February, 1982

The Future of Personal Service Corporations

Howard S. Chapman, *Chicago-Kent College of Law*

THE FUTURE OF PERSONAL SERVICE CORPORATIONS

Howard S. Chapman*

Professionals have incorporated their practices for many years to take advantage of tax benefits available only to corporate employees. Within the past few years, however, the incorporation of personal service corporations[1] has mushroomed. A recent study estimates that as of 1980, there were 5,500 incorporated law practices in the United States, an increase of 15.5% over 1979.[2] In addition, the use of the multiform partnership consisting of individual and corporate partners, has significantly increased.[3] The reason for this incorporation activity is simple: corporate employees enjoy significant tax benefits which are unavailable to self-employed persons.[4] The Internal Revenue Service (IRS), however, has consistently attacked the tax status of personal service corporations for forty years. The position taken by the IRS is that the individual shareholder/employee, not the corporation, earns the income; therefore, the corporate income will be taxed to the individual.

Within the last year, two major developments occurred in connection

---

* Professor of Law, Illinois Institute of Technology, Chicago-Kent College of Law. B.S., University of Illinois, 1963; J.D., University of Illinois, 1968.

The author gratefully acknowledges the assistance of his research assistant, Mr. Richard Mittelman.

1. As used herein, the term "personal service corporation" means a corporation which provides the services of its employee/stockholder(s), such as law, medicine or art, to third parties. The Revenue Act of 1918 defined a "personal service corporation" as "a corporation whose income is to be ascribed primarily to the activities of the principal owners . . . and in which capital . . . is not a material income-producing factor . . . ." Revenue Act of 1918, ch. 18, sec. 200, 40 Stat. 1057, 1059. Personal service corporations were not defined in the 1954 Internal Revenue Code until section 250 of the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 51 U.S.L.W. 5 [hereinafter cited as TEFRA], added section 269(b)(1) to the Internal Revenue Code defining a personal service corporation as "a corporation the principal activity of which is the performance of personal services . . . substantially performed by employee-owners."

2. Unpublished compilation by the Incorporation of Law Firms Subcommittee of the Committee on Professional Service Corporations of the American Bar Association's Committee on Taxation.

3. *See generally*, Harnack, *Multiform Partnerships Provide Access to Corporate Tax Benefits for Partners of Law Firms*, 70 ILL. B.J. 564 (1982).

4. *See infra* notes 173-77 and accompanying text.

with personal service corporations. First, a series of cases[5] have been decided which would seem to have settled the tax issues in this area. Second, Congress enacted the Tax Equity and Fiscal Responsibility Act of 1982[6] (TEFRA) which eliminates the most significant tax advantage of a personal service corporation: more favorable retirement plan provisions.[7] TEFRA also effectively eliminates the multiform partnership.[8]

This Article will review the history[9] of the IRS challenges to the legitimacy of personal service corporations and then focus on recent cases which have resolved these tax issues. This Article will then examine the impact of TEFRA on retirement provisions. Finally, the Article will analyze the post-TEFRA tax advantages and disadvantages which remain for corporate employees.

EARLIER CASES: FROM SHAMS TO SECTION 482

The Commissioner has used several theories to tax individual shareholders on the income earned by a personal service corporation. Initially, the Commissioner relied on the "sham corporation" argument to attempt to attribute the corporation's income to the shareholder. Under this argument, if the corporation is a "sham" and not truly a viable tax entity, then the Commissioner can properly ignore it and tax the income to the individual shareholders. The Commissioner also attempted to apply the "assignment of income" doctrine, which originated in the landmark case of *Lucas v. Earl*.[10] This doctrine provides that a taxpayer cannot assign his income to another person or entity for tax purposes. In *Lucas*, the United States Supreme Court stated that income must be taxed to the one who earns it and taxation "could not be escaped by anticipatory arrangements and contracts however skillfully devised."[11] In the personal service corporation cases, the Commissioner argued that the individual shareholder is the "true earner" and is merely attempting to assign the income to his corporation; therefore, under *Lucas*, the individual, not the corporation, must be taxed on the income. More recently, the Commissioner has relied on sec-

5. Johnson v. Commissioner, 78 T.C. 882 (1982); Pacella v. Commissioner, 78 T.C. 604 (1982); Foglesong v. Commissioner, 77 T.C. 1102 (1981), *rev'd*, 82-2 U.S. TAX CAS. (CCH) ¶ 9650 (7th Cir. Oct. 29, 1982); Keller v. Commissioner, 77 T.C. 1014 (1981), *appeal docketed*, No. 82-1414 (10th Cir. Apr. 2, 1982); Achiro v. Commissioner, 77 T.C. 881 (1981).

