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ORIGINS OF TAX LAW: THE HISTORY OF THE PERSONAL SERVICE CORPORATION

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I. INTRODUCTION

The study of federal tax law involves an understanding of the many factors which interact to make our law. While the primary purpose of the tax law is to collect the money necessary to run the government, an increasingly important collateral motivation underlying the enactment of tax laws involves the desire to use the law as a vehicle for effectuating certain social goals.¹

In the environment of these motivating elements, taxpayers must respond to the rules established by Congress that are interpreted in a process involving both the administrative sector of the government and the courts. As a consequence of the competing considerations underlying this process of creating, interpreting and enforcing the tax laws, inconsistent policies sometimes become evident. Reconciliation of these inconsistent policies is often made by administrative or judicial compromises.²

One area of tax law that illustrates a process involving inconsistent rules concerns the personal service corporation (PSC). This article will review the history of the PSC and analyze its tax treatment in an attempt to provide a student of tax law with a perspective into the workings of the federal tax system. The topic represents a unique confluence of fundamental substantive issues in the context of frequent legislative, administrative, and judicial activity. The latest example of this activity is the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA),³ a statute which will have a significant impact in amending many of the sections of the Internal Revenue Code of 1954 (Code) that govern the tax treatment of PSC's.

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¹ One example of the use of the tax laws to achieve certain social goals is the enactment of the rehabilitation tax credit with the Economic Recovery Tax Act of 1981 (ERTA). Pub. L. No. 97-34, § 212(b), 95 Stat. 172 (1981) (codified at I.R.C. § 48(g)).

² See *infra* text at Part II (The History of the Personal Service Corporation).

³ Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (1982) (TEFRA).

A PSC is an entity organized under the applicable state corporation law statute, the primary activity of which is to sell the services of individuals.⁴ The extreme example of a PSC is one which has one person as both the corporation's sole shareholder and its only employee.⁵ It is this type of PSC upon which this article will focus.

Three areas of tax benefits are available to a service-provider who incorporates instead of operating as a sole proprietorship. The first benefit is the ability to shift the taxation of income from the individual tax rates to lower corporate tax rates.⁶ This advantage, however, only benefits an individual who causes the PSC to retain and accumulate some of its earnings, instead of distributing all of its income as deductible expenses.⁷

The second benefit available to an individual who performs services as an employee of a PSC involves tax law provisions that establish certain fringe benefits available to "employees" but not to self-employed individuals.⁸ Thus, in the context of a PSC, the shareholder-employee can provide for personal expenses to be paid and deducted by his employer and have the benefit excluded from his taxable income by virtue of his status as an "employee."⁹

The third benefit of a PSC concerns timing differences in the recognition of income. A fundamental concept in tax planning is that a

⁴ Most personal service corporations are chartered under the particular state's stock corporation act or under the state's professional corporation act. For examples of state professional corporation statutes, see VA. §§ 13.1-543 to -556 (Supp. 1982); N.Y. BUS. CORP. LAW §§ 1501-1516 (McKinney Supp. 1982-83); CAL. CORP. CODE §§ 13401-13410 (West Supp. 1982).

⁵ The Internal Revenue Service has directed its attacks on the tax status of personal service corporations primarily toward corporations owned by one person. A common assertion of the Service is that income the corporation purportedly earns actually is earned by its sole shareholder. In the context of corporations with two or more shareholders, the attempted allocations of corporate income to multiple shareholders is made less frequently because an arm's length pooling of income has occurred. See Bittker, *Professional Associations and Federal Income Taxation: Some Questions and Comments*, 17 TAX L. REV. 1 (1961).

⁶ The average tax rate for a corporation's first \$100,000 of income during 1982 is 26 1/4% for taxable years beginning in 1982. A single individual's average tax rate for the first \$100,000 of taxable income is approximately 41% for calendar year 1982. Under the Economic Recovery Tax Act of 1981, both individual and corporate tax rates decreased for taxable years beginning in 1983.

⁷ Even if a shareholder-employee causes a personal service corporation (PSC) to distribute all of its income in deductible expenses, providing services through a corporation nevertheless can be advantageous because the corporation can deduct certain expenses that a self-employed individual cannot deduct. See *infra* note 8.

⁸ Benefits available to an employee but not to a self-employed individual include group term life insurance, a medical reimbursement plan, and a \$5,000 death benefit. See I.R.C. § 79 (life insurance); *id.* § 105 (medical); *id.* § 101 (death benefit). See also Zalutsky, *Comparison of a Professional Corporation With an Unincorporated Practice After ERISA*, 34 INST. FED. TAX'N 1355, 1356 (1976); Popkin, *The Taxation of Employee Fringe Benefits*, 22 B.C.L. REV. 439 (1981).

⁹ See Zalutsky, *supra* note 8, at 1356.

taxpayer's wealth can be increased to the extent the payment of income tax otherwise immediately payable is postponed.¹⁰ In a PSC, corporate income taxes may be deferred by the judicious selection of its fiscal year.¹¹ Individual income taxes of the shareholder-employee may be deferred with compensation arrangements whereby income earned on behalf of the PSC is held in the corporation for a period of time before it is distributed to the shareholder-employee.¹²

Until the enactment of TEFRA, one of the most attractive aspects of a PSC was that a shareholder-employee could defer more income tax under a corporate employee retirement plan than an individual could defer under a self-employed retirement plan.¹³ By 1984 TEFRA will eliminate this gap between deductions available under corporate employee plans and self-employed individual plans, and thereby will decrease the prior incentive to incorporate. An understanding of this historical differential is important, however, since it constituted the

¹⁰ See Blum, *An Introduction to the Mathematics of Tax Planning*, 57 TAXES 707, 708 (1979).

¹¹ See Report of Committee on Special Problems of Executives and Professionals, Probate and Trust Division, Section of Real Property, Probate and Trust Law (ABA), *Current Problems for Incorporated Professionals*, 17 REAL PROP. & TR. J. 357, 357 (1982).

¹² See Eaton, *Professional Corporations and Associations in Perspective*, 23 TAX L. REV. 1, 23 (1967). The most simplistic form of income deferral between a corporation and the corporation's shareholder-employee involves postponing the distribution of corporate income earned at the beginning of the taxable year until the end of the taxable year. Another method of deferring individual income tax on corporate distributions concerns accumulating the corporate income during more than one corporate taxable year. The accumulated earnings tax imposed under Internal Revenue Code (I.R.C.) § 531, however, limits the amount of corporate earnings that a corporation may hold.

¹³ Before Congress enacted the Self-Employed Individual's Tax Retirement Act of 1962 (often referred to as the Keogh Bill or H.R. 10), the tax laws prohibited self-employed individuals from deferring portions of their taxable income by contributing to a retirement plan. Pub. L. No. 87-792, 76 Stat. 809 (1962). The law's discriminatory treatment resulted from the common law rule that a sole proprietor acted in his individual capacity and, therefore, could not be an employee of himself. The enactment of the Keogh Bill, however, did not result in equal treatment of employees and the self-employed individual. The passage of the Employee Retirement Income Security Act of 1974 increased the discriminatory manner in which the Code's deferred compensation rules treated self-employed individuals. Pub. L. No. 93-406, 88 Stat. 829 (1974). See Lewis & Hevener, *Attribution of Income in Personal Service Corporations*, 1 VA. TAX REV. 327, 327 n.2 (1981). Although the Economic Recovery Tax Act of 1981 increased the contribution limits for Keogh plans, objectionable discrimination against self-employed individuals remained after ERTA. Lewis, *Taxation of Private Pension Plans under T.E.F.R.A.: Keogh Remembered*, 68 A.B.A. J. 1568, 1570 (1982) [hereinafter cited as *Keogh Remembered*].

Immediately before Congress enacted TEFRA, the tax law limited contributions to a qualified defined contribution plan to the lesser of 25% of compensation or \$45,475. I.R.C. § 415(c). Under a qualified defined benefit plan, the law limited annual benefits payable to the lesser of 100% of compensation or \$136,425 for life annually, if retirement began at age 55. I.R.C. § 415(b).

