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## SHOULD LAWYERS INCORPORATE?

By H. BRADLEY JONES\*

### *A Discussion*

The problems of lawyers, as second class taxpayers in this modern age of fringe benefits and tax shelter available to the great majority of our citizens, were discussed by a panel of Los Angeles lawyers at the State Bar Conference in San Francisco in September, 1959. The panel members (Maynard J. Toll, Arthur B. Willis, F. Daniel Frost and H. Bradley Jones) explored "The Professional Corporation" proposal originally made in an article appearing in the Autumn, 1958, issue of the *Fordham Law Review* and which is the subject of a special study authorized by the Board of Governors of the California State Bar under the chairmanship of the proponent.

Graham L. Sterling, President of the State Bar, in his concluding message as President of the State Bar said:

"It appears doubtful at this time that the Simpson-Keogh Bill now before the U. S. Senate Finance Committee will get out of committee. This is the bill which would permit self-employed persons, including members of professions, to set aside moneys from current income for ultimate retirement in the same manner permitted to employees of corporations. So long as Congress refuses to eliminate this unfair discrimination against sole proprietors and practitioners of professions, it is particularly important that the bar give careful consideration to the proposal that members of professions be allowed to practice in corporate form in a manner which will preserve the traditional individual professional responsibility to the client or patient, while at the same time making available to professional practitioners the income tax benefits of doing business in corporate form. A Special Committee of the State Bar under the chairmanship of H. Bradley Jones of Los Angeles is studying the matter and has arranged for a panel discussion of the subject to be held at the State Bar Convention next September. Since Congress does not appear willing to equalize the tax impact on professional persons, certainly it would seem that the legal profession is best qualified to find another solution. This will take imagination, ingenuity and open minds, free of prejudice not based on reason."

The panel addressed itself to the tax, ethical, practical, and legislative problems and attributes of a professional corporation as proposed.

### *Proposal for a Form of Professional Corporation*

The Jones proposal, as stated at the outset of the panel discussion was as follows:

"A professional corporation should be subject to the supervision and regulation of the state administrative agency regulating the profession

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which the particular corporation is formed to practice. Such a professional corporation should have, as a matter of California law, the following limitations and special characteristics:

1. All of its officers, directors, and shareholders shall be persons licensed to practice the profession by the state of domicile.
2. No member of a professional corporation shall be permitted to practice more than one licensed profession within the scope of the business of the corporation.
3. Shares may be held only by such licensees who are natural persons and no professional corporation may hold stock in another professional corporation, merge or consolidate with a foreign professional corporation, or permit any lay person at any time to own any of its shares.
4. Shares shall not be transferable without the consent of the state agency licensing the profession, except in retirement or redemption thereof by the corporation or among the existing shareholders of the corporation. Shares may be issued only with the consent of the state licensing agency.
5. The professional corporation shall afford no limitation on the liability of its officers, directors or shareholders for any errors, omissions, malpractice or other torts committed by its agents, employees, officers, directors, or shareholders in the scope of their employment by or professional activities on behalf of the corporation.
6. No layman shall have any part in the ownership, management, or control of the corporation. No proxy may be given to any person to vote any shares of the corporation other than a person licensed by the law of the state of corporate domicile to practice the profession of the corporation.
7. Upon the death or retirement of a stockholder, the corporation must purchase, redeem, or retire all of the shares of such stockholder out of capital as well as surplus without restriction, unless the shares are promptly purchased by the remaining shareholders of the corporation or other licensed practitioners (with the consent of the state licensing agency). This redemption may require execution by the remaining shareholders of a bond or undertaking to be delivered to the state agency governing the practice of the profession, indemnifying creditors of the corporation, and shall be lawful even though such purchase or redemption temporarily renders the corporation insolvent.
8. The corporation's franchise shall be subject to revocation in any of the following events:
  - a) upon the revocation of the professional license of any officer, director, or shareholder not promptly retired by the corporation;
  - b) should any judgment for malpractice against the corporation remain unsatisfied;
  - c) upon the final order, after appropriate hearing, of the state agency governing the profession, upon petition of such agency or any shareholder of the corporation having a grievance on the grounds of a violation of the standards or rules of ethics of the licensed profession against the corporation, its officers or directors; of any client or patient of the corporation; or of the Attorney General of the state;
  - d) upon the death or surrender of the license of the last remaining shareholder of the corporation.

