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Taxation of Unincorporated Medical Groups

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TAXATION OF UNINCORPORATED MEDICAL GROUPS

The recent decision of the United States District Court of the Northern District of Texas in *Galt v. United States*,[1] holding that a group of doctors practicing as the Southwest Clinic Association, though unable to incorporate under the laws of Texas, was to be treated as an "association" under § 7701(a)(3) of the IRC of 1954, adds another case to the growing weight of authority granting the benefits of corporate status to groups of doctors associated together in practice. While the language of the case is of no great significance, the result reached by the court may be of important consequence to similar groups of doctors. A survey of the background of the *Galt* case and its impact on the attitude of the Internal Revenue Service may be of interest.

History

Section 7701(a)(3) provides that the term "corporation" includes "associations, joint stock companies, and insurance companies."[2] The problem of determining just what an association is as contrasted to a partnership has been the subject of many decisions under several Revenue Acts. In 1935 the Circuit Court of Appeals for the First Circuit declared that ". . . the decisions are seemingly in a hopeless state of confusion."[3] In the same year the Supreme Court in *Morrissey v. Commissioner*[4] undertook to clarify the situation by establishing definite rules characterizing an association. In *Morrissey* the Court considered as pertinent to the classification the following tests:

1. title to the property held by the entity,
2. centralized management,
3. continuity uninterrupted by death among the beneficial owners,
4. transfer of interests without affecting the continuity of the enterprise, and
5. limitation of personal liability of the participants.

It was indicated in *Morrissey* as well as in several cases following it that absence of one or more of the characteristics does not preclude the organization from being an association.[5] Thus, in *Bert*

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[1] 175 F. Supp. 360 (N.D. Tex. 1959).

[2] 1954 IRC § 7701(a)(3).

[3] Coleman-Gilbert Associates v. Commissioner, 76 F.2d 191, 193 (1st Cir. 1935); rev'd on other grounds 296 U.S. 369 (1935).

[4] 296 U.S. 344 (1935).

[5] Ibid. at 357: "The inclusion of associations with corporations in the Internal Revenue Code implies resemblance, but it is resemblance and not identity." Cf.: Helvering v. Combs, 296 U.S. 365 (1935); Poplar Bluff Printing Co. v. Commissioner, 149 F.2d 1016 (8th Cir. 1945); Helm & Smith Syndicate v. Commissioner, 136 F.2d 440

v. Helvering[6] it was stated ". . . the real test is whether the enterprise more nearly resembles in general form and mode of procedure a corporation than a partnership." The court also pointed out that similarities and dissimilarities must be compared and contrasted and resemblances balanced to determine whether the entity is predominantly akin to a corporation or a partnership in method and form of conducting business.[7]

The authorities and regulations have made it clear that for the purpose of federal taxation Congress is not bound by the legal classification of business organizations as determined by state laws.[8] The status of a particular entity as a partnership or as a corporation under state law is not, therefore, controlling in determining whether it is subject to federal taxation. An unincorporated association, though a partnership by state law, may nevertheless be included within the term "corporation" as defined in the Revenue Act.[9] "Substance rather than form controls . . . , and the realities of the taxpayer's economic interest rather than the niceties of the conveyancer's art should determine the power to tax."[10]

This is not to say, however, that state law never enters this area. It is important to keep in mind that the presence or absence of any of the requisite characteristics set out in *Morrissey* could depend on rights or liabilities created under local law. The fact that the agreement or charter might contain language under which any of these *Morrissey* characteristics would appear to be present or absent would be immaterial if local law actually gives a contrary result. Thus, in *Glensder Textile Co. v. Commissioner*[11] the court examined the organization and legal powers and liabilities of the members of the limited partnership under the New York statute and concluded that it was not an association for federal tax purposes since although there was centralized management by the general partners, they were acting in

(9th Cir. 1943); Pa. Co. for Insurance on Lives & Granting Annuities v. United States, 138 F.2d 869 (3rd Cir. 1943).

6 92 F.2d 491, 495 (D.C. Cir. 1937). See, Commissioner v. Brouillard, 70 F.2d 154 (10th Cir. 1934).

7 Ibid. See also, Del Mar Addition v. Commissioner, 113 F.2d 410 (5th Cir. 1940).

8 1954 IRC Regs. 118, § 39.3797-1 (1953); Burk-Waggoner Oil Association v. Hopkins, 269 U.S. 110 (1925); Poplar Bluff Printing Co. v. Commissioner, supra note 5; Sherman v. Commissioner, 146 F.2d 219 (6th Cir. 1944); Pa. Co. for Insurance on Lives & Granting Annuities v. United States, supra note 5; Commissioner v. Fortney Oil Co. County Farm Lease, 125 F.2d 995 (6th Cir. 1942); Commissioner v. Brouillard, supra note 6.