TEFRA limits annual contributions to defined contribution plans to \$30,000. Under defined benefit plans, TEFRA will limit a participant to \$90,000 yearly. TEFRA § 235(a).

primary motivation in many cases for incorporating a service provider's business activities.¹⁴

Before discussing the history of the PSC, it is appropriate to introduce certain sections of the Code, and one of the common law tax principles thereunder, that constrain a taxpayer's ability to take advantage of the foregoing benefits of a PSC. Fundamental to the assessment of tax, of course, is the existence of a taxpaying entity.¹⁵ Income producing activities may be performed by, among others, an individual, partnership, corporation, or trust.¹⁶ Yet, depending upon the characterization of these entities for federal income tax purposes under Code section 7701,¹⁷ the income tax attributable to these activities can vary significantly.

Once the operating entity has been defined under federal tax law, section 61 of the Code and the assignment of income doctrine govern the threshold question of whether that entity earns income on which tax may be assessed. The assignment of income doctrine often proves to be an obstacle to an individual who would like to shift the taxability of personal service income to a PSC.¹⁸ The assignment of income doctrine is a common law tax principle, the statutory nexus of which is section 61, which is founded on the premise that the "true earner" of the income is the entity to which the income will be taxed.¹⁹

The assignment of income doctrine, which has been described as "the first principle of income taxation," was set forth in the classic Supreme Court decision of *Lucas v. Earl*.²⁰ In *Lucas*, the individual taxpayer contracted with his wife to pay her one-half of his future earnings.²¹ The Supreme Court held that the taxpayer, the true earner, was taxable on the entire amount of his earnings, notwithstanding his wife's prior legal claim to the one-half interest.²² The Court thus

¹⁴ See Appel & Harris, *The Personal Service Company—A Tax Planning Tool*, 31 MAJOR TAX PLAN. 10-1, at 10-5 (1981) [hereinafter cited as Appel]; Battle, *The Use of Corporations by Persons Who Perform Services to Gain Tax Advantages*, 57 TAXES 797, 798 (1979).

¹⁵ Treasury Regulation § 301.7701 contains the rules for classification of organizations for tax purposes. Although state law defines the legal attributes of any particular organization, federal tax law establishes the classes into which organizations fall for purposes of federal taxation. Treas. Reg. § 301.7701-1(c), T.D. 6797, 1965-1 C.B. 553, 554. See generally B. BITTKER, 3 FED. TAX'N INCOME, EST. & GIFTS ¶ 90.1 (1981).

¹⁶ See generally Freeman, *Combining the Use of Corporations, Partnerships, and Trusts to Minimize the Income and Transfer Tax Impact on Family Businesses and Investments*, 57 TAXES 857 (1979).

¹⁷ See *supra* note 15.

¹⁸ See, e.g., *American Sav. Bank v. Commissioner*, 56 T.C. 828 (1971), *acq.* on other issues, 1972-2 C.B. 1.

¹⁹ *Lucas v. Earl*, 281 U.S. 111 (1930). See generally Brown, *The Growing "Common Law" of Taxation*, 34 S. CAL. L. REV. 235 (1961).

²⁰ *Id.*

²¹ *Id.* at 113-14.

²² *Id.* at 114-15.

established the common law attribution-of-income rule which would prove troublesome for taxpayers utilizing PSC's.²³

Section 482 embodies concepts analogous to the assignment of income doctrine. Section 482 provides that the Internal Revenue Service (IRS) may apportion income between commonly controlled trades or businesses if apportionment is necessary to prevent evasion of taxes or clearly to reflect the income of each of these entities.²⁴ Determining whether, under section 482, income is clearly reflected between two entities or individuals involves many of the same considerations as identifying the "true earner" of income under section 61 and the assignment of income doctrine.²⁵ Because of the similar concepts under section 482 and the assignment of income doctrine, both typically are asserted by the IRS when it attacks taxpayers' income shifting.²⁶

Other Code sections which the IRS has applied to taxpayers' attempts to avail themselves of the tax planning possibilities of PSC's are sections 269 and 531.²⁷ Section 269 provides that the Secretary of the Treasury may disallow any deduction or credit if a taxpayer acquired direct or indirect control of a corporation for the primary purpose of securing the benefit of such deduction or credit.²⁸ Since many PSC's have been formed to permit their shareholder-employees to obtain the benefit of deductions for contributions to retirement plans,²⁹ section 269 potentially could apply to a PSC depending on the specific circumstances involved.

Section 531 imposes a penalty tax on a corporation's accumulation of earnings and profits beyond those reasonably needed for the corporation's business.³⁰ The Code, however, establishes that the corporation

²³ *Id.*

²⁴ I.R.C. § 482. Section 482 provides that:

[I]n any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

Id.

An allocation by the Commissioner under § 482 will not be set aside unless clearly shown to be unreasonable, capricious, and arbitrary. *See Ballentine Motor Co., Inc. v. Commissioner*, 321 F.2d 796, 800 (4th Cir. 1963).

²⁵ *See, e.g., infra* text accompanying notes 95-128.

²⁶ *See, e.g., Achiro v. Commissioner*, 77 T.C. 881 (1981).

²⁷ *See, e.g., Ach v. Commissioner*, 42 T.C. 114 (1964), *aff'd*, 358 F.2d 342 (6th Cir.), *cert. denied*, 385 U.S. 899 (1966).

²⁸ I.R.C. § 269.

²⁹ *See Appel, supra* note 14, at 10-5.

³⁰ I.R.C. § 531. *See generally* Cunningham, *More Than You Ever Wanted To Know About The Accumulated Earnings Tax*, 6 J. CORP. TAX'N 187 (1979).

may safely accumulate \$250,000 of earnings and profits in corporations other than certain service corporations.³¹ For corporations whose principal function is the performance of services in certain professional fields, section 535 provides that the corporation may accumulate only \$150,000 before such corporations must rely on the firm's reasonable business needs to accumulate more earnings and profits.³²

II. THE HISTORY OF THE PERSONAL SERVICE CORPORATION

The history of the PSC can be instructive to students of tax law because it illustrates the process by which tax law is made. In the simplest view of the process, tax law is made when Congress enacts statutes to be codified in the Internal Revenue Code,³³ the Treasury Department then promulgates regulations, the IRS issues rulings, and courts interpret all of the foregoing.³⁴ All of these factors naturally are reflected in the history of the PSC. What makes the PSC a rewarding area of study, however, is that the issues surrounding a PSC contain a high concentration of the many statutory and common law concepts necessary for the practice of tax law.³⁵ Moreover, these fundamental concepts operate in the context of an ongoing struggle between the Service and taxpayers determined to ascertain the limits of legitimate tax avoidance.³⁶

The legal dilemma of whether to tax a PSC on income earned on the activities of its sole shareholder-employee has arisen largely because corporate retirement plans before TEFRA were more attractive than retirement plans available for self-employed individuals.³⁷ It is a com-

³¹ I.R.C. § 535(c)(2).

³² *Id.* The minimum accumulated earnings credit allowable for purposes of offsetting accumulated taxable income under I.R.C. § 535 is \$150,000 "in the case of a corporation, the principal function of which is the performance of services in the field of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting."

³³ Not all tax law, however, is codified in the Internal Revenue Code. Congress instead enjoys the alternative of enacting provisions that affect a narrow class of taxpayers and records this enactment only in the Statutes at Large. See Note, *Tax Equity and Ad Hoc Tax Legislation*, 84 HARV. L. REV. 640, 641 (1971). See generally Surrey, *The Congress and the Tax Lobbyist—How Special Tax Provisions Get Enacted*, 70 HARV. L. REV. 1145 (1957); Cary, *Pressure Groups in the Revenue Code: A Requiem in Honor of the Departing Uniformity of the Tax Laws*, 68 HARV. L. REV. 745 (1955).

³⁴ See generally M. SALTZMAN, *IRS PRACTICE AND PROCEDURE* (1981).

³⁵ One commentator has stated that the Treasury's handling of professional corporations since the 1930s is a classic instance of the cumulative reverberation of mistakes. See Eaton, *supra* note 12, at 1. The attractiveness of the history of the personal service corporation as a case study in federal tax law is attributable not only to the Treasury's less than artful handling of PSC's. The strategy of taxpayers when faced with administrative rule-making and courts' responses thereto is an integral part of this case study.

