).

11. *Id.* § 301.7701-2(h)(1) (1965).

continue to share in the profits after termination of his employment, the regulations provide that there is no "continuity of life."[12] The Drexler and Wald stockholders were required to dispose of their shares if they ceased to be actively employed by the company. Moreover, shares could only be transferred to the company or to individual employees of the company, sales to outsiders being permissible only if such people subsequently enter an employment relationship with the company.[13] Consequently, the company could not meet the "continuity of life" test of the regulations. In addition, the regulations provide that when an ownership interest in a professional service organization is dependent upon the maintenance of an employment relationship, "if a member . . . may transfer his interest to a qualified person who is not a member of the organization only after having first offered his interest to other members of the organization at its fair market value, the corporate characteristic of free transferability of interests does not exist."[14] The company's articles of incorporation provided that the sale of a shareholder's interest was subject to the right of first refusal of the other shareholders.[15] Thus, Drexler and Wald also did not satisfy the criterion of "free transferability of interests."

With respect to a third corporate characteristic, the regulations provide that a professional service organization has "centralized management" when the "managers" have continuing exclusive authority to deal with a list of matters enumerated in the regulations.[16] The court apparently found that Drexler and Wald met

12. *Id.* § 301.7701-2(h)(2) (1965).

13. Drexler and Wald's articles of incorporation adopted §§ I(D) & (E) of rule 265 of the Colorado Rules of Civil Procedure. *See* text of these sections quoted in note 2 *supra*. While article twenty-three of the corporation's articles of incorporation provided for the free transferability of a shareholder's interest to any licensed attorney, the shareholders added a stock redemption agreement requiring that the other shareholders be given ten days notice and an opportunity to purchase the stock at the price an outsider was willing to pay.

14. Treas. Reg. § 301.7701-2(h)(5)(ii) (1965).

15. See reference to article twenty-three of the corporation's articles of incorporation in note 13 *supra*.

16. Treas. Reg. § 301.7701-2(h)(3) (1965) states that:

> In *applying the rules of paragraph (c)* of this section, relating to centralized management a professional service organization does not have centralization of management where the managers of a professional service organization under local law are not vested with the *continuing exclusive authority* to determine any one or more of the following matters: (i) The hiring and firing of professional members . . . and its professional and lay employees, (ii) the compensation of the members and of such employees, (iii) the conditions of employment—such as working hours, vacation periods, and sick leave, (iv) the persons who will be accepted as clients or patients, (v) who will handle each individual case or matter, (vi) the professional policies and procedures to be followed in handling each individual case, (vii) the fees to be charged by the organization, (viii) the nature of the records to be kept, their use, and their disposition, and (ix) the times and amounts of distributions of earnings of the organization to its members as such. Moreover, although a measure of central control may exist in a professional service organization, the managers of a professional service organization in which a member retains *traditional professional responsibility* cannot have the continuing

this requirement.[17] However, the regulations provide further that if each member of a professional service organization retains his "traditional professional responsibility," the organization cannot be said to have "centralized management," regardless of the amount of authority vested in the board of managers.[18] This second limitation is not particularly helpful, since the regulations neglect to define "traditional professional responsibility." Each Drexler and Wald attorney retained a form of "professional responsibility" in accordance with rule 265 of the Colorado Rules of Civil Procedure, which not only prohibits practices by the corporation or by the individual attorneys that would be inconsistent with the local standards of professional conduct, but also imposes personal responsibility upon an attorney who attempts to use the organization to shield his own unethical acts or omissions.[19] If this is the kind of "traditional professional responsibility" contemplated by the regulations,[20] it is doubtful whether Drexler and Wald could satisfy the test of "centralized management."

Drexler and Wald did seem to possess the fourth major corporate attribute. If members of an organization are not personally liable for the debts of or claims against the organization, it is said to have the corporate characteristic of "limited liability."[21] Drexler and

exclusive authority to determine all of the matters described in the preceding sentence (Emphasis added.)

To the requirements of paragraph (h), paragraph (c) adds, among others, the requirement that the management must be a group of persons which does not include all of the shareholders.