9 Burk-Waggoner Oil Association v. Hopkins, supra note 8; Haley v. Commissioner, 203 F.2d 815 (5th Cir. 1953).

10 Haley v. Commissioner, supra note 9 at 818.

11 46 B.T.A. 176 (1942); Western Construction Co. v. Commissioner, 14 T.C. 453 (1950), aff'd per curiam, 191 F.2d 401 (9th Cir. 1951).

their own interest and not merely in a representative capacity; the limited partners were not able to remove the general partners and control them as agents; the limited partners could be increased in number, but new limited partners acquired no share in control; continuity of existence was contingent on agreement of the remaining general partners; on the death of a general partner his interest had to be paid over to his personal representative, and to that extent the capital would be liquidated; and finally, the assets were held in tenancy in partnership and not by the partnership as an entity. Here, plainly, the organization as it actually existed under the laws of New York resembled a partnership more closely than a corporation.

Thus, it is the local law which must be applied in determining such matters as the legal relations of the members of the organization among themselves and with the public at large and the interests of the members of the organization in its assets. The end result of this application is then held up to the federal regulations and criteria established thereunder to see if the organization is similar to a corporation.

Temporary Fluctuation

In *Pelton v. Commissioner*[12] in answer to the Commissioner's contention that a group of doctors was an association and taxable as a corporation, the petitioner argued that under the laws of Illinois a corporation could not practice medicine. It was held nevertheless that as long as the organization was in substantial conformity with the established criteria of *Morrissey,* its formal status under state law was of no significance. Yet, in 1954, in the well-known case of *United States v. Kintner*[13] the Commissioner reversed his position taken in *Pelton* and contended that since Montana did not allow a corporation to practice medicine, the medical group was to be taxed as a partnership, seemingly proposing a new and additional test for the taxability of groups as associations, namely, that state law controls as to the purpose for which an association may be formed. The Commissioner's change of position on this point was commented on by the court while deciding "that (1) the association had more of the criteria of a corporation and (2) that this being so, the status of the association under state law should be disregarded under the Bureau's own regulations."[14]

Following the decision in *Kintner* the Commissioner ruled that he would continue to treat such groups of doctors as partnerships for all purposes of the Internal Revenue Code.[15] Later, he promised to issue

[12] 82 F.2d 473 (7th Cir. 1936).
[13] 216 F.2d 418 (9th Cir. 1954).
[14] Ibid at 422.
[15] Int. Rev. Rul. 56-23, 1956-1 C.B. 598.

a ruling listing basic criteria to be used in testing whether a particular organization of doctors or other professional groups should be treated as an association or a partnership.[16]

PRESENT STATUS

In the 1959 decision in *Galt v. United States,* previously mentioned in the introduction, the District Court of Texas held that since there was ownership by the association of property used in the operation of the clinic, centralization of management through an executive committee and the board of directors chosen by members of the association, continuity of organization without interruption of the business by reason of the death or retirement of a member, transferability of membership, and limitation of liability, the Southwest Clinic Association was entitled to be treated for federal income tax purposes as though it were a corporation. The *Galt* case involved a suit by a taxpayer and his wife to recover federal income taxes paid under protest. Plaintiff was a member of a partnership of doctors which in 1954 formed an association to which the partners transferred all partnership assets. The doctors who had been partners retained no interest in these assets. The association was set up with a life of thirty-five years. The laws of Texas do not include the practice of medicine as one of the purposes for which a corporation can be formed, but the doctors drew up articles of association containing in substance all the characteristics of a corporation. Interests were held by seven doctors from whom was elected a six-man board of directors. The doctors as well as the employees of the predecessor partnership became employees of the Association. The doctors were controlled by the Association to the extent that each was limited to practice in his own department, hours of work were set by the board of directors and no doctor could refuse a patient assigned to him. No separate record was kept of individual billings of the doctors, and in lieu of fees from patients they received as the sole income from their services a salary and bonus from the Association. The articles of association provided that when a doctor retired he would not receive any of the assets of the Association, they being distributable only on termination of the Association. A schedule of priority of payments was established. While the bylaws provided that ownership of an interest in the Association could be transferred, the Association and the other associates had first option of purchase at the offering price. The associates were not liable for indebtedness either of the Association or of any other

[16] Int. Rev. Rul. 57-546, 1957-2 C.B. 886.

associates until the assets of the Association and of the defaulting associate had been used in full to reduce the indebtedness.