9. Issuance of securities by a professional corporation to its shareholders shall not be subject to state corporate securities regulation by the Commissioner of Corporations."

### *The Tax Problem of the Lawyer*

As a proprietor or partner, the lawyer cannot avail himself of corporate tax shelter from the graduated income tax rates applied by both federal and state income tax laws upon his individual income derived from the practice of his profession because of existing statutory and ethical objections, prohibitions and limitations upon the practice of law by a corporation organized for profit. As an additional consequence of his present inability to use the corporate form of doing business, the lawyer who is a sole proprietor or a partner cannot be treated as an "employee" for tax purposes. As a result, he is unable, in the private practice of law, to participate in any of the following important tax and fringe benefits which are available to those who are not excluded from the use of the corporate form of doing business:

- a) Profit sharing and retirement plans;
- b) Pension plans;
- c) Group life insurance wherein the premiums paid by the employer are deductible to the employee and do not constitute income to the employee;
- d) Health and welfare plans;
- e) Deferred compensation plans.

### *Other Tax Considerations*

The panel members considered the possible use by a professional corporation of the privilege embodied in subchapter S (I.R.C. Sec. 1371-1377) to elect to be taxed as a "small business corporation" and concluded that, in the light of the proposed regulations issued by the Treasury Department and the legislation which had been proposed in Congress which would tend to strip a subchapter S of the privilege of claiming deductible fringe benefits of the sort above described, subchapter S might not prove to be a satisfactory tax alternative for many professional corporations. In the event that the professional corporation did not elect to be taxed under subchapter S it would, in each instance, be confronted with the problems of the personal holding company tax, the penalty on unreasonable accumulation of current income, and exposure to unfavorable tax treatment of unreasonably high salaries. These problems, however, would be no greater than nor different from the same problems confronting a personal service business corporation organized for profit, and it was concluded that a professional corporation made up of lawyers would probably distribute all or substantially all of its

current earnings through salaries, bonuses, fringe benefit costs and operating expenses.

In the light of the stubborn opposition of the Treasury Department to the Simpson-Keogh Bill and its predecessors on the grounds that the Treasury would suffer substantial loss of tax revenue, the panel members considered the possible line of attack which the Treasury Department might take against a professional corporation. It was suggested that this attack might take the form of the proposal of federal tax legislation which would seek to cause professional corporations to be treated as partners. The conclusion of the panel was that, from a tax standpoint, the professional corporation as a matter of state legislation presented a potentially workable and reasonable method of accomplishing tax equality among professional men and other citizens engaged in business and commerce. True equality could, in theory, be accomplished much more simply if Congress could be persuaded to permit sole proprietors and partners to be treated as their own employees for tax purposes, thereby affording them the fringe benefits which make the professional corporation such an attractive tax proposal. However, this legislation would not provide tax shelter from graduated individual taxes which is afforded through the lower corporate income tax rates.

### *Ethical Considerations*

Of greater importance, perhaps, to lawyers and to the public is the serious question of whether or not practice of law, or the related professions of the healing arts, accounting, architecture and the like, can ethically be carried on in the corporate form. The ethical objections which have been advanced in respect to practice of law by corporations were summarized as follows:

1. A corporation is not eligible for a license to practice the profession; hence, such practice is not a "lawful purpose" for which a corporation may be formed.
2. The relation of the practitioner of a profession and his client or patient is purely personal; statutory prerequisites to the right to practice are high and form a basis for trust and confidence. A corporation cannot have these personal qualifications and would not be deserving of the same personal trust.
3. If a corporation employs a practitioner, his first duty is to his employer rather than to the client or patient. He would be subject to the directions of his employer rather than to those of his client or patient.
4. A "middleman" should not, as a matter of public policy, be permitted to intervene for profit in establishing the professional relationship between the practitioner and members of the public.
5. Priority of contract would be with the corporation, not the practitioner.
6. Even if all officers and directors are licensed, transfer of their shares by

sale, operation of law, or succession would result in unlicensed laymen profiting from the practice of a profession through share ownership in such a corporation. Marketable shares descendible under the laws of inheritance are objectionable.

7. The corporation could not be disbarred or suspended.

8. Unscrupulous practitioners might find shelter from liability in corporations in cases of malpractice claims, particularly in the medical professions.