6. TEFRA, *supra* note 1.

7. *See* TEFRA, *supra* note 1, at secs. 235-54; *see also infra* notes 178-86 and accompanying text.

8. *See* TEFRA, *supra* note 1 at secs. 246, 250; *see also infra* notes 236-50 and accompanying text.

9. For additional historical information, see generally, Banoff, *Reducing the Income Tax Burden of Professional Persons by Use of Corporations, Joint Ventures, Subpartnerships and Trusts*, 58 TAXES 968 (1980); Battle, *The Use of Corporations by Persons Who Perform Services to Gain Tax Advantages*, 57 TAXES 797 (1979); Feuer, *Section 482, Assignment of Income Principles and Personal Service Corporations*, 59 TAXES 564 (1981); Nolan, *New Options for Lawyer Retirement Plans Under the Economic Recovery Tax Act of 1981*, 1982 AM. B. FOUND. RESEARCH J. 157; Olson, *Personal Service Corporations: Who is the Income Earner*, 13 PAC. L.J. 333 (1982); Volpe, *Section 482 and the Personal Service Corporation*, 26 ST. LOUIS U.L.J. 155 (1981).

10. 281 U.S. 111 (1930).

11. *Id.* at 115.

tion[12] 482[13] of the Internal Revenue Code to reallocate income from the personal service corporation to the individual taxpayer. Each of these theories will be examined more thoroughly below.

In the 1930's, personal service corporations were being used by entertainers and other creative persons primarily to take advantage of lower corporate rates. These individuals used their corporations as "incorporated pocketbooks." The corporations paid relatively small salaries and no dividends; corporate income, taxed at the lower corporate rates, was retained in the corporation and used for investment or other purposes. In addition, these taxpayers took advantage of corporate deductions which were not available to the self-employed. Needless to say, such practices were not condoned by the IRS.

The first major personal service corporation cases, *Fox v. Commissioner*[14] and *Laughton v. Commissioner*,[15] were won by the taxpayers. In *Fox*, the taxpayer, a highly paid cartoonist, formed a corporation to market his cartoons; he then signed an exclusive employment contract with the corporation for a fixed monthly salary.[16] The corporation thereafter entered into syndication contracts for the cartoons and received substantially more income than it was paying the taxpayer/employee.[17] The IRS invoked both the sham corporation theory and the assignment of income doctrine in an attempt to tax Mr. Fox on all of the corporation's income.[18] The Board of Tax Appeals held for the taxpayer, rejecting the sham argument because the corporation had been validly formed under state law, and all corporate formalities had been observed.[19] The Board held the corporation should not be disregarded as a separate tax entity. The assignment of income doctrine was also rejected by the Board which held that the taxpayer assigned income-producing property (the syndication contracts), and not income produced from the property.[20]

In *Laughton*, the taxpayer, a successful actor, formed a corporation to engage in the movie business and executed an exclusive employment contract to provide his acting services to the corporation.[21] The corporation then contracted with studios to "loan out" the taxpayer.[22] The corporation received substantially more income from these contracts than it was paying to Laughton.[23] The Board of Tax Appeals, recognizing that this case was

12. Unless otherwise stated, code references are made to sections of the Internal Revenue Code [I.R.C.] of 1954, as amended.

13. I.R.C. § 482 (1976), entitled "Allocation of Income and Deductions Among Taxpayers". This section authorizes the Commissioner to reallocate income among jointly controlled taxpayers when necessary to prevent tax evasion or to more clearly reflect the income of such taxpayers.

14. 37 B.T.A. 271 (1938).

15. 40 B.T.A. 101 (1939), *remanded*, 113 F.2d 103 (9th Cir. 1940).

16. Fox v. Commissioner, 37 B.T.A. 271, 273 (1938).

17. *Id.*

18. *Id.* at 276.

19. *Id.* at 277.

20. *Id.* at 278.

21. Laughton v. Commissioner, 40 B.T.A. 101, 103 (1939), *remanded*, 113 F.2d 103 (9th Cir. 1940).

22. *Id.*

23. In one year, for example, the corporation received over $190,000 for taxpayer's services but paid him only $39,000. *Id.*

similar to *Fox*, held the corporation was not a sham and that the assignment of income doctrine was not applicable.[24] On appeal,[25] the Ninth Circuit agreed that the corporation was not a sham but remanded the case for a determination of whether the assignment of income doctrine was applicable.[26] Since there are no further reports, the case was apparently settled after remand.