17. It is doubtful whether the board of managers was solely responsible for deciding "who will handle each individual case or matter" or "the professional policies and procedures to be followed in handling each individual case." But these are subjects which are typically decided by the individual employees in any corporation, and it seems unreasonable if the retention of only these prerogatives by the employees would prevent a professional service organization from having the characteristic of "centralized management."

18. Treas. Reg. § 301.7701-2(h)(3) (1965) (quoted in note 16 *supra*).

19. Furthermore, the rule does not purport "to modify the attorney client privilege [or] any comparable common law privilege." COLO. R. CIV. P. 265, §§ II (B), (C), & (D) (quoted in note 2 *supra*).

20. If "traditional professional responsibility" does mean the ethical responsibility normally associated with members of the legal profession, it would appear that this criterion bears very little relation to "centralized management." It would be unusual if the fact that lawyers continued to be responsible for their personal acts of misconduct were held to preclude the existence of the "centralized management" characteristic.

21. Treas. Reg. § 301.7701-2(d)(1) (1960), to which Treas. Reg. § 301.7701-2(h)(4) (1965) refers for the test of limited liability, defines personal liability as follows: "Personal liability means that a creditor of an organization may seek personal satisfaction from a member of the organization to the extent that the assets of the organization are insufficient to satisfy a creditor's claim." Treas. Reg. § 301.7701-2(h)(4) (1965), however, provides the additional requirement that "the personal liability of its members, in their capacity as members of the organization, [be] *no greater in any aspect* than that of shareholders of an ordinary business corporation." (Emphasis added.)

Wald was incorporated under the general corporation law of Colorado, which provides that no shareholder will be personally liable for corporate debts.[22] However, rule 265 of the Colorado Rules of Civil Procedure superimposes personal liability on members of professional service corporations unless liability insurance of specified amounts is maintained.[23] Since the company had the required insurance coverage at all times, the individual lawyers were not in fact personally liable. Nevertheless, the government argued that the owners of Drexler and Wald did not have the necessary limited liability because the statutory requirement of liability insurance was a precondition to their immunity.[24] There were apparently two grounds for this argument. First, the personal liability of the members could be said to have failed the test laid down by the regulations of being "no greater in any aspect than that of shareholders of an ordinary business corporation."[25] It should be noted, however, that the requirement of insurance is comparable to the insurance requirements or minimum asset restrictions which local law typically places on many kinds of ordinary corporations such as banks and insurance companies.[26] Second, there would always be the possibility that a future failure to insure would render the shareholders personally liable. This seems beside the point, however, since Drexler and Wald's shareholders were, as the regulations require, not *in fact* personally liable.[27]

Thus, the court's conclusion was based on a somewhat casual application of the Kintner regulations' criteria.[28] Indeed, it may even be reasonable to infer that since Drexler and Wald lacks at least two, and probably three, of the relevant characteristics, it more nearly resembles a partnership than a corporation. Even assuming the court's decision to be incorrect on this issue, however, the ques-

22. COLO. REV. STAT. ANN. § 31-4-20 (1963).

23. COLO. R. CIV. P. 265, § I(G) (quoted in note 2 *supra*). Article six of Drexler and Wald's articles of incorporation provided for personal liability if the company failed to carry the requisite insurance.

24. Brief for the United States in the principal case at 44-45.

25. Treas. Reg. § 301.7701-2(h)(4) (1965).

26. *See, e.g.*, N.Y. BANKING LAW § 95 (McKinney 1957).

27. It might also be maintained that members of the organization lack limited liability because each retained his personal liability to a client. *See* COLO. R. CIV. P. 265, § II(C) (quoted in note 1 *supra*). It should be noted, however, that such liability would arise only from a shareholder-attorney's acts and omissions, just as it would for an employee who was not an owner; such liability has nothing to do with his *capacity as a member* of the organization, and is not at all the same as the mutual agency relationship between partners and a partnership. *See* O'Neill v. United States, 68 A.F.T.R.2d 405 (1968), which held that personal liability for an employee's own acts did not preclude his limited liability as a shareholder.