The conclusion of the panel on these ethical questions was, however, that the proposal satisfied all of these objections. The panel considered the possibility, however, that even though the original professional corporation law might be drawn in such a way as to effectively prevent lay ownership or control of professional practice, or any of the other abuses above described, a danger of the relaxation of the rigid limitations by subsequent changes in the law might be presented. Continuing vigilance by the State Bar and the interested professions would be required in order to prevent legislative erosion of such a statute and its original safeguards to the professions and to the public. It was the conclusion of the panel that the creation of professional corporations probably would not, in practice, vary or alter the relationship between the professional man and his client or patient, or tend to create economic giants within the field of the profession.

### ***Comparison With Other Proposals***

The panel described and discussed the association taxable as a corporation which has been adopted by medical corporations on the authority of the case of *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954), as recently reinforced by *Galt v. United States*, (U.S. District Court, No. Dist. Texas, Dallas Div., No. 8121 Civil, 7/27/59, reported at CCH Federal Tax Reporter Sec. 9602).

Although there is some division of thinking in the Tax Bar as to the advisability and desirability of the adoption of Kintner associations for doctors for the purpose of obtaining for them the same benefits which the professional corporation would seek, all of the panel members agreed that Kintner associations were dangerous, in the absence of any Treasury Department rulings or regulations covering their formation and tax treatment, and because of the absence of the uncertainties in the law respecting associations as compared with the relative certainty of the law of partnerships and corporations. Furthermore, the Kintner association affords no possibility of tax relief to the sole practitioner and is probably not available to the small partnership.

The Simpson-Keogh Bill, which has once again failed to pass, was closely analyzed by the panel. The members agreed that, in its present form, the Bill provided far less tax and investment advantages than are available under profit sharing and retirement plans which could be estab-

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lished by professional corporations. Moreover, after reviewing the history of the efforts of eight million professional taxpayers through their associations to obtain equal tax treatment in Congress over the past fifteen years, it was concluded that Congress had hitherto failed to act on any proposal for the tax relief for these professional people and that it would now be proper to consider state legislation, such as the professional corporation proposal, to accomplish tax relief as probably the only politically available alternative.

The discussion also touched upon a proposal made in 1957 in California to permit professional corporations to be formed. This proposal did not reach the floor of either the Senate or Assembly and appeared to be designed primarily to provide shelter for practitioners against malpractice claims. The panel shared the view that there should be no limitation of liability to a professional man for any acts, errors or omissions which he might commit in the practice of his profession. The present proposal so contemplates such a relinquishment of the privilege of the limitation of liability by the professional corporation and its shareholders.

Incorporation of similar personal service and professional enterprises appears to be on the increase. The New York Stock Exchange had changed its rules and regulations and permitted members to incorporate; the Attorney General of the State of California (Opinion 56-298) expressly sanctions the practice of architecture in the corporate form in California; the laws of Connecticut and Oklahoma have been amended to permit the corporate practice of medicine; and the trend towards corporate practice of medicine in the form of nonprofit corporations has been increasingly apparent in recent years.

It was the conclusion of the panel that all of the professions share common tax disadvantages wherever they are prohibited from using the corporate form and that efforts were being made wherever possible to correct this situation within the framework of existing state law.

### *Legislative Problems*

No proposal for professional corporations should be presented to the California State Legislature, the panel concluded, without careful and mature consideration by the Bar. The members of the panel agree with the proponent that the professional corporation legislative problems "cry out for refinement and closer study, require precise consideration and hard work by legislative draftsmen and lobbyists for the affected professions in the several states, and demand full and open critical discussion wherever the second-class professional taxpayers congregate." In California, the report of the Special Committee on Professional Corporations to the Board

of Governors of the State Bar, which is expected to be published shortly in the State Bar Journal, should provide a starting point for this study. Critical evaluation of the proposal by lawyers is an essential prerequisite to the preparation of a draft of a professional corporation law for this state. If a proper law can be drafted, it is thought that the legislators in the California Senate and Assembly will give it prompt and favorable consideration, upon being satisfied that it is in the best interests of the public and the affected professions. Since proper business organization of professional groups and offices will tend to increase efficiency, it is to be anticipated that one of the ultimate consequences of the professional corporation would be an increase in net revenue to the professions and a reduction of costs of professional services to the public, if the patterns of other types of business enterprises are any precedent. The reduction in employee turnover and the increase of incentives to responsible and capable individuals to enter the professions are added anticipated by-products of the professional corporation. The panel, of course, disclaimed any insight into the possible political fortunes of a professional corporation law in our state legislature. Assuming, however, that an adequate and carefully considered statute could be prepared and proposed and that it receives the support of the interested professions, the view was expressed that California would not be reluctant to be a pioneer in this new field of corporate law.