In 1943, the United States Supreme Court set forth a test for corporate recognition in *Moline Properties, Inc. v. Commissioner*.[27] In *Moline Properties*, a corporation was organized solely for use as a security device for loans made by a third party to the taxpayer. The Commissioner alleged that the corporation was a mere agent and should be disregarded for tax purposes. While acknowledging that a corporation may be disregarded if it is a "sham or unreal,"[28] the Court stated:

> Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity.[29]

The amount of business activity necessary for corporate recognition is so low that the Commissioner seldom advances the sham corporation doctrine anymore, even when it may appear that the corporation was formed for tax avoidance purposes.[30]

Having lost the argument that a corporation formed solely to provide personal services is a sham and should be disregarded, the IRS began to attack the tax status of professional associations, contending that under its regulations,[31] they were not taxable as corporations for federal tax purposes.[32] After the IRS lost a series of cases on this issue,[33] it announced on August 8, 1969 that it would no longer litigate the tax classification of professional service corporations formed under state professional corporation laws except where "special circumstances" were present.[34]

The Commissioner successfully argued the assignment of income theory in a personal service corporation case in *Rubin v. Commissioner*,[35] but

---

24. *Id.* at 106.
25. Commissioner v. Laughton, 113 F.2d 103 (9th Cir. 1940).
26. *Id.* at 105.
27. 319 U.S. 436 (1943).
28. *Id.* at 439.
29. *Id.* at 438-39.
30. *See, e.g.*, Foglesong v. Commissioner, 77 T.C. 1102 (1981); Battle, *supra* note 9, at 803. Olson, *supra* note 9, at 359, states: "The sham doctrine has such a low threshold for compliance that it is useful only in the most outrageous situations."
31. Treas. Reg. § 301.7701-2(a)(5) & (h) as they read prior to their revocation in 1977 by T.D. 7515, 1977-2 C.B. 482.
32. See, e.g., United States v. Kintner, 216 F.2d 418 (9th Cir. 1954), where the Commissioner contended that a corporation could not engage in the practice of medicine because such practice was too personal in nature. The Ninth Circuit rejected this contention and held the medical association taxable as a corporation.
33. 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).
34. T.I.R. 1019 (Aug. 8, 1969). *See also* Rev. Rul. 70-101, 1970-1 C.B. 278.
35. 51 T.C. 251 (1968), *rev'd*, 429 F.2d 650 (2d Cir. 1970).

the Tax Court decision was reversed on appeal by the Second Circuit.[36] The taxpayer, Rubin, formed a corporation, Park International, Inc., to provide management services to another corporation he controlled, Dorman Mills.[37] The management contract with Dorman Mills, which was executed before Park was even formed, provided that Dorman Mills was to compensate Park for its management services based on a percentage of Dorman's profits.[38] Rubin, who had no employment contract with Park, performed all the management services Park provided but was paid a salary substantially less than Park's income. Rubin was held out to third parties as an employee of Dorman Mills.[39] The Commissioner challenged the arrangement, and allocated all of Park's income to Rubin relying on sections 61 and 482.[40]

The Tax Court decided that while in form, Rubin worked for Park, in substance he worked for Dorman Mills and therefore should be taxed on the income Dorman paid to Park for his services.[41] This form versus substance analysis is based on section 61 which provides: "gross income means all income from whatever source derived."[42] In the alternative, the court found Rubin should be taxed on the corporation's income under the assignment of income doctrine because he "controlled" Park's income.[43] This control was evidenced by Rubin's work for other entities during the period of the management contract, the execution of the management contract even before Park was incorporated and the termination of the management contract by Dorman Mills without consideration to Park.[44] The court noted, however, that the assignment of income doctrine might only be "semantically different" from the section 61 form versus substance analysis.[45]

The Second Circuit reversed and remanded the case.[46] Judge Friendly, writing for the court, acknowledged the difficulty inherent in deciding personal service corporation cases because of the competing policies of (1) the graduated income tax which is undermined by artificial income splitting and (2) the policy of recognizing corporations as separate taxable entities.[47] Judge Friendly rejected the Tax Court's reliance on "common law" doctrines of taxation, such as assignment of income and substance versus form, and instructed the Tax Court to reconsider the case under section 482.[48] According to the court, section 482 is preferable to the