28. The court discussed the major characteristics *seriatim* and apparently concluded that Drexler and Wald satisfied all of them. Principal case at 854. In applying the tests of the regulations, however, the court appears to have ignored the stricter standards in paragraph (h), which would have disqualified Drexler and Wald on at least two of the characteristics. *See* notes 12-27 *supra* and accompanying text.

tion remains whether the Kintner regulations, which stipulate that certain organizations are to be taxed as partnerships regardless of incorporation under state law, are themselves valid.

The court in the principal case reached its conclusion that the regulations are invalid by a process of seemingly incontestable syllogistic reasoning. For tax purposes an organization which carries on business for profit can only be either a partnership or a corporation.[29] The Internal Revenue Code (Code) defines "partnership" as including "a syndicate, group, pool, joint venture, or *other unincorporated* organization . . . ."[30] Since the language refers to "other unincorporated" organizations, and since all of the forms of organization specifically enumerated are in fact unincorporated, the most reasonable interpretation of the statutory definition is that it is intended to exclude incorporated organizations from the category of partnerships.[31] Therefore, since an incorporated organization cannot be a "partnership," and since for tax purposes a business organization is either a partnership or a corporation, all incorporated organizations must be corporations within the meaning of the Code. Having progressed this far, the court concluded that the Kintner regulations, which purport to classify some incorporated professional service organizations as "partnerships,"[32] are inconsistent with the Code, and, as such, are invalid.

If the court's reasoning is correct, however, any organization incorporated under state law would be a corporation for federal tax purposes, regardless of its lack of corporate characteristics. An argument can be made that the presence or absence of corporate characteristics should be a matter of indifference to those charged with enforcement of the federal tax laws and that incorporation under state law should be dispositive of the question of tax status, but such a result seems to be undesirable as a matter of tax policy. In bestowing certain tax benefits, Congress has chosen to differentiate between corporations and their employees on the one hand and partners and self-employed persons on the other.[33] It would be unfortunate if states could undermine congressional policy and provide tax avoidance havens simply by donating the label of "corporation" to an organization which exhibits nearly all of the characteristics of an ordinary partnership.

29. Of course, a business may be operated as a sole proprietorship. When it does, however, the sole proprietor is taxed as an individual, under the theory of § 61 of the 1954 Code.

30. INT. REV. CODE OF 1954, § 7707(a)(2) (emphasis added).

31. This analysis is supported by the general rule of statutory construction: *expressio unius est exclusio alterius*. It can perhaps be argued, however, that the language should not be interpreted to exclude incorporated organizations, and that the enumeration is intended to be language of inclusion only and not limitation.

32. Treas. Reg. § 301.7701-2(h)(1) (1965). *See also id.* § 301.7701-1(c) (1960).

33. *See* note 4 *supra*.

Furthermore, approaching the question from the opposite direction, if, as the Kintner regulations suggest, some incorporated organizations were not intended to be corporations within the meaning of the Code, then the court's major premise that for tax purposes an organization can only be either a corporation or a partnership would require that these organizations be categorized as "partnerships." This analysis suggests that the court's interpretation of the "partnership" definitional section as excluding incorporated organizations may have been incorrect.[34] Clearly, unless there is a gap in the Code, incorporated professional service organizations which more nearly resemble partnerships than corporations must fall into one category or the other. As was suggested above, policy may dictate inclusion of these organizations in the partnership category. But, the language of the "partnership" definitional section of the Code appears to the contrary. Thus, it is necessary to analyze the scope of the "corporation" definitional section.[35]

The first pertinent legislation creating separate tax treatment for corporations was the Revenue Act of 1894, which provided corporate tax treatment for associations and for corporations *"no matter how created and organized,* but not including partnerships."[36] The Revenue Act of 1909, using substantially the same language, again provided corporate tax treatment for associations and for corporations *"organized of any state."*[37] Thus, while it was within Congress' power to do otherwise,[38] it chose to tax organizations incorporated under state law as corporations.[39] The Revenue Act of 1918

34. *See* note 31 *supra* and accompanying text.

35. INT. REV. CODE OF 1954 § 7701(a)(3):

Corporation.—Term "corporation" includes associations, joint-stock companies, and insurance companies.

