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# Lawyers and The Professional Association Act

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The Professional Association Act passed by the recent General Assembly of Virginia becomes effective as Chapter 277 of the Acts of 1962 on June 29, 1962. It permits three or more individuals authorized to practice in Virginia any one of the following named professions to form an association, which will be a legal entity separate from the associates comprising it: "architecture, professional engineering, land surveying, certified public accounting, dentistry, optometry, practice of the healing arts, and veterinary medicine, surgery and law". Heretofore members of these professions could not form a legal entity through incorporation or otherwise under which to practice. They practiced in a comparatively satisfactory manner either individually or as members of partnerships. The immediate questions raised by the passage of the Act are why is the creation of the legal entity now permitted, to what extent will the Act accomplish its purpose, and is it advisable for lawyers to employ this new device.

## A. *Background of the Act.*

Under the federal law, a corporation is taxed as a separate legal entity, so that its profits are subject to the income tax. If any portion of such profits is distributed to its shareholders as a dividend, the amount of such dividend must be included by each shareholder in his income tax return. This "double tax" is slightly alleviated now by a $50 dividend exclusion and a four per cent dividend credit subject to certain restrictions. Also, the addition in 1958 of Subchapter S to the Internal Revenue Code permits certain corporations to elect to have their profits taxed to their shareholders as if such corporations were partnerships with the shareholders as partners. On the other hand, partnerships are not legal entities separate from their partners. The share of partnership profits distributable to any partner (including what the partnership may term a salary) is includible in such partner's individual income tax return, but no income tax is assessed against the partnership on account of such profits. Likewise, the profits of a sole proprietorship or a trust are taxed only once. However, the elimination of personal liability of a shareholder for the obligations of a corporation makes the corporate entity attractive notwithstanding the "double tax" imposed upon its profits.

In recent years, Congress has provided for special tax benefits available only to "employees". These include income tax deferred pension and profit sharing plans with capital gains status as to certain distributions and exemption from estate tax in certain situations. Further benefits include $100 a week sick pay exclusion, $5,000 death benefit exclusion, and the exemption from income taxation of premiums paid by the employer on certain kinds of insurance for the benefit of employees. Any shareholder of a corporation (even though he owns all of the shares) is deemed an "employee", if he works for it as an officer or even without official status. But a partner of a firm and a sole proprietor are not considered "employees" and hence are denied such tax benefits.

To remedy this situation, the so-called "Keogh" bills introduced in Congress would allow self-employed individuals to set up their own pension or profit sharing plans without incorporating or forming associations and would give to them some, but not all, of the tax benefits accorded to "employees". These bills have been introduced in several sessions of Congress, but they have in each instance failed of passage. One is now pending, but its outcome is unpredictable.

Another possible device to obtain such tax benefits is the use of an "association". Long before the above mentioned tax benefits were allowed, group combinations were devised in attempts to escape the corporate income tax. Naturally the Internal Revenue Service contended that these combinations, usually termed "associations", had in fact the essentials of corporations and should therefore be assessed with corporate income taxes. It maintained that these associations were taxable as corporations if they had the characteristics of continuity of life, centralization of management, liability for the association's obligations limited to its property, and free transferability of the interests of the associates. This contention usually prevailed.

B. *Kintner Case and Kintner Regulations.*

The use of the "association" to gain the tax benefits abovementioned reached the courts in the case of *United States* v. *Kintner,* 216 F. 2d 418 (9 Cir. 1954). Some physicians in Montana sought to work out a qualified pension plan for themselves which would be exempt from federal income taxes to the extent permitted under Section 501(a) of the Internal Revenue Code by organizing an association as a clinic for the practice of their profession. Under the agreement, no member would be liable for the professional misconduct of another not associated with him in the particular case, an executive committee would manage the operation of the clinic, the association would continue notwithstanding the death of a member or his separation from the clinic, but the interests of the respective members were not assignable. The physicians contended that the association was taxable as a corporation and that therefore its associates were entitled to the tax benefits of corporate "employees". The Circuit Court of Appeals held that the clinic had a preponderance of corporate attributes and that its pension plan with its associates included among the employees constituted a qualified plan entitled to the tax exemptions under Section 501(a).

This decision led to new Treasury Regulations defining an association and adopted on November 15, 1960. They are popularly known as the "Kintner Regulations" and are found in Treasury Regulations Section 301.7701-2. They state that an organization will be treated as an association for the purposes of taxation as a corporation if its characteristics are such that it more nearly resembles a corporation than a partnership or a trust. The major characteristics to be considered in determining whether the organization is to be deemed an association are there stated to be (1) continuity of life, (2) centralization of management, (3) limited liability, and (4) free transferability of interests. Each of these characteristics is discussed in detail.

These Regulations recognize that whether a group can by agreement create an association with corporate characteristics depends entirely upon state law. If the state law does not permit professional persons to practice through a separate legal entity with themselves considered among the "employees", the Kintner Regulations do not aid such persons. They cannot by their own agreement set up an association with the requirements of these regulations and reap the tax benefits of "employees", unless the state law sanctions such an organization.