The taxpayer and his wife filed a joint income tax return. A tax return was filed for the Association. Both paid taxes. The Revenue Service determined that the Association should be treated as a partnership with the result that the taxes on the money set aside by the Association as a reserve fund should be allocated and paid by the respective members. The portion thus assessed against the taxpayer was paid under protest, and he brought suit to recover the same, taking the position that the tax liability was discharged by payment in the name of the Association.

In answer to the Commissioner's contention that the absence of the practice of medicine as one of the purposes for which a corporation could be formed in Texas prevented the Association from qualifying as an association taxable as a corporation, Davidson, C. J. emphasized that ". . . the act of a state can neither raise nor lower the federal taxes that may be due by the association by whatever name it may be called under the laws of the particular state."[17]

This decision seems to have hastened the issuance of the long-awaited detailed ruling promised earlier by the Commissioner. Proposed regulations to Chapter 79 of the IRC of 1954 were published on December 23, 1959, and § 301.7701-2(g) outlines the position of the Internal Revenue Service on associations of doctors. Basically, there has been no change in the law itself since the proposed regulations adopt the holdings of *Morrissey* as to the criteria required and *Bert v. Helvering* as to the degree of similarity necessary. The regulations also reflect the decisions in the *Kintner* and *Galt* cases, and it now seems settled that the mere formalistic inability of a corporation to practice medicine under state law will not be a barrier to the classification of a group as an association.

Once classified as an association, that designation applies for all purposes of the IRC,[18] and the group is eligible to establish pension or profit-sharing plans.[19] If the plan qualifies as one set up for the exclusive benefit of employees or their beneficiaries, the income paid into it by the association will be tax-free and the income payable to the participants of the plan will be tax-deferred.[20] In *Kintner* it was held not only that the association could establish such a plan but also

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[17] Supra note 1 at 362.

[18] Burk-Waggoner Oil Association v. Hopkins, and Sherman v. Commissioner, supra note 8.

[19] 1954 IRC § 401-404.

[20] Tavannes Watch Co., Inc. v. Commissioner, 176 F.2d 211 (2nd Cir. 1949).

that the doctor-associates as employees of the association were eligible to participate. Section 404.1004(c)(2) of Regulations, in defining "employee," states that 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, and in this connection it is not necessary that the employer actually direct or control the manner in which the services are performed as long as he has the right to do so.[21] The right to discharge is an important factor indicating that the person possessing that right is an employer.[22] As pointed out by the lower court in *Kintner,* by the very nature of the medical profession, there can be no over-the-shoulder supervision of the doctor's methods and techniques, but where the association set his office hours and vacation periods and the doctor received none of his fees as such and could be discharged from membership in the association without interrupting the continuity of life of the association, the doctor was an employee of the association.

Thus, the recent action of the Commissioner indicates a willingness to allow the members of medical associations equal status with corporate officers who have long been held to be employees of a corporation.[23]

OUTLOOK

At the present time, local law as it affects the substance of the organization is an insurmountable obstacle in some states, and for this reason, a thorough check of the state law must be made as the first step toward establishing a similar clinic or association.

It is not inconceivable that a situation could develop in this area similar to that which brought about Congressional action in the income-splitting provisions which were designed to afford to spouses in non-community property states the tax advantages of an equal division of income between them, such formerly being available as an automatic privilege only under the community property system.[24]

Similarly, since it would appear that the states' interest in these associations is centered mainly on the personal versus the corporate liability factor, it may well be that agitation on the part of medical groups who desire to gain some of the valuable tax advantages accru-

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21 20 C.F.R. § 404.1004(c)(2).

22 Jones v. Goodson, 121 F.2d 176 (10th Cir. 1941); Hemmerle v. Hobby, 114 F. Supp. 16 (D. N.J. 1953); Kintner v. United States, 107 F. Supp. 976 (D. Mont. 1952).

23 20 C.F.R. § 404.1004(b).

24 1954 IRC § 6013; Marshall v. Hofferbert, 108 F. Supp. 350 (D. Md. 1952), aff'd 200 F.2d 648 (4th Cir. 1952). In connection with possible Congressional action in this area, see H.R. 64, 86th Cong., 1st Sess. (1959) on Smathers, Morton, Keogh, Simpson Bill, which would allow self-employed individuals to set up individual retirement programs.

ing to classification as an association, such as tax-exempt pension plans and profit-sharing plans, will result in state action to insure that all the other standards can be met under local law.[25]

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[25] Just as many states legislated to permit donees of powers of appointment to freely release the powers and avoid the impact of the federal estate tax.