36. Rev. Act of 1894, ch. 349, § 32, 28 Stat. 556 (emphasis added). It would appear that Congress intended a broad scope for the term "corporation," having left it to be read *in pari materia* with "association" and other similar terms. *See* Scallen, *supra* note 6, at 611-13.

37. Rev. Act of 1909, ch. 6, § 38, 36 Stat. 112 (emphasis added).

38. Burnet v. Harmel, 287 U.S. 103, 110 (1932) ("State law creates legal interests but the federal statute determines when and how they shall be taxed."); Wholesalers Adjustment Co. v. Commissioner, 88 F.2d 156 (8th Cir. 1937) (local law irrelevant to federal tax treatment and classification since to permit otherwise would destroy uniformity of tax treatment among the states).

39. This conclusion follows if one assumes that "organized," as used, means incorporated. The Rev. Act of 1913, ch. 16, § 2G(a), 38 Stat. 172, and the Rev. Act of 1916, ch. 463, § 1(a), 39 Stat. 756-57, by using language substantially similar to that of the preceding acts, would seem to have adopted the earlier conception of the term "corporation." That is, Congress intended to define "corporation" broadly to include "associations" and various other organizations not generally recognized as corporations. In fact, Congress' intention to tax state chartered corporations as such was never doubted until the promulgation of the 1960 Kintner regulations. Anderson, *Tax Aspects of Professional Corporations*, S. CAL. 15TH TAX INST. 309, 320-22 (1963); Eaton, *Professional Associations as Planning Techniques*, N.Y.U. 25TH INST. ON FED. TAX 671, 673-74 (1966); Note, *Professional Corporations and Associations*, 75 HARV. L. REV. 756, 785 (1962). *See also* Moline Properties v. Commissioner, 319 U.S. 436, 438-39 (1943); Burnet v. Commonwealth Improv. Co., 287 U.S. 415, 419 (1932).

retained virtually the same language, but, in addition, it specifically denied corporate tax status to "personal service corporations and associations," including those comprised of doctors or lawyers, stating that these organizations were to be taxed as ordinary partnerships.[40] However, the Revenue Act of 1921 repealed this special treatment of personal service corporations and associations, apparently manifesting a congressional intent not to use different standards for determining the tax status of these organizations.[41] Since 1921, succeeding revenue acts have used substantially the same language to distinguish between organizations entitled to tax treatment as corporations and those to be taxed as partnerships, without again adopting special rules for the treatment of personal service corporations.[42] Therefore, one must assume that Congress has intended not to change its 1921 policy of determining the tax status of ordinary corporations and personal service organizations according to the same standards.[43]

From the earliest Treasury regulations to go beyond a mere restatement of the statutory language in 1913 until the Kintner regulations in 1960, the statutory terms "corporation" and "association" have been construed broadly to embrace even some unincorporated organizations with few corporate characteristics.[44] Throughout this same period, Congress re-enacted statutes at least eleven times without significantly altering the language used to define corporations and partnerships,[45] and the regulations interpreting these statutes were sustained by the courts.[46] When the interpretations of a statu-

---

40. Rev. Act of 1918, ch. 18, § 218(e), 40 Stat. 1070 (1919).

41. Rev. Act of 1921, ch. 136, § 218(d), 42 Stat. 245 (1921). The repeal of the special treatment provision for personal service organizations, like its enactment, arose in the Senate Finance Committee, and was passed with little or no debate. Repeal may have been motivated by doubts as to the constitutionality of the discriminatory treatment of such organizations by the Revenue Act of 1918. Scallen, *supra* note 6, at 617-18.

42. Scallen, *supra* note 6, at 556-66. Section 7701(a) of the 1954 Code uses substantially the same form of definition for the terms "corporation" and "partnership" as was used in §§ 3797(a)(2) & (3) of the 1939 Code.

43. Although changes in the tax law have given corporations and their owners more favorable treatment than they had received in the past (*see* note 4 *supra*), these changes alone cannot be said to be indicative of a congressional intent to restrict the scope of the previously adopted definition of "corporation"; for, if one were to conclude otherwise, one would be suggesting that every time Congress altered the tax treatment of a previously defined item, the definition, as Congress understood it, would also be altered.