³⁶ Tax avoidance schemes may exact a heavy price under TEFRA's new compliance provisions, to the extent the IRS successfully attacks them. See Roth, *New Penalty Provisions and Their Effect On Aggressive Tax Planning*, 61 TAXES 52 (1983).

³⁷ See *supra* text accompanying notes 13 & 14.

mentary on our tax system that this unnecessary distinction created a tremendous incentive to incorporate which, in turn, generated a large amount of litigation when the IRS began to contest this practice.

The reasons for the employee/self-employed distinction are obscure. Indeed, it may be that there was no reason why such a distinction was made when corporate retirement plans were permitted in the Revenue Act of 1921.³⁸ The rationale of provisions in the Revenue Act of 1921 continuing tax-favored treatment to corporate pension plans was "the desire to improve the welfare of *employees* by encouraging the establishment of trusts for their benefit."³⁹ Yet, Congress apparently gave little thought originally to extending the benefits to the self-employed.

Representative Keogh, the primary advocate for enactment of the present day retirement plan provisions for the self-employed, believed the original omission of self-employed individuals was inadvertent.⁴⁰ The lack of parity after enactment of Keogh's self-employed retirement plan, however, was the result of a deliberate political maneuver by Representative Keogh. Keogh put forth a discriminatory proposal for self-employed retirement plans that avoided parity with the corporate plan deductions because he believed that the limited nature of the tax break would enhance its chances of passage.⁴¹ When Congress first enacted the employee retirement provisions in the early 1920s, few could have foreseen that by the 1970s the favorable treatment of employees would spawn enactment of professional corporation or association statutes in all the states and the District of Columbia.⁴²

In the face of the desirability of shifting business activities to entities taxed as corporations, the IRS challenged this practice on two levels. The Service attempted to treat common law associations of professionals, such as doctors, as partnerships instead of corporations for tax purposes.⁴³ In the years before state legislatures enacted professional corporation statutes, professionals formed "associations" in lieu of corporations because of the ethical and legal requirements that prohibited them from incorporating their practices.⁴⁴ With respect to individuals who legally could operate within the corporate cloak, the IRS

³⁸ See Keogh, *Pensions for the Self-Employed*, 100 TR. & EST. 175, 175 (1961).

³⁹ See Rice, *Employee Trusts Under the Revenue Act of 1942*, 20 TAXES 721 (1942).

⁴⁰ See Keogh, *supra* note 38, at 175.

⁴¹ See *Voluntary Pension Plans by Self-Employed Individuals, 1961: Hearings on H.R. 10 Before the Senate Committee on Finance, 87th Cong., 1st Sess.* 117, 125 (1961) (statement of Hon. Eugene J. Keogh, Representative in Congress from the State of New York).

⁴² Mullane & Williams, *Professional Organizations—General Coverage*, TAX MGMT. (BNA) No. 227, A-1 (1970).

⁴³ See, e.g., *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954).

⁴⁴ States typically would not allow professionals such as physicians and attorneys to practice as employees of corporations. Moreover, ethical considerations such as the rule against fee-splitting presented an obstacle to groups of professionals who, if they practice in a corporation, would by definition pool their income. See Eaton, *supra* note 12, at 25, 26.

attacked this practice by invoking the assignment of income doctrine and section 482.⁴⁵

The early tax law recognized that PSC's represented a special situation. The Revenue Act of 1918 contained a special definition of personal service corporations and taxed them as partnerships.⁴⁶ The definition presciently anticipated problems which would subsequently arise concerning attempts by service-providers to assign their earnings to their PSC's. A personal service corporation was defined in the 1918 Revenue Act as "[a] corporation whose income is to be ascribed primarily to the activities of the principal owners or stockholders, who are themselves regularly engaged in the active conduct of the affairs of the corporation, and in which capital (whether invested or borrowed) is not a material income-producing factor. . . ."⁴⁷

The Revenue Act of 1921 eliminated the special statutory treatment of personal service corporations, except for the purpose of applying the excess profits tax.⁴⁸ Thereafter, a PSC was taxed as a corporation. Controversy, however, existed as to the proper definition of an "association" for federal income tax purposes. In 1935, the Supreme Court in *Morrissey v. Commissioner*⁴⁹ established the criteria for determining whether an unincorporated entity should be taxed on its income as an association. In *Morrissey*, the Court established the "resemblance test" for distinguishing an association from a trust or partnership for federal income tax purposes.⁵⁰ Under this test, an unincorporated business group would be taxed as a corporation if the group exhibited the formal characteristics of a "corporation" under state law.⁵¹ These indicia of a corporation included limited liability, centralized management, free transferability of interests, and continuity of life of the enterprise.⁵²

The year after *Morrissey* was handed down, the IRS published its position that the service would apply the resemblance test on a nationwide basis.⁵³ In an attempt to enlarge its tax base during the Depression, the government was trying to force association status on organizations such as business trusts and limited partnerships.⁵⁴ The incentive to tax income under the more burdensome corporate rate structure, however, ended in the early 1940s.

⁴⁵ See, e.g., *Ach v. Commissioner*, 42 T.C. 114 (1964), *aff'd*, 358 F.2d 342 (6th Cir.), *cert. denied*, 385 U.S. 899 (1966) (§ 482 case); *American Sav. Bank v. Commissioner*, 56 T.C. 828 (1971), *acq. on other issues*, 1972-2 C.B. 1.

⁴⁶ Revenue Act of 1918, § 200, ch. 18, 40 Stat. 300.

⁴⁷ *Id.*

⁴⁸ See *Eaton*, *supra* note 12, at 2.

⁴⁹ 296 U.S. 344 (1935).

⁵⁰ *Id.*

⁵¹ *Id.* at 356-60.

⁵² *Id.* Also considered as indicia of a corporation under *Morrissey* were the existence of associates and carrying on a business enterprise for profit. *Id.* at 356-59.

⁵³ See *Mim*, 4483, XV-2 Cum. Bull. 175 (1936); *Eaton*, *supra* note 12, at 5.

⁵⁴ See *Eaton*, *supra* note 12, at 5; *Mullane & Williams*, *supra* note 42, at A-5.

The advent of steeply progressive individual income tax rates under the Revenue Act of 1942 created the opposite incentive to incorporate.⁵⁵ The availability of corporate retirement plans only increased the attractiveness of operating in corporate form.⁵⁶ Unfortunately for the IRS, the government had recently been successful in *Pelton v. Commissioner*,⁵⁷ where the Service asserted that a medical clinic with three physicians doing business under a trust form was actually an association which should be taxed as a corporation.⁵⁸ The Service subsequently was saddled with the *Pelton* decision when it revised its position in the 1950s and began to assert that associations of professionals could not be taxed as corporations.⁵⁹

In the face of *Pelton*, the government lost in *United States v. Kintner*⁶⁰ when the Service argued that a Montana common law association of physicians could not adopt a pension plan.⁶¹ Undaunted by the *Kintner* defeat, the IRS asserted in Revenue Ruling 56-23⁶² that a group of doctors who adopt the form of an association in order to obtain the benefits of a corporate pension plan should be taxed as a partnership.

The following year, the IRS revoked Revenue Ruling 56-23,⁶³ but the Treasury in 1960 adopted regulations that administratively would overrule the holding of the Ninth Circuit in *Kintner*.⁶⁴ These regulations, aptly referred to as the Kinter regulations, effectively precluded partnerships and unincorporated business groups from being taxed as corporations.⁶⁵ Stung by the Service's unvarnished attempt at legislation by administrative edict, professionals caused state legislatures to enact statutes authorizing professionals to incorporate.⁶⁶ By 1970, forty-nine states had statutes permitting professional corporations or associations.⁶⁷ Currently, all states and the District of Columbia have one of these statutes in force.⁶⁸

The move by the states to enact professional corporation statutes prompted the Service to respond with new regulations in 1965 which

⁵⁵ See Eaton, *supra* note 12, at 5; Mullane & Williams, *supra* note 42, at A-5.

⁵⁶ *Id.*

⁵⁷ 82 F.2d 473 (7th Cir. 1936).

⁵⁸ *Id.* at 475.

⁵⁹ See Eaton, *supra* note 12, at 6.

⁶⁰ 216 F.2d 418 (9th Cir. 1954).

⁶¹ *Id.* at 421.