### C. *The Virginia Act.*

The members of the various professions have turned to the legislatures of the several states to authorize such associations. The Professional Association Act is the result in Virginia. The Act authorizes three or more persons in a covered profession to create a professional association which as a legal entity may practice the profession of its associates. All of its associates must be authorized to practice the same profession in Virginia. The professional services of this association must be rendered through officers, employees, and agents who are themselves duly authorized to render such professional services in Virginia. The association has continuity of life, as death, insanity, incompetency, resignation, withdrawal, transfer of membership or of interest, retirement, or expulsion of any one of its associates or the happening of any other event which would dissolve a partnership does not cause its dissolution. The Act provides for centralization of management through a board of directors consisting of three associates, except that, if the number of associates be less than four, the number of directors shall be two. An associate is not by reason of being an associate rendered personally liable for any obligations or liabilities of the association. Each associate shall be entitled to a certificate of ownership evidencing his proportionate part of the assets of the association; and, except as restricted in the articles of association or the by-laws, such certificate is freely transferrable by such associate to any person duly authorized in Virginia to render the kind of professional service which the association is organized to render.

It therefore appears that an association organized under the Act will, if its Articles of Association and by-laws are carefully drawn, constitute an assocation complying with the Kintner Regulations and that such association, if it actually operates in accordance with these articles and by-laws, can formulate a pension plan for the benefit of its "employees" (including its associates) that will qualify under Section 401(a) of the Internal Revenue Code, so that the contributions of the association to such plan will be entitled to the tax exemption provided in Section 501(a) of that Code. However, if the relationship of "employer-employee" does not *in fact* exist between the association and its associates, the Internal Revenue Service will in all probability seek to deny the tax benefits of "employees" to the associates.

If a qualified pension plan is established by an association of lawyers under the Act for the benefit of its "employees" (including the lawyers who are the associates), the amount contributed to the plan by the association for each employee would, subject to certain restrictions, be deductible by the association as a business expense, but this amount would not be currently taxable to such employee as income. As each associate would receive as a salary from the association the balance of the net profits distributable to him, the association would have no net income left to be subject to the federal income tax. Normally it would appear that the entire amount of such salary would constitute a deductible association expense. However, it is possible in particular instances the Internal Revenue Service may contend that the salary was unreasonable compensation to the associate and that only that portion deemed reasonable would be deductible as an expense of the association.

It is to be noted the Act provides that an association shall be taxable as a corporation for Virginia income tax purposes and shall be subject to the provisions of Chapter 4 of Title 58 of the Code of Virginia entitled "Income Taxes" to the extent these provisions are applicable and that property of the association shall be taxable in the actual form in which it may be and not as capital. No state or local revenue license is required of any association.

D. *Does an association violate any Canon of Ethics?*

Of transcendent importance is the question of whether lawyers who practice law as associates of a professional association violate any of the Canons of Ethics. Opinion 303 of the Committee on Professional Ethics of the American Bar Association rendered November 27, 1961, and found in 48 A.B.A.J. 159 (1962) deals with this question. It first states the mere fact that the form of organization used by lawyers to practice law is a professional association does not in and of itself constitute a violation of any Canon. The Opinion then considers in detail the Kintner Regulations' requirements of limited liability, centralized management, continuity of life, and transferability of interests. Its conclusion is:

> "The question initially presented in this Opinion—Can lawyers carry on the practice of law as a professional association or professional corporation, which has the characteristics of limited liability, centralized management, continuity of life, and transferability of interests, without being in violation of one or more of the Canons of Ethics is answered in the affirmative provided appropriate safeguards are observed. It is the substance of the arrangement and not the form which will be controlling in determining whether the ethical restraints imposed on the legal profession have been violated."

However, the precise language of the Opinion must be studied with the utmost care by those considering the use of the professional association, so that a violation of any Canon may be avoided by the incorporation of the suggested safeguards. Thus, as to limited liability, the Opinion considers that no Canon is violated if (1) the lawyer or lawyers rendering the legal services to the client be personally responsible to the client and (2) restrictions on liability as to other lawyers in the organization be made apparent to the client. Just how the second condition is to be satisfied is not revealed in the Opinion.

E. *Some practical difficulties to be considered.*

Practical difficulties of a formidable nature may well deter the formation by lawyers of professional associations. Centralized management by a board of directors limited to three (or two, if the associates be less than four) associates may be unwelcome. Lawyers are usually independent creatures! However, the board cannot include all of the associates. Withdrawal of an associate upon a disagreement with the others may well be financially unfortunate for him. There may be no ready purchaser of his interest in the association. Even if the association itself is obligated to purchase his interest, the ready cash to do so may not be available. Such withdrawal may mean to him a sacrifice of the very pension-plan benefits that caused him to become an associate initially. If any associate has the right to dissolve the association in event of serious disagreement, the essential of continuity of life in the Kintner Regulations would be impaired. The requirement of free transferability of interests raises an acute problem. The entrance of a new associate may be quite distasteful to the remaining associates from personal or professional reasons. Only time will tell how much restriction on transferability may be imposed within the framework of the Kintner Regulations. It will take careful planning indeed to work out an association that will be deemed to comply with these Regulations and yet preserve as far as possible the operational characteristics of the present law partnership. The large law firm managed in fact by senior members who produce the bulk of the practice may stand a transition into a professional association far better than a small partnership with all of the partners operating on an equal basis and taking part in major policy decisions. The foregoing indicates quite sketchily that the decision to form an association under The Professional Association Act may be very difficult and its formation attendant with grave consequences to the associates.

### F. *Conclusion.*

While it appears that The Professional Association Act may by used by lawyers to federal tax advantage, before entering into this new mode of practicing law any group should consider with the utmost care the problems indicated above as well as others that may be brought to light through experience in the course of time. The disadvantages may outweigh the federal tax benefits, which are indeed the sole reason for the Act.