44. *See* Treas. Reg. 33, art. 62 (1918); Treas. Reg. 45, art. 1506 (1921); Treas. Reg. 65, arts. 1503 & 1506 (1924); Treas. Reg. 74, arts. 1313 & 1516 (1929); Treas. Reg. 77, arts. 1312 & 1316 (1933); Treas. Reg. 86, art. 801-5 (1935). *Compare* Treas. Reg. § 301.7701-2 (1965). Other regulations provided that the new statutes were to be interpreted in substantially the same manner as in earlier regulations and, in some cases, even broadened the meaning of "corporation." Scallen, *supra* note 6, at 655-66.

45. Rev. Acts of 1913, 1916, 1917, 1918, 1921, 1924, 1932, 1936, and 1938 and the INT. REV. CODES OF 1939 and 1954. *See* notes 36-42 *supra* and accompanying text.

46. *E.g.*, Morrissey v. Commissioner, 296 U.S. 344 (1935); Pelton v. Commissioner, 82 F.2d 473 (7th Cir. 1936).

tory provision by the courts and by the regulations is substantially uniform over a period of years, and Congress repeatedly re-enacts the provision without material changes, the doctrine of congressional adoption is sometimes invoked to incorporate, in effect, the previous administrative and judicial interpretations into the statute. Such interpretations acquire the force of law and, like any law, are amenable to change by Congress but not by the courts or by subsequent Treasury regulations.[47] Thus, there is strong justification for applying the "congressional adoption" doctrine to the administrative interpretation of "corporation" contained in the pre-Kintner regulations and for making that interpretation immune to amendment by subsequent regulations.

Without challenging the "congressional adoption" doctrine, the Internal Revenue Service (IRS) has apparently taken the position that the doctrine is inapplicable to the problem of determining the tax status of professional service organizations. Its argument is that subsequent regulations alone are sufficient to modify previous interpretations of the statute because neither the regulations prior to the 1954 Code nor those promulgated immediately afterward dealt specifically with "professional service organizations."[48] While this argument might be persuasive if the Kintner regulations were merely an explanation of how to apply the historical tests to professional service organizations, in fact these regulations completely reject prior standards used to define ordinary corporations. Thus, it would seem immaterial that the prior regulations did not specifically consider professional service organizations, especially in light of the apparent congressional intent not to distinguish between the standards for determining the tax status of such organizations and that of ordinary corporations.[49]

---

47. In Fribourg Navigation Co. v. Commissioner, 383 U.S. 272, 283 (1966), which held an attempted change in regulations invalid, the Court said:

> Over the same extended period of years during which the foregoing administrative and judicial precedent was accumulated, Congress repeatedly re-enacted the depreciation provision without significant change. Thus beyond the generally understood depreciation provision itself, the Commissioner's prior long-standing and consistent administrative practice must be deemed to have received congressional approval.

See also Commarano v. United States, 358 U.S. 498, 510-11 (1959); United States v. Leslie Salt Co., 350 U.S. 383, 396-97 (1956); Commissioner v. Flowers, 326 U.S. 465, 469 (1946); Helvering v. Winmill, 305 U.S. 79, 83 (1938). For critical comment on the "congressional adoption" doctrine, *see* Griswold, *A Summary of the Regulations Problem*, 54 HARV. L. REV. 398 (1941); Surrey, *The Scope and Effect of Treasury Regulations Under Income, Estate and Gift Taxes*, 88 U. PA. L. REV. 556, 559-61 (1940).

48. Brief for the United States in the principal case at 55. It is interesting to note, however, that in 1936 the Internal Revenue Service (IRS) successfully maintained that such organizations were subject to the same rules as other organizations. Pelton v. Commissioner, 82 F.2d 473 (7th Cir. 1936). Also militating against this argument is the 1921 Act's abolition of the brief statutory recognition of special treatment accorded such organizations. *See* notes 40 & 41 *supra* and accompanying text. A prior argument as to the inapplicability of the doctrine, under somewhat similar circumstances involving depreciation, was summarily rejected by the Court. Fribourg Navigation Co. v. Commissioner, 383 U.S. 272, 283 (1966).