⁶² Rev. Rul. 56-23, 1956-1 C.B. 598, *revoked*, Rev. Rul. 57-546, 1957-2 C.B. 886.

⁶³ Rev. Rul. 57-546, 1957-2 C.B. 886.

⁶⁴ Treas. Reg. §§ 301.7701-1 to -11 (1960).

⁶⁵ See *Zuckman v. United States*, 524 F.2d 729 (Ct. Cl. 1975); B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* 2-15 (1979); Scallen, *Federal Income Taxation of Professional Associations and Corporations*, 49 MINN. L. REV. 603, 641 (1964-65).

⁶⁶ See B. BITTKER & J. EUSTICE, *supra* note 65, at 2-20; Scallen, *supra* note 65, at 605.

⁶⁷ See B. BITTKER & J. EUSTICE, *supra* note 65, at 2-20.

⁶⁸ See Mullane & Williams, *supra* note 42, at A-1.

made it practically impossible for a professional corporation to attain corporate status for federal tax purposes.⁶⁹ The government subsequently lost several attempts to uphold the validity of these regulations.⁷⁰ The Service ultimately abandoned its position in 1970 when the Service finally conceded that professional corporations and associations could be taxed as corporations.⁷¹

Although the Treasury was unsuccessful in attacking the PSC in the regulations by using a restrictive definition of a corporation for federal tax purposes, the Service has had some success employing the assignment of income doctrine and section 482 to undercut taxpayers' efforts to shift personal service income into a corporation. Unfortunately, in the reported PSC cases in which courts have applied the assignment of income doctrine or section 482, the courts have failed to agree whether the common law assignment of income doctrine established under section 61 or the purely statutory section 482 rule should apply to reallocate personal services income in appropriate circumstances.⁷² The confusion over the priority between the assignment of income doctrine and section 482 is a result of two inconsistent premises in tax law which collide at the point of the one-person PSC.

The first premise concerns the principle that an individual must be taxed on the income that person earned.⁷³ The integrity of the progressive tax rate structure depends on the maintenance of this premise, since otherwise it would be possible to split earned income among related parties at will. The second premise involves the recognition of the corporation as an entity that can earn its own income through the activities of its agents.⁷⁴ When a corporation's only agent is its only shareholder, an obvious conflict exists and one premise must be subordinated to the other.

The following cases demonstrate a progression in the logic of the courts. The early PSC cases based their decisions largely on the common law assignment of income doctrine.⁷⁵ As will be seen, the recent PSC

⁶⁹ *Eaton & Maycock, Final Professional Corporation Regs are an Improvement—But Not Much*, 22 J. TAX'N 208, 209 (1965).

⁷⁰ *See Kurzner v. United States*, 413 F.2d 97 (5th Cir. 1969); *O'Neill v. United States*, 410 F.2d 888 (6th Cir. 1969); *United States v. Empey*, 406 F.2d 157 (10th Cir. 1969).

⁷¹ Rev. Rul. 70-101, 1970-1 C.B. 278.

⁷² *Compare American Sav. Bank v. Commissioner*, 56 T.C. 828 (1971) (assignment of income doctrine applied) with *Rubin v. Commissioner*, 429 F.2d 650 (2d Cir. 1970) (§ 482 applied).

⁷³ *See Lucas v. Earl*, 281 U.S. 111 (1930).

⁷⁴ *See Rubin v. Commissioner*, 429 F.2d 650, 652-53 (2d Cir. 1970). *See generally* Clark, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, 87 YALE L. J. 90, 97-100 (1977).

⁷⁵ The contractual arrangements between a PSC and its shareholder-employee also have been held to govern attribution of income issues in PSC cases. *See, e.g., Fox v. Commissioner*, 37 B.T.A. 271 (1938). In determining the person or entity to which certain income will be taxed, contracts may constitute evidence pointing to the entity that actually earns

cases have preferred, under certain circumstances, to employ section 482 to attribute income to shareholder-employees.⁷⁶ The utilization of section 482 in these recent cases reflects the manner in which courts attempt to harmonize conceptually inconsistent rules.

The earliest case to arise in the PSC area was *Fox v. Commissioner*.⁷⁷ The taxpayer there, Fontaine Fox, was a cartoonist and originator of the Toonerville Trolley comic strip. Fox caused to be organized an almost wholly owned corporation, the Reynard Corporation (Reynard), which then entered into an employment agreement with Fox.⁷⁸ Under the employment contract, Fox transferred his copyrights to Reynard and agreed to render to Reynard his exclusive services as a cartoonist for a specified period of time. Reynard subsequently entered into a contract with a third party, Bell, for syndication of the cartoons. Reynard paid Fox a salary of \$2,500 per month under this arrangement. The contract between Reynard and Bell provided that Bell would pay Reynard amounts far in excess of the monthly \$2,500 Reynard paid Fox. For the year in dispute Bell paid Reynard well over \$100,000 while Reynard paid Fox a salary of \$30,000.⁷⁹

The Commissioner argued that all the income Reynard received should be taxed to Fox. The Commissioner based this contention on the alternative grounds that (1) the corporation was a mere dummy whose

the income. Taxpayers often argue that they earn income only from their controlled PSC because their employment contract requires them to render their services exclusively to the PSC. Recent cases, however, have disregarded either the contractual arrangements, or the lack of them, in resolving whether a certain taxpayer earns his income from his PSC or a third party. See, e.g., *Foglesong v. Commissioner*, 621 F.2d 865 (7th Cir. 1980) (actual performance of services exclusively for PSC more meaningful than contract with controlled corporation); cf. *Johnson v. Commissioner*, 78 T.C. 882, 893 n.21 (1982) (employment contracts do not necessarily determine true earner of income).

Closely related to the issue of whether contract rights may establish the true earner of income is the issue of whether personal service income may be taxed to a PSC after its shareholder-employee assigns a pre-existing employment contract to that entity. Normally, a transfer of "property" (e.g., a contract) will change the person to whom the property's income will be taxed. In the area of personal service contracts, however, this rule that income from property is taxed to the property's owner typically does not supercede the common law requirement that the true earner of income must pay the income tax thereon. But see *McGee v. Commissioner*, 81-1 U.S.T.C. ¶ 9184 (D.C. Neb. 1980) (transfer of physician's service contract to controlled corporation transfers taxability of income under contract to corporation). Where a person is obligated to work under a personal service contract but has not performed yet, a better chance exists to shift the tax attributable to the contract proceeds than if that person had performed before the contract was assigned.

⁷⁶ See, e.g., *Foglesong v. Commissioner*, 621 F.2d 865 (7th Cir. 1980).

⁷⁷ 77 B.T.A. 271 (1938).

⁷⁸ *Id.* at 272. Fox owned 98 shares of the 100 authorized shares of Reynard stock. The corporation issued the remaining two shares to Fox's attorney and his brother, apparently to qualify them as directors. *Id.*

⁷⁹ *Id.* at 275-76. While Fox's motivations are not entirely clear from the facts, the discrepancy between Reynard's earnings and Fox's salary indicates that at least part of Fox's motivation was to shift part of his individual income to Reynard.

separate existence the court should therefore disregard, and (2) Fox made an invalid anticipatory assignment of income.⁸⁰ The Board of Tax Appeals rejected both these arguments. First, quoting the Supreme Court in *New Colonial Ice Co. v. Helvering*,⁸¹ the Board found Reynard had a separate, independent existence for federal tax purposes.⁸² The Board based this finding on several facts which indicated that proper corporate formalities had been followed, that Fox had an exclusive employment contract with Reynard, and that Bell entered into a contract with Reynard and Fox. Reynard also carried out other business transactions in Reynard's name and Reynard filed income tax returns. The Board summarily disposed of the assignment of income contention, saying that no contractual relationship existed between Fox and Bell and, therefore, Fox had no income rights to assign.⁸³

The next major case was *Laughton v. Commission*,⁸⁴ which involved a corporation (Industries) established for the motion picture actor Charles Laughton. Although Laughton was the beneficial owner of all Industries' outstanding stock, Laughton did not actively participate in the management of this company and was not a member of the board of directors. In an employment contract, Laughton agreed to devote his services exclusively to Industries.⁸⁵ At this time Laughton had an outstanding contractual obligation to make three pictures for an English film company. Laughton assigned the profits from that contract to Industries, and transferred his right to ten percent of the gross receipts from the motion picture "The Private Life of Henry VIII" to Industries. Subsequently, Laughton also caused a contract between himself and Paramount Studios to be cancelled. Simultaneously with this cancellation, Industries entered into a contract with Paramount for the services of Laughton. Laughton personally guaranteed that Industries would perform according to the terms of the Industries-Paramount contract.⁸⁶

The Commissioner in *Laughton* contended that the Service could disregard the corporate form on the ground that Laughton organized Industries as a mere tax avoidance scheme. The Commissioner further argued that the arrangements between Laughton and Industries were anticipatory assignments of income. The Board of Tax Appeals determined that the issue was "whether the corporation should be recognized or disregarded as an entity separate and apart from the petitioner."⁸⁷ The Board upheld the corporation's separate status for tax purposes saying

⁸⁰ *Id.* at 276-77.

