US-Owned Professional Corps Revisited

An earlier article addressed a controversy commonly associated with a US citizen in Canada who owns a professional corporation ("US-Owned Professional Corps," Canadian Tax Highlights, April 2013). Physicians, engineers, lawyers, and accountants, for example, often practice through professional corporations and benefit from corporate tax rates—generally lower than individual tax rates—if the corporation defers payment of its after-tax earnings to its shareholders. That deferral may not necessarily result in subpart F income for the individual professional under US controlled foreign corporation (CFC) rules.

A CFC is a force of which more than 50 percent of (1) the total voting power of all classes or (2) the total value of all its stock is owned (or considered to be owned) by US shareholders for at least one day during its tax year (Code section 957). A US person includes a direct, indirect, or constructive owner of at least 10 percent of a CFC's total voting power. A force's US shareholder is generally taxable on distributed earnings only, but a CFC's US shareholder is also taxable on certain income—such as personal service contract income (PSCI)—earned by the CFC but not distributed.

PSCI is defined to include income received by a corporation under a contract to provide personal services if (1) the person who is to perform the services is designated under the contract or can be designated by someone other than the corporation, or (2) that person is or may be designated under the contract directly, indirectly, or constructively and owns at least 25 percent in value of the corporate stock outstanding at any time during the tax year in which the corporation receives the income (Code section 954(c)(1)(H)). The PSCI rules were intended to prevent a taxpayer such as a performer or an artist from income splitting with a CFC.

The earlier article cited two favourable revenue rulings (Rev. rul. 75-67, 1975-1 CB 169 and Rev. rul. 75-250, 1975-1 CB 172). The former ruling concluded that a finding of PSCI requires contractual language that designates a specific service provider or unique services that cannot be substituted. The latter ruling concluded that a certified public accountant (CPA) and his corporation did not earn PSCI because the client contracts did not require that the CPA perform the services himself.

On the other hand, two Tax Court memoranda opinions that were cited concluded that designations of the service provider were implicit based on past performance under oral agreements despite subsequent written contracts to the contrary. In RAS of Sand River, Inc. (TCM 1990-322), the written contracts did not name or describe the service provider, provide for a right of designation, or preclude substitution. The sole shareholder performed all services, which were not unique or irreplaceable. An oral agreement for the work was reduced to a written contract presumably to address problems and delays. The written contract did not designate a service provider, but the Tax Court found that the oral agreement created a binding designation because the client only accepted the sole shareholder’s work.

Gerald D. Roberts Consultants, Inc. (TCM 1991-490) involved backdated written contracts that did not designate the service provider or involve unique or irreplaceable services, but did provide that the client "entered into this agreement based on a given consultant’s resume, experience and potential and that individual shall put forth 100% effort in return for the subject compensation at all times.” The Tax Court was "convinced" that the clients knew that they were contracting for personal services on the basis of reputation and qualifications, and because the taxpayer never attempted to supply any service provider other than its sole shareholder and never considered anyone else to provide the services. In one contract, the right to reject any substitutes was exercised because the client accepted only the sole shareholder’s services. The court concluded that the oral contracts designated the sole shareholder to perform the services.

Two earlier IRS general counsel memoranda may suggest a more favourable result for a taxpayer. In General Counsel Memorandum 35155 (December 8, 1972), the IRS found that PSCI existed only if a patient had the right to designate a particular physician in an oral or written contract or if the contract specified the physician by name or description. Legislative history and case law clearly established that the nature of the services involved did not dictate the outcome, even if the services were unique. The IRS also concluded that a person other than the service provider must have a contractual right to designate who can perform the services. In addition, a designation cannot be implied without a contract, not even if there was a longstanding relationship that included specific designations in prior contracts. In order to find PSCI, the IRS required that a patient request and receive services of a particular physician or request and receive services that only a particular physician could perform. However, contracting for medical services in general, rather than medical services from a particular physician, did not create PSCI.

GCM 35457 (August 27, 1973) clarified GCM 35155 by further requiring that for PSCI to exist, an express contract between a patient and physician must prevent the physician from withdrawing his or her services or substituting those of another physician. In the absence of an express contract, a designation did not arise merely because a patient solicited, expected, and received services from a particular physician.

In a private letter ruling (PLR 8130049, April 28, 1981), the IRS concluded that no PSCI existed: legal services performed by the sole shareholder/corporate of a professional corporation that was a partner in a law firm were not
rendered by the sole shareholder-employee of a professional corporation and that a partner in a law firm were not unique and thus did not preclude the substitution of another lawyer, and the client contracts did not expressly or implicitly prohibit substitution or designate a particular lawyer to personally perform the services.

Thus, PSCI may not be present if a professional can or must substitute for another. In a medical context, for example, a patient does not ordinarily contract with any one physician to provide services, particularly in a clinical setting; the patient may visit a hospital or clinic and be seen by someone other than the attending physician. Of course, a patient may expressly contract with a specific physician, such as a plastic surgeon or an eye surgeon.

No US precedent appears to conclude that a health insurer who pays for the services can change the nature of the patient-physician relationship to render the physician a specifically designated service provider. Arguably, therefore, it is unlikely that a provincial health insurance plan can by itself modify the physician-patient relationship and render the physician a specifically designated service provider, but the patient-physician relationship covered under a plan must be examined to determine whether the service provider is specifically designated. Tax advisers should review contracts and identify language that addresses the parties’ delegation and substitution rights.

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