49. *See* notes 40 & 41 *supra* and accompanying text. With the Kintner regulations,

The Kintner regulations are inconsistent not only with previous regulations, but also with judicial interpretations of the "corporation" definitional section of the Code—section 7701(a)(3) of the 1954 Code and its predecessors. For example, in *Pelton v. Commissioner*,[50] in 1936, the IRS successfully maintained that an association of three doctors who carried on their medical practice through a trust arrangement was taxable as a corporation. It seems clear, however, that this association could not qualify as a corporation under the Kintner regulations, since it more nearly resembled a trust than a corporation.[51] Moreover, *Morrissey v. Commissioner*,[52] the very case upon which the Kintner regulations are purportedly based,[53] seems to indicate that the treatment accorded professional organizations by the regulations is not justified. In *Morrissey* the Supreme Court noted that "[t]he inclusion of associations with corporations implies resemblance, but it is resemblance and not identity. The resemblance points to features distinguishing associations from partnerships . . . ."[54] The Kintner regulations purport to follow such a test of resemblance,[55] but, as a practical matter, they create a formidable barrier to a determination that a professional service organization is a corporation. This is perhaps best demonstrated by the all-or-nothing standard which the regulations apply to determine the presence or absence of the major corporate attributes in a public service corporation. For example, an organization does not possess

---

especially the 1965 revised Kintner regulations, the Commissioner has attempted unilaterally to reverse this "presumptively corporate" treatment and in effect has administratively legislated that virtually all professional service organizations are partnerships for federal tax purposes. This not only abandons the IRS's long-standing practice of extending corporate tax status to as many unincorporated organizations as possible, but also attempts to classify as partnerships a large group of businesses which are corporations under state law.

50. 82 F.2d 473 (7th Cir. 1936).

51. *See* Treas. Reg. § 301.7701(a)(1) (1960); Scallen, *supra* note 6, at 625-48. *See also* United States v. Kintner, 216 F.2d 418 (9th Cir. 1954) (association of doctors held to be a "corporation"); Foreman v. United States, 232 F. Supp. 134 (S.D. Fla. 1964) (association of doctors held to be a corporation in spite of the 1960 Kintner regulations); Galt v. United States, 175 F. Supp. 360 (N.D. Tex. 1959), *appeal dismissed*, 257 F.2d 811 (8th Cir. 1960) (association of doctors held to be "corporation" on the eve of the 1960 Kintner regulations).

52. 296 U.S. 344 (1935).

53. *See* Treas. Reg. § 301.7701-2(a)(1) (1960). *See also id.* § 301.7701-1(c) (1960).

54. 296 U.S. at 357. The resemblance test has been articulated as follows:

> Where an entity of this kind resembles a corporation in some respects and that of a partnership in others—that frequently being the case—the features of similarity should be compared and the marks of dissimilarity contrasted. The resemblances should be balanced. It should be determined by that method the one to which the enterprise is predominantly akin in the method, mode, and form of procedure of the conduct of its business.

Commissioner v. Brouillard, 70 F.2d 154, 158 (10th Cir. 1934). It should be noted that some characteristics of resemblance might well be disregarded under certain circumstances. *See* note 10 *supra* and accompanying text.

55. Treas. Reg. § 301.7701-2(a)(1) (1960).

"limited liability" when the liability of its members "*in any aspect*" rises above that of a shareholder-employee of an ordinary business corporation.[56] Similarly, there is no "centralized management" if any one of several indicia of control is absent or if an owner-employee retains "traditional professional responsibility" regardless of the extent to which the management is in fact centralized.[57] Furthermore, if the organization has a right of first refusal when a shareholder attempts to sell him stock, and if the benefits from ownership of stock are inseparable from the employment relationship, there is no free transferability of interests,[58] even though the interests are otherwise freely transferable. Finally, also because the benefits of ownership are dependent upon employment, the organization technically would lack "continuity of life,"[59] irrespective of the actual extent to which the organization could endure the departure of one or more of its members.[60] Consequently, the cumulative effect of the Kintner regulations could produce distorted results to the extent that the mere presence or absence of these corporate attributes determines the characterization of the organization for federal tax purposes.[61]