⁸¹ 292 U.S. 435 (1934).

⁸² 37 B.T.A. at 276-77.

⁸³ *Id.* at 277-78.

⁸⁴ 40 B.T.A. 101 (1939), *nonacq.*, 1939-2 C.B. 56, *remanded*, 113 F.2d 103 (9th Cir. 1940).

⁸⁵ 40 B.T.A. at 103.

⁸⁶ *Id.* at 104.

⁸⁷ *Id.* at 105.

that Industries was a separate business organization operated by persons other than Laughton and created for valid business purposes. Further, the Board rejected the Commissioner's assignment of income argument that the corporation, not Laughton, had earned the income, despite the fact that Laughton personally guaranteed the performance of his services under the contract between Industries and the studio.

On appeal,⁸⁸ the Ninth Circuit remanded *Laughton* to the Tax Court to determine whether Laughton's hiring of himself to Industries for a salary substantially less than the compensation for which Industries supplied Laughton's services as Industries' employee "constituted, in effect, a single transaction by Laughton in which he received indirectly the larger sum paid by the producers."⁸⁹ The Ninth Circuit's remand was based upon the fact that the Supreme Court, subsequent to the Board of Tax Appeals decision, decided the case of *Higgins v. Smith*,⁹⁰ which disregarded the existence of a wholly owned corporation by disallowing a loss on a sale between the corporation and its sole shareholder.⁹¹ Unfortunately, there is no report of the *Laughton* decision on remand.⁹²

The next flurry of activity in the PSC area began with *Borge v. Commissioner*.⁹³ Victor Borge, a well-known professional entertainer, operated for several years a separate poultry-raising business as a sole proprietorship. Borge's poultry business had consistently shown losses which Borge used to offset his entertainment business income. When the hobby loss provision of former section 270 threatened Borge, he was advised to transfer the poultry business to his newly formed, wholly owned corporation (Danica). Borge contracted with Danica to perform entertainment and promotional services for Danica over a five-year period. The contract set compensation at \$50,000 per year. Danica then offset the poultry losses against the company's entertainment profits, which profits far exceeded the \$50,000 a year Danica had contracted to pay Borge.⁹⁴ The court found as a fact that Borge would not have entered into such a contract with an unrelated party.⁹⁵ The court, therefore, upheld the Commissioner's allocation under section 482⁹⁶ of a portion of the entertainment business profits to Borge. The *Borge* court was influenced by the facts that: (1) Danica had done nothing to further the entertainment business, (2) third parties who contracted with Danica for

⁸⁸ *Commissioner v. Laughton*, 113 F.2d 103 (9th Cir. 1940).

⁸⁹ *Id.* at 104.

⁹⁰ 308 U.S. 473 (1940).

⁹¹ *Id.* at 477-78.

⁹² Bittker, *Professional Associations and Federal Income Taxation: Some Questions and Comments*, 17 TAX L. REV. 1, 5 n.8 (1961).

⁹³ 405 F.2d 673 (2d Cir. 1968), *aff'g*, T.C.M. (P-H) ¶ 67,173 (1967), *cert. denied*, 395 U.S. 933 (1969).

⁹⁴ 405 F.2d at 675.

⁹⁵ *Id.*

⁹⁶ *Id.* at 675-76.

Borge's services required Borge's personal guarantee on the contract, and (3) Danica underpaid Borge's stipulated salary.⁹⁷

Borge represented a fundamentally new judicial treatment of a PSC. *Borge* appears to be the first case in which the IRS allocated purely personal service business income to the service-provider solely under section 482 principles.⁹⁸ Despite the court's attention to the formalities of Borge's arrangements with the corporation, the determinative factor in *Borge* was that the court believed that Borge formed and operated the corporation as a tax avoidance device. The court made a specific finding under section 269 that "Danica was incorporated with the purpose of evading or avoiding federal income taxes."⁹⁹

The next significant decision, *Rubin v. Commissioner*,¹⁰⁰ constituted a quantum leap in the Tax Court's approach to the PSC. Rubin, the taxpayer, controlled a manufacturing corporation (Dorman). Along with his brothers, Rubin set up a management company (Park). Rubin owned seventy percent of Park and his brothers owned thirty percent. The management company also engaged in an art business. Park entered into a contract with Dorman under which Park would manage Dorman for four years at an agreed compensation, with the understanding that Rubin would personally perform the management services. Rubin signed the contract as president of Park, although at the time Rubin signed the contract Park was not yet incorporated. Rubin apparently did not enter into any employment contract with Park. During the time the management contract was in effect, Rubin also performed services for some other business entities. Rubin generally recognized the separate existence of Park in its dealings with Dorman, but did not do so with outside parties.¹⁰¹

The Commissioner, relying on both section 61 and section 482, allocated to Rubin as an individual the management fees which Dorman paid to Park for the management services.¹⁰² The Tax Court found that the Commissioner was correct on several grounds. The first ground was simply substance versus form. Although the court refused to deny the validity of Park for tax purposes, the court recognized a distinction be-

⁹⁷ *Id.* at 675. In the Tax Court, the Commissioner had relied upon both §§ 61 and 482. Both the Tax Court and the Second Circuit in *Borge*, however, premised their decisions on § 482 and ignored § 61.

⁹⁸ *But cf.* *Ach v. Commissioner*, 42 T.C. 114 (1964), *aff'd*, 358 F.2d 342 (6th Cir.) (merchandising operation rather than purely personal service business), *cert. denied*, 385 U.S. 899 (1966).

⁹⁹ 405 F.2d at 678. Borge's tax avoidance maneuvers succeeded partially since the service reallocated only a portion of the entertainment business income to him under § 482. The Commissioner had allocated only that portion and had not asked the court for more. The court found the Commissioner's allocation "indeed, generous." *Id.* at 677.

¹⁰⁰ 51 T.C. 251 (1968), *rev'd*, 429 F.2d 650 (2d Cir. 1970), *on remand*, 56 T.C. 1155 (1971), *aff'd*, 460 F.2d 1216 (2d Cir. 1972).

¹⁰¹ 51 T.C. at 263.

¹⁰² *Id.* at 264.

tween attacking the corporation's validity and attacking the validity of purported transactions into which the corporation entered.¹⁰³ The *Rubin* court reasoned that since Rubin controlled both Dorman and Park, there was no business purpose in the form used by Rubin.¹⁰⁴

The Tax Court then offered an alternate but "perhaps only semantically different" rationale. It said it would have reached the same result applying the assignment of income doctrine.¹⁰⁵ Citing a classic law review article,¹⁰⁶ the court asserted that the issue of identifying the appropriate taxpayer turned on the question of who controlled the earning of the income.¹⁰⁷ The Tax Court found that Rubin "clearly directed and controlled the earning of the income" because (1) Rubin himself negotiated the management services contract before Park was incorporated, (2) Rubin performed services for other business entities after Park was incorporated, and (3) Rubin terminated the contract without consultation with or consideration to Park.¹⁰⁸

The *Rubin* court distinguished *Laughton* and *Fox* on the ground that the taxpayers in *Laughton* and *Fox* were contractually bound to render services exclusively to the corporation.¹⁰⁹ Rubin, on the other hand, remained free to (and actually did) engage in other work.¹¹⁰ Rubin's failure to dedicate his services completely to Park influenced the court because it indicated that Rubin, and not Park, controlled the earning of income in question.¹¹¹ Thus, the Tax Court in *Rubin* seemed to require an exclusive services contract between the taxpayer and the corporation. The *Rubin* court also indicated that the taxpayer should not control both the service-provider and the recipient of the service.¹¹²

On appeal, the Second Circuit reversed and remanded.¹¹³ The Second Circuit recognized that loan-out situations create a tension between two competing policies of tax law: the recognition of the corporate form on the one hand, and the principle of a graduated tax rate on the other.¹¹⁴ Judge Friendly declared that the Tax Court's inquiry as to the true earner of income merely restated the issue. According to Judge Friendly, resort to common law doctrine of taxation and the broad application of section 61 only occasionally proves useful, and then only when tax avoidance motives not susceptible to other safeguards heavily freight

¹⁰³ *Id.*

¹⁰⁴ *Id.* at 265.