The impact of state professional corporation laws on Congress might, it was suggested, have the additional effect of causing Congress to grant to professional proprietors and partners the tax relief which they have sought unsuccessfully for so many years. It was recalled that Pennsylvania and other common law states adopted, during the early 1940's, community property laws which were designed to give the citizens of those states the same income, gift and estate tax advantages which had been enjoyed by residents of community property states for so many years. Most tax commentators credit, in considerable part, these state community property laws with the adoption by Congress in 1948 of the marital deduction privilege in the estate and gift tax laws and the income splitting reform in the income tax law which has substantially equalized the tax treatment in these two important areas between residents in the common law states and the community property states. After Congress acted in 1948, all of the newly adopted community property laws were discarded and repealed. The tax results sought, however, have continued to be enjoyed by taxpayers on a fair and equal basis throughout the United States since 1948.

### *The Professional Corporation in Practice*

The panel then discussed the results of a report by Milliman & Robertson, Inc., consulting actuaries, on a hypothetical professional corporation.

The report closely analyzed the costs of fringe benefits and their after-tax effect upon the hypothetical incorporated law firm over a thirty-six year period and compared these results with operation in the partnership form over the same period of time. It appeared that in the early years of the existence of the professional corporation there might be some slight disadvantage, tax-wise, to senior partners which would have to be adjusted through deferred compensation plans. However, the benefits to both professional and non-professional employees were very substantial and far beyond the financial capacity of a professional sole proprietor or partner to provide for himself or for his employees under present law. As a practical matter, it was agreed that the professional corporation would probably never accumulate any substantial surplus and that consequently little or no problem in the admission of a stockholder-partner to ownership or membership in the professional corporation would be encountered from an economic standpoint. It was also concluded that provisions requiring the redemption of stock, in the event of the death of a stockholder in a professional corporation, would tend to solve any of the problems which might arise under those circumstances. The life insurance acquired on a tax deductible basis, the profit sharing and pension plan benefits available to the practitioner or his heirs, and the medical coverage on a tax deductible basis appeared also to be far beyond the reach of any professional partnership or proprietor at the present time, absent the privilege of doing business as a corporation. It was pointed out, for example, that a young lawyer starting with the hypothetical law firm at age 29 at a salary of \$7,500 a year could expect, on retirement at age 65, to receive nearly \$450,000 from his profit sharing plan, or an annuity of \$3,200 a month for the rest of his life. By the same token, a secretary starting with a law firm at age 30 and retiring at 65 would receive nearly \$165,000 cash for her profit sharing account or a pension of \$955 a month for the rest of her life. Naturally, the panel pointed out in its discussion of the report that it was based upon certain assumptions of income and expense and turnover of employees, as well as income from and growth in value of investments, which share the defects of all hypothetical statements looking to the future. However, it was agreed that the results expressed by the report were based upon conservative predictions and the benefits above-described could and probably would be substantially greater. Moreover, in a report by Aetna Life Insurance Company, it appeared that several professional corporations could probably obtain very substantial amounts of group life insurance, at extremely low cost, by associating together for the purpose of forming a group of more than twenty-five persons, and could acquire entirely satisfactory medical coverage, also on a tax deductible basis, at very low cost. Furthermore, it was pointed out that individuals who might be uninsurable

under private contracts could probably be covered by group policies of health, accident and life insurance in substantial amounts.

### *Conclusion*

The panel discussion closed with an invitation to all members of the California Bar to give serious consideration to the proposal and make their suggestions respecting the proposal to the Special Committee on Professional Corporations of the California State Bar in aid of the preparation of its report to the Board of Governors. When the report is published, the members of the Bar were further urged to give it careful consideration and to afford the proposal the benefit of their "imagination, ingenuity and open minds."