56. Treas. Reg. § 301.7701-2(h)(4) (1965). *See* note 21 *supra* and accompanying text.

57. Treas. Reg. § 301.7701-2(h)(3) (1965). *See* notes 16 & 20 *supra* and accompanying text. It should be noted that the disqualification for retention of traditional professional responsibility is either somewhat at odds with the IRS's position that retention of professional responsibility is inherent in, and not inconsistent with, the employment of a professional, or it signifies that the IRS feels that professional service organizations can *never* have centralized management. *Compare* Treas. Reg. § 301.7701-2(h)(3) (1965), *with* Cody v. Ribicoff, 289 F.2d 394, 398 (8th Cir. 1961), *and* Flemming v. Hucke, 284 F.2d 546, 550 (9th Cir. 1960), *and* Walker v. Attmeyer, 137 F.2d 531, 533 (2d Cir. 1943), *and* Wendell E. James, 25 T.C. 1296, 1301 (1956), *and* Rev. Rul. 61-178, 1961-2 CUM. BULL. 153.

58. Treas. Reg. § 301.7701-2(h)(5) (1965). Although paragraph (e)(2) recognizes a modified form of free transferability where sale of stock is subject to the company's rights of first refusal, paragraph (h), for no apparent reason, rejects this concept in the context of professional service organizations. One should note also that there is an apparent conflict between the requirements of "centralized management," which specify that the managers must have complete control over hiring and firing of employees and the requirement of "free transferability of interests," which specifies that employment must be "transferable" without consent, where benefits are dependent upon employment. *Compare* Treas. Reg. § 301.7701-2(h)(3) (1965), *with id.* § 301.7701-2(h)(5) (1965).

59. Treas. Reg. § 301.7701-2(h)(2) (1965). This corporate characteristic was not specified in the *Morrissey* decision, upon which the regulations are purportedly based.

60. *Id.* § 301.7701-2(h)(2) (1965).

61. Further evidence of the adverse impact of the Kintner regulations is the fact that closely held corporations, which uniformly have been treated as "corporations" for federal tax purposes, perhaps would not be classified as corporations if the rigid standards of corporateness of Treas. Reg. § 301.7701-2(h) (1965) were applied. Consider the not atypical example of a closely held corporation managed by two men, each of whom owns fifty per cent of the stock. Assume that the stock is subject to a transfer restriction which prohibits transfer of ownership without the consent of the other shareholder and which provides that the corporation will purchase at a given price the stock of a shareholder desiring to sell. Obviously, there would not be "free transferability of interests." Furthermore, the transfer restrictions coupled with the buy-

Courts have considered four factors in determining the proper weight to accord a Treasury regulation when its validity is in issue: (1) whether the regulation is "legislative" or merely "interpretative";[62] (2) if it is interpretative, whether the regulation and the statute were contemporaneous;[63] (3) the length of time since the regulation was first promulgated; and (4) whether the regulation has withstood re-enactments of the Code.[64] Since the Kintner regulations are interpretative, were drafted long after the drafting of the relevant section of the 1954 Code,[65] and are not of long standing, and since there has been no re-enactment of that Code section since the Kintner regulations were promulgated, it is submitted that the regulations should be accorded a very slight presumption of validity.

The analysis that has been followed throughout this Note would suggest that at this point only Congress, and not the IRS, can change the historical practice of treating organizations that are incorporated under state law as corporations for federal tax purposes.[66] If, as was suggested above,[67] it is undesirable as a matter of federal tax policy