¹⁰⁵ *Id.*

¹⁰⁶ Lyon & Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case*, 17 TAX L. REV. 295 (1962).

¹⁰⁷ 51 T.C. at 265-66.

¹⁰⁸ *Id.* at 266.

¹⁰⁹ *Id.* at 266-67.

¹¹⁰ *Id.* at 267.

¹¹¹ *Id.*

¹¹² *Id.*

¹¹³ *Rubin v. Commissioner*, 429 F.2d 650 (2d Cir. 1970).

¹¹⁴ *Id.* at 652.

the transaction.¹¹⁵ The Second Circuit held that where a statutory provision adequately deals with the problem, drastic remedies have no place.¹¹⁶ Therefore, section 482 of the Code was clearly superior to the "blunt tool" the Tax Court employed, since section 482 provided greater flexibility than the all-or-nothing approach of section 61.¹¹⁷ The Second Circuit remanded *Rubin* for consideration of the Commissioner's claim under section 482.¹¹⁸

On remand, the Tax Court again decided against Rubin.¹¹⁹ The facts the Tax Court used to support its prior holding under section 61 also established the basis for an allocation under section 482.¹²⁰ Thus, although Judge Friendly criticized the use of section 61 in determining Rubin's tax liability, the Tax Court on remand based its decision on the same fundamental substance-over-form principles.¹²¹ This time, however, the Tax Court used the rubric of section 482 rather than section 61.

Rubin set a new judicial course that eventually placed primary emphasis on section 482. During this period of transition, however, the Tax Court appeared to waver between relying on section 61 and making reallocations under section 482. In some cases, section 61 and the assignment of income doctrine provided the sole ground for the results; in other cases section 482 was determinative; while in still others the court relied on both assignment of income and section 482.¹²²

¹¹⁵ *Id.* at 653.

¹¹⁶ *Id.*

¹¹⁷ *Id.*

¹¹⁸ *Id.* at 654.

¹¹⁹ *Rubin v. Commissioner*, 56 T.C. 1155 (1971), *aff'd per curiam*, 460 F.2d 1216 (2d Cir. 1972).

¹²⁰ *Id.* at 1162.

¹²¹ *Id.* Using § 482, the *Rubin* court allocated a somewhat smaller portion of the corporation's income to Rubin than the court would have allocated to Rubin under § 61. Under § 61 the Tax Court upheld a reallocation to Rubin of \$25,000 in income and \$17,000 in expenses for 1960 and \$59,000 in income and \$17,000 in expenses in 1961. On remand the Tax Court charged Rubin with net income of \$4,400 and \$23,500 for the years 1960 and 1961 respectively. *Id.* at 1164.

¹²² See, e.g., *Jones v. Commissioner*, 64 T.C. 1066 (1975); *Gettler v. Commissioner*, T.C.M. (CCH) ¶ 442 (1975); *Jordan v. Commissioner*, 60 T.C. 872 (1973); *Estate of Cole v. Commissioner*, T.C.M. (P-H) ¶ 73,074 (1973); *American Sav. Bank v. Commissioner*, 56 T.C. 828 (1971); *Roubik v. Commissioner*, 53 T.C. 365 (1969). In *American Savings Bank* the court relied solely on the assignment of income doctrine, both parties having expressly disclaimed application of § 482. The American Savings Bank paid fees to the PSC of two members of the bank's board of directors. The Tax Court attributed these fees to the income of the shareholder-employees, since the shareholders exercised control over both the PSC and the corporation receiving the service. The court allocated the income to the shareholder-employees even though the court expressly found that the PSC was a valid corporate entity. The *American Savings Bank* court invoked § 61 and assignment of income principles, and found that the shareholder-employees actually owned and controlled the income. The court distinguished *Fox* and *Laughton* since the shareholder-employees did not work exclusively for the PSC, the shareholder-employees controlled both the PSC and the recipient corporation, and the shareholder-employees failed to show that the PSC employed the shareholder-employees or that the shareholder-employees acted as the PSC's agents. 56 T.C. at 841.

By the end of the 1970s, the courts obviously still had failed to form a completely satisfying doctrinal basis for dealing with the PSC dilemma of respecting the existence of the corporate entity while simultaneously

Perhaps the most important fact that the court considered was that the PSC never paid the individual shareholder-employees any compensation for their services. *Id.* at 842.

Roubik also turned solely on § 61 and the assignment of income doctrine. In *Roubik*, several doctors formed a PSC. The court defined the issue as whether the corporation actually carried on the doctors' business or whether the doctors carried on their business outside the organization. The professional service corporation in *Roubik* never arranged to provide its employees' services to any of the institutions for which the doctors provided service. The court found that the relationship between the doctors and their patients was an inherently personal relationship, and expressed doubt that a professional service corporation could interfere with such relationships. 53 T.C. at 379. More importantly, the taxpayers failed to treat the corporation as a corporation. The doctors largely ignored the corporate form, followed few corporate formalities, and in the words of Judge Tannenwald's concurring opinion, failed to "put flesh on the bones of the corporate skeleton." *Id.* at 382. Courts and commentators have largely dismissed *Roubik* as representing no more enlightening a principle than that a taxpayer must follow the requisite formalities to obtain recognition of the corporate status. However, *Roubik* also manifested the Tax Court's greater willingness to question the validity of a PSC than previously manifested in *Fox* and *Laughton*.

In *Jordan*, the Tax Court rested its decision not on § 61 and the assignment of income doctrine but rather on § 482. The court rested its decision on grounds similar to the grounds the *Roubik* court invoked to allocate income under the assignment of income doctrine. The court found overwhelming evidence that the PSC had no control over the taxpayer's responsibility to perform services for which the PSC received income. 60 T.C. at 883. The court also noted that the evidence proved that the taxpayer performed services and received commissions with little regard to the existence of the PSC. *Id.* The *Roubik* court earlier gave similar reasons for applying § 61 and the assignment of income doctrine.

In *Jones*, a court stenographer formed a PSC. The *Jones* court refused to attribute to the PSC the income generated when the PSC purportedly contracted out the stenography services of the stenographer, its principal shareholder. The court reasoned that the stenographer could not legally delegate stenographic services, and that the corporation carried out precisely the identical functions the stenographer previously performed. Of course, most, if not all, solely owned PSC's carry out functions identical to the functions the individual taxpayer previously performed. The *Jones* court made a feeble attempt to distinguish *Fox* on the ground the taxpayer in *Fox* had an employment contract with the PSC, and the PSC contracted with the third parties receiving the taxpayer's services.

One notable taxpayer victory during this period was *Gettler*. In *Gettler*, two lawyers and a labor relations specialist formed a PSC to perform labor relations services. The *Gettler* court rejected the Commissioner's attempt to allocate income from the PSC to the individuals under either § 61 or § 482. The court supported its decision with several factors concerning observance of corporate formalities. For instance, the corporation maintained separate books, kept its funds in separate bank accounts, used its own letterhead, and paid small annual dividends. Aside from these formalities, however, the corporation's existence was ephemeral, since the corporation's office was the office of the taxpayers' law partnership, the corporation paid the law partnership only \$720 a year for rent and for secretarial and accounting services, and the corporation had only three clients, two of whom were substantial clients of the law partnership. However, and perhaps most important, the court found a valid business purpose for the arrangement.