back agreement probably prevent the organization from having "continuity of life," since the dissatisfaction of either owner would seriously impair the capital of the corporation and/or cause dissolution, either from the impairment of the capital or from the impasse between the two shareholders on key decisions. If this corporation is organized or does business in a state whose laws provide that the shareholders, or the officers or directors are liable personally for wages of employees, or if the owners run the business so informally and directly as to subject themselves to personal liability through the *"alter ego"* concept of "piercing the corporate veil," there would be no "limited liability." In addition, it is very often the case with closely held corporations that outsiders will not do business with the corporation unless the shareholders personally guarantee the corporate debts. Such guarantees would preclude any traditional notion of limited liability. *See* note 21 *supra.* Furthermore, "centralized management" might well be lacking under Treas. Reg. § 301.7701-2(h)(3) (1965), because decisions about the compensation, hiring, and working conditions of each employee might not be subject to the "exclusive authority" of the management, or, even if it were, because all members (shareholders) might constitute managers. *See* Treas. Reg. § 301.7701-2(c) (1960); note 16 *supra.* Thus, it is conceivable that such an organization, or even one which more closely resembled an ordinary corporation, could fail to meet the resemblance test of the Kintner regulations.

62. A regulation is "legislative" when it is promulgated pursuant to specific statutory direction to fill in the details of a statute [*e.g.,* INT. REV. CODE OF 1954, § 472(a)], whereas it is "interpretative" when promulgated under the general grant of power to interpret the Code. INT. REV. CODE OF 1954, § 7805. Of course, legislative regulations are accorded much more judicial deference than interpretative regulations.

63. If the regulation were drafted contemporaneously with the statute, the interpretation is accorded a high presumption of validity since the same staff of Treasury attorneys who draft the regulations also work with Congress in drafting the statute and thus "knew" the intent of Congress.

64. *See* B. BITTKER & E. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 38 (2d ed. 1966); Scallen, *Federal Income Taxation of Professional Associations and Corporations,* 49 MINN. L. REV. 603, 648-49 (1965).

65. INT. REV. CODE OF 1954, § 7701(a). The section was drafted prior to 1954, whereas the Kintner regulations, which appeared in 1960 and were revised in 1965, were drafted in 1959 and 1964, respectively.

66. *See* notes 44-49 *supra* and accompanying text.

67. *See* note 28 *supra* and following text.

to allow states to make various corporate tax benefits available to their partnerships simply by designating them as "corporations" or "associations," Congress can foreclose this opportunity by amending the Code or by explicitly authorizing the Treasury Department to promulgate appropriate regulations.[68] But, even if regulations promulgated without congressional authorization could reverse the traditional practice of taxing incorporated organizations as corporations, there is no basis for distinguishing in this respect between professional service organizations and any other form of business organization. In other words, even if subsections (a) through (g) of the Kintner regulations, which lay out the general resemblance test applicable to all corporations, are found to be legitimate administrative interpretations of the Code, subsection (h), which provides burdensome handicaps for professional service organizations in their attempts to qualify for corporate tax treatment, would appear to be discriminatory in a way not justified by the statute and therefore invalid.[69] Finally, assuming, *arguendo,* that subsections (a) through (g) are valid in principle, the standards embodied in those subsections should be applied in a more flexible and objective manner, and the resemblance test patterned after the *Morrissey* case should be accepted for what it is—a test calling for similarity rather than virtual identity.[70] Whether an organization is a corporation for tax purposes is a question of fact; each of the so-called "major characteristics" is relevant to this determination, but the decision should not be based on a wooden application of intractable rules.

68. If Congress were to authorize the Treasury Department to promulgate regulations, such rules would be legislative rather than merely interpretative and would thus be entitled to a higher presumption of validity than the current Kintner regulations. *See* note 62 *supra.* One could argue that since a congressional authorization can shroud subsequent regulations with validity, congressional silence in the face of an "unauthorized" or "interpretative" regulation is tantamount to acceptance and such regulations, after a while, also acquire the presumption of validity.

69. *See* O'Neill v. United States, 68 A.F.T.R.2d 405 (1968), holding that paragraphs (a) through (g) are valid while paragraph (h) is invalid.

70. On the desirability of a flexible application of the resemblance test, the court in *Morrissey* stated:

> These definitions while helpful, are not to be pressed so far as to make mere formal procedure a controlling test. The provision itself negatives such a construction . . . it is impossible in the nature of things to translate the statutory concept of "association" into particularity of detail that would fix the status of every sort of enterprise or organization which ingenuity may create.

296 U.S. 344, 358 (1935).