Another taxpayer victory was *Estate of Cole*. Cole, a well-known entertainer, made several loan-out arrangements through a series of trusts and corporations. The court refused to apply either § 61 or § 482 to allocate income from the corporation to Cole. *Cole* involved incredibly complicated and perhaps unique facts and the court handed down a memorandum decision. The decision's precedential value, therefore, is limited.

protecting the integrity of the progressive tax rates. The disparity in pension treatment between employees and self-employed individuals by the 1970s led to a situation where individual taxpayers incorporated themselves in the hope of shifting their income to their controlled corporations. While the courts responded in diverse ways to this shifting of income, a halting movement toward judicial dependence on section 482 to police the area occurred.

*Foglesong v. Commissioner*¹²³ seemed to confirm this judicial movement towards using section 482 to address the assignment of income to PSC's. Foglesong, a sales representative rendering services to two steel tubing companies, organized Frederick H. Foglesong, Inc. (FHF, Inc.) in which he was the controlling shareholder and sole employee. Foglesong contributed one hundred percent of the initial capital to FHF, Inc. and received ninety-eight percent of its common stock. FHF, Inc. issued the remaining two percent of the common stock to Foglesong's wife and to his accountant. FHF, Inc. issued all of its preferred stock to Foglesong's four children. During the first four years of FHF, Inc.'s existence, the corporation paid no dividends on the common stock but paid dividends in excess of \$30,000 on the preferred stock.

FHF, Inc. employed Foglesong to do the same sales work he had previously done in his individual capacity. After incorporation and at Foglesong's request, the companies for which he was sales representative sent his commissions to FHF, Inc. None of the companies executed written agreements with FHF, Inc., nor did a written employment contract exist between Foglesong and FHF, Inc.¹²⁴ In the Tax Court, the Service successfully argued that Foglesong in reality earned ninety-eight percent of the income FHF, Inc. purportedly earned. Accordingly, under the authority of section 61 and the assignment of income doctrine, the income was taxed to Foglesong.¹²⁵

The Seventh Circuit, following the lead of Judge Friendly in *Rubin*, reversed the Tax Court.¹²⁶ The Seventh Circuit held that application of assignment of income principles in this context effectively disregarded the corporate existence. The circuit court opinion explained that in light of *Moline Properties*,¹²⁷ absent more extreme facts than appeared in *Foglesong*, the court could not use the assignment of income doctrine to achieve essentially the same results as the court would achieve by treating the corporation as a sham for tax purposes.¹²⁸

¹²³ T.C.M. (P-H) ¶ 76,294 (1976), *rev'd*, 621 F.2d 865 (7th Cir. 1980), *on remand*, 77 T.C. 1102 (1981), *rev'd*, 691 F.2d 848 (7th Cir. 1982).

¹²⁴ T.C.M. (P-H) ¶ 76,294, at 76-1287 to -1289.

¹²⁵ *Id.* at 76-1289.

¹²⁶ See *Foglesong v. Commissioner*, 621 F.2d 865 (7th Cir. 1980).

¹²⁷ *Moline Properties v. Commissioner*, 319 U.S. 436 (1943) (corporation a viable taxable entity so long as the purpose for its creation is the equivalent of business activity or its creation is followed by carrying on of business by the corporation).

¹²⁸ 621 F.2d at 869.

The court found that the absence of a written employment contract between the taxpayer and his corporation was immaterial. The Seventh Circuit concluded that Foglesong had in fact worked exclusively for the corporation, and that Foglesong's arrangement with the corporation was more significant than the lack of a written agreement.¹²⁹ The court pointed out that in any situation where a sole shareholder-employee contracts with his corporation, the individual can terminate his services by simply rescinding the contract in his capacity as a corporate officer. *Foglesong's* use of section 482 was premised on the court's view that section 482 was a more precise tool than section 61 and the assignment of income doctrine. While the Seventh Circuit asserted that the taxpayer engaged in "very aggressive tax avoidance measures" which appear to be vulnerable, the court insisted "there is no need to crack walnuts with a sledgehammer."¹³⁰

On remand to the Tax Court,¹³¹ Foglesong argued that the court could not apply section 482 to him, because he was a mere corporate employee and not an organization, trade, or business as required by section 482. The Tax Court explicitly dismissed the taxpayer's contention¹³² and then applied an arm's length standard to determine whether or not the court should allocate the corporation's income to Foglesong under section 482.¹³³ The *Foglesong* court defined the section 482 determination standard as the extent to which the total compensation that FHF, Inc. paid Foglesong exceeded the amount Foglesong would have earned absent incorporation. The Tax Court found that Foglesong received compensation far below what he would have received in an arm's length transaction.¹³⁴ Therefore, the court refused to tax Foglesong for the income. Section 482 thus yielded the same result as the assignment of income doctrine. Significantly, the Tax Court in *Foglesong* specifically stated that it did not intend to discourage PSC's where one of the purposes for incorporating was to take advantage of tax law benefits such as medical reimbursement plans, death benefits, and retirement plans.¹³⁵

¹²⁹ *Id.* at 872.

¹³⁰ *Id.* at 872-73.

¹³¹ 77 T.C. 1102 (1981).

¹³² *Id.* at 1104.

¹³³ *Id.* at 1105.

¹³⁴ *Id.* at 1106.

¹³⁵ On taxpayer's appeal of the remand, a different panel of the Seventh Circuit surprisingly held that § 482 was unavailable to reallocate income between Foglesong and his PSC. *Foglesong v. Commissioner*, 691 F.2d 848 (7th Cir. 1982). The court rejected the Tax Court position that being an employee of one's own PSC constitutes a trade or business separate from that of the PSC. *Id.* at 851. Therefore, it found that § 482's two trade or business requirements was not satisfied. It distinguished cases such as *Borge v. Commissioner*, 405 F.2d 673 (2d Cir. 1968), *cert. denied*, 395 U.S. 933 (1969), and *Ach v. Commissioner*, 358 F.2d 342 (6th Cir.), *cert. denied*, 385 U.S. 899 (1966), which had applied § 482 to reallocate income between a corporation and its shareholder, saying that such cases involved situations in which the shareholder was actually carrying on a business separate from that of the cor-

The Tax Court's decision in *Keller v. Commissioner*¹³⁶ foreshadowed the application of section 482 in *Foglesong*. Keller, a pathologist, was a partner in Medical Arts Laboratory (MAL), a general partnership composed of several pathologists. MAL rendered pathology services to hospitals and physicians. MAL received its technical and laboratory support from Medical Arts Laboratory, Inc. (MAL, Inc.), while MAL provided quality control and supervisory services to MAL, Inc. All of the MAL partners were shareholders and directors of MAL, Inc.¹³⁷

Keller formed a PSC, Keller, Inc. Keller was the sole shareholder, director, and employee. Keller, Inc. adopted a tax qualified retirement plan and a medical reimbursement plan. An agreement between Keller and MAL substituted Keller, Inc. as a partner in MAL. Thereafter, Keller, Inc. received Keller's prior share of the income that the partnership earned. Keller, Inc. paid Keller an annual salary for his services.¹³⁸

On alternative grounds, the Commissioner sought to tax Keller directly on the income Keller, Inc. received. First, under section 61, the Commissioner sought to hold Keller liable based on the doctrines of lack of business purpose, substance-over-form, and assignment of income.¹³⁹ In response to the Commissioner's lack of business purpose and substance-over-form arguments, the court refused to deem efforts to obtain the advantages of qualified retirement and medical plans by conducting business in the corporate form sufficient to render the taxpayer culpable of illegitimate tax avoidance. The court ignored the issue of whether the desire to obtain these benefits comprises a business purpose since Keller, Inc. did in fact engage in business activity, *i.e.*, medical services.¹⁴⁰ The court reached this conclusion despite the facts that Keller, Inc. had the same offices as MAL and MAL, Inc., did not pay rent, did not purchase or own property, and did not employ anyone but Keller and Keller's wife. The court also refused to accept the Commissioner's assignment of income argument. The court decided that the assignment of income doctrine, if successful, would render Keller, Inc. a nullity for federal income tax purposes, a result inconsistent with the policy favoring the recognition of corporations as entities independent of their shareholders.¹⁴¹

poration, or in which a taxpayer was attempting to shift losses from one business to another. *Id.* at 851-52. The issue of whether being an employee of one's controlled PSC constitutes a separate trade or business under § 482 is by no means settled, however, since the Tax Court clearly took the opposite position in *Keller v. Commissioner*, 77 T.C. 1014 (1981) which is currently on appeal to the Tenth Circuit. *See* 2 ABA Section of Taxation, Newsletter No. 2, at 10 (Winter 1983).

¹³⁶ 77 T.C. 1014 (1981).

¹³⁷ *Id.* at 1016.

¹³⁸ *Id.* at 1016-17.

¹³⁹ *Id.* at 1021.

¹⁴⁰ *Id.* at 1023-24.

¹⁴¹ *Id.* at 1031.

Under section 482, the Commissioner sought to allocate to Keller one hundred percent of the income which Keller, Inc. reported. The court held that being an employee of one's own PSC constitutes a separate trade or business and, consequently, it could apply section 482 in the one person PSC situation.¹⁴² The court nevertheless found that the Commissioner's attempt to shift all of Keller, Inc.'s income to Keller under section 482 was arbitrary and capricious.¹⁴³ The standard the court used in testing the employment arrangement was whether both Keller, Inc. and Keller would have entered into their financial relationship if they had been unrelated parties dealing at arm's length. The court inquired whether the total compensation Keller, Inc. paid Keller (including salary, pension plan contributions, and medical expense reimbursements) was substantially equivalent to what Keller would have received absent incorporation.¹⁴⁴

A strongly worded dissent,¹⁴⁵ in which six judges joined, rejected the majority's quantification-of-compensation approach. The dissent pointed out that Keller's PSC was basically a paper entity. The PSC owned no medical supplies, office furniture, or technical medical equipment. The corporation employed neither medical technicians nor nurses. To the dissenters, the corporation was nothing more than a bank account through which the taxpayer's income was funneled. As a result, "the attenuated subtleties triumph over economic substance and practical reality, and form and artifice reclaims center stage of our tax laws."¹⁴⁶ The dissenters in *Keller* feared that "[a]fter this decision, anyone may form a corporation, paper the file a little, and market his services with his salary being paid to his corporation."¹⁴⁷ The dissenting opinion concluded with a ringing defense of the assignment of income doctrine and took issue with the Second Circuit opinion in *Rubin*, which the dissenters believed dealt cavalierly with a fundamental principle in income taxation.¹⁴⁸

The competing concepts of the assignment of income doctrine and the recognition of a corporation as a separate earning entity illustrate how courts fashion compromise from conflict. Judicial resort to section 482 in the PSC area exemplifies the manner in which courts reconcile inconsistent premises. Conceptually, the assignment of income doctrine can operate to tax a sole shareholder-employee on the income his PSC purportedly earns despite the fact that a corporation generally is a separate taxpaying entity. In *Lucas v. Earl*,¹⁴⁹ the government did not

¹⁴² *Id.* at 1022-24.

¹⁴³ *Id.* at 1025.

¹⁴⁴ *Id.*

¹⁴⁵ *Id.* at 1035 (Wilbur, J., dissenting).

¹⁴⁶ *Id.* at 1039.

¹⁴⁷ *Id.*

¹⁴⁸ *Id.* at 1043-44.

¹⁴⁹ 281 U.S. 111 (1930).

contend that Mrs. Earl had no legal existence as a separate taxpaying entity. Rather, the Court simply held that Mrs. Earl did not earn the income that her husband assigned to her.¹⁵⁰ Nevertheless, courts have often been reluctant to apply the assignment of income doctrine in PSC cases for fear of eroding the idea of the corporation's separate existence for tax purposes. The use of section 482 in cases involving one-person PSC's constitutes a judicial compromise in recognition of the competing concepts of the assignment of income doctrine and the corporation's existence as a separate entity that can earn its own income. By applying section 482, courts are able to respect the corporate entity as a distinct earner while simultaneously allocating income from the corporation to its controlling shareholder-employee.

III. THE FUTURE OF THE PSC AFTER TEFRA

In recognizing that a corporation can earn its own income, courts have used the compromise measure of section 482 to limit the assignment of income to PSC's. Once courts decided that section 482 could preempt section 61 and the assignment of income doctrine, the results in many of the PSC cases seemed to have turned on whether the taxpayer operated the PSC in connection with a "good" or "bad" tax avoidance motive. In many cases where the taxpayer successfully avoided the reallocation of income under section 482, the principal purpose underlying incorporation appeared to be securing the permissible benefit of a corporate deferred compensation plan. Conversely, in many cases when the taxpayer was unsuccessful in avoiding reallocation, the taxpayer created the PSC primarily for "bad" motives such as to split income or utilize losses.¹⁵¹

In the future, however, taxpayers in many cases will be unable to use a legitimate tax avoidance motive to avoid reallocation of corporate income to shareholder-employees. Not only does TEFRA eliminate the incremental advantage of a corporate deferred compensation plan,¹⁵² but the addition of section 269A to the Code by TEFRA¹⁵³ no longer recognizes the favorable tax treatment of PSC's and their shareholder-employees as a permissible justification for recognizing the PSC as a true earner of income.

Section 269A provides that the IRS, under certain circumstances, may allocate all income and deductions between "a personal service corporation" and its "employee-owners" if such allocation is necessary to

¹⁵⁰ *Id.* at 114.

¹⁵¹ Compare *Borge v. Commissioner*, 405 F.2d 673 (2d Cir. 1968) (principal motive of incorporation apparently to offset personal service income with corporate losses) with *Keller v. Commissioner*, 77 T.C. 1014 (1981) (a principal motive of incorporation apparently to obtain tax benefits of employee pension plan).

¹⁵² TEFRA §§ 235(a), 238.

¹⁵³ *Id.* § 250.

prevent avoidance or evasion of federal income tax. Before the IRS can allocate income and deductions under section 269A, two conditions must be met. First, substantially all of the services of the personal service corporation must be performed for (or on behalf of) one other corporation, partnership, or other entity. Second, the principal purpose for forming the personal service corporation must be the avoidance or evasion of federal income tax by benefitting any employee-owner in a manner not otherwise available without a corporation. The House-Senate Conference Agreement, out of which section 269A was reported, stated that "the conferees intended that the provisions overturn the results reached in cases like *Keller v. Commissioner*, 77 T.C. 1014 (1981), where the corporation serves no meaningful business purpose other than to secure tax benefits which would not otherwise be available."¹⁵⁴

By virtue of the reduced marginal benefits available to incorporated service-providers, the enactment of TEFRA likely will decrease the number of PSC's incorporated in the future. To the extent that individuals desire to form PSC's notwithstanding these reduced benefits, however, the question remains whether courts will subject service-providers who incorporate to a more stringent test under section 269A than courts in the past applied under section 482 and the assignment of income doctrine. While section 482 addresses whether evasion of taxes or a distortion of income occurred, section 269A permits reallocation if the principal purpose of a PSC is the avoidance of federal tax.

Despite the ostensibly more expansive reach of section 269A with its "tax avoidance" language, the impact of section 269A on existing law probably will be minimal due to TEFRA's establishing parity between the retirement plans available for employees and self-employed individuals. Precisely because the principal purpose for the incorporation of service-providers had been to take advantage of the more attractive corporate deferred compensation plans, the elimination of this benefit will mean that the nontax benefits of incorporating will assume greater significance in the decision whether to incorporate. As a consequence of the enhanced importance of the nontax aspects of incorporating, the Service will have more difficulty persuading a fact-finder that the principal purpose of forming a PSC was to avoid federal income tax. In those cases where, for example, obvious income-splitting constitutes the motivation for incorporating a service-provider, section 61 and the assignment of income doctrine—even under pre-TEFRA law—would operate to reallocate the income properly. Thus, even when the personal service corporation performs substantially all of its services for another entity, section 269A is unlikely to have much impact beyond the present reach of sections 61 and 482.

Section 269A thus illustrates why attempts at a complete statutory

¹⁵⁴ H. REP. NO. 760, 97th Cong., 2d Sess. 634 (1982).

resolution of any tax problem are likely to be deficient. As the history of the tax law amply demonstrates, attempts to legislate general principles, such as the assignment of income doctrine, inevitably challenge the ingenuity of tax advisors to devise ways to avoid the strictures of the statute. Due to the dynamics of tax law evolution and its present state in the PSC area, further change is unavoidable.

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