36. 429 F.2d 650 (2d Cir. 1970), *rev'g* 51 T.C. 251 (1968).
37. 51 T.C. at 255 (1968).
38. *Id.*
39. *Id.* at 263.
40. *Id.* at 264.
41. *Id.* at 265.
42. I.R.C. § 61(a) (1976).
43. 51 T.C. at 266 (1968).
44. *Id.*
45. *Id.* at 265.
46. Rubin v. Commissioner, 429 F.2d 650 (2d Cir. 1970).
47. *Id.* at 652.
48. *Id.* at 653. I.R.C. § 482 had been used against taxpayers before in this type of case, with some success. *See* Danica Enterprises, Inc. v. Commissioner, 395 U.S. 933 (1969); Borge v. Commissioner, 405 F.2d 673 (2nd Cir. 1968), *cert. denied*, 395 U.S. 933 (1969); Ach v. Commissioner, 42 T.C. 114 (1964), *aff'd*, 358 F.2d 342 (6th Cir. 1966), *cert. denied*, 385 U.S. 899 (1966).

"blunt tool"[49] of section 61 or to the assignment of income doctrine. The court listed several reasons for the preference: section 482 provides greater flexibility over the all-or-nothing assignment of income approach; it more clearly commands analysis of the facts in terms of the competing tax policies; and it permits taxpayers taxed under section 482 to receive funds from the corporation without further tax.[50] In overturning the Tax Court's decision, the Second Circuit observed that the practical effect of applying the assignment of income doctrine in this situation would be to disregard the existence of the corporation.[51]

On remand, the Tax Court allocated the corporation's income to Rubin under section 482.[52] Rubin argued that as an individual taxpayer, he was not a "trade or business" and therefore section 482 was inapplicable.[53] The court rejected Rubin's contention that although it was not holding that employment status always constituted a trade or business,

> where the particular facts of a case are such as to justify a finding that a shareholder operated an independent business and merely assigned to the corporation a portion of the income therefrom, the business activity of the taxpayer may constitute a trade or business to which allocation of all or part of the income attributable to his efforts is authorized under section 482.[54]

This second Tax Court decision was affirmed by the Second Circuit,[55] which found a trade or business sufficient for the application of section 482.

In *Foglesong v. Commissioner* (*Foglesong I*),[56] the Commissioner again prevailed in the Tax Court on the assignment of income theory, only to suffer reversal on appeal.[57] Foglesong was a steel tubing sales representative who had sales agreements with two manufacturers to sell their products in specified geographical areas.[58] He formed a corporation to carry on his business and issued ninety-eight percent of the common stock to himself, one percent to his wife and one percent to his accountant.[59] The corporation also issued preferred stock to Foglesong's four minor children for a total consideration of $400, paid for by the taxpayer.[60] Foglesong immediately notified the two manufacturers of the arrangement and requested that future commission checks be made payable to the corporation.[61] Written agreements between the corporation and the manufacturers were not executed until three and four years later.[62]

---

49. *Rubin*, 429 F.2d at 653.
50. *Id.*
51. *Id.* at 652 n.3.
52. Rubin v. Commissioner, 56 T.C. 1155, 1161 (1971).
53. *Id.* at 1160.
54. *Id.* at 1161.
55. Rubin v. Commissioner, 460 F.2d 1216 (2d Cir. 1972).
56. 35 T.C.M. (CCH) 1309 (1976), *rev'd*, 621 F.2d 865 (7th Cir. 1980).
57. Foglesong v. Commissioner, 621 F.2d 865 (7th Cir. 1980) [hereinafter *Foglesong II*].
58. *Foglesong I*, 35 T.C.M. (CCH) at 1310.
59. The taxpayer paid for all of the stock; the accountant was made a shareholder merely to comply with state law. *Id.*
60. *Id.*
61. *Id.*
62. *Id.* at 1311.

Foglesong worked exclusively for the corporation although he did not have a written employment contract.[63] The corporation employed a secretary, paid taxpayer's sales expenses, carried its own insurance and complied with all formalities of a corporation.[64] As in *Rubin*, the individual's salary was substantially less than the income of the corporation, although his efforts produced all of the income.[65] The corporation paid the children $38,000 in dividends on their preferred stock over a four-year period.[66] The taxpayer contended he formed the corporation to obtain limited liability and to provide a better vehicle for expansion into new business ventures.[67] The Tax Court found, however, that the taxpayer's primary motive in forming the corporation was income tax avoidance.[68]

The Commissioner sought to have the income of the corporation taxed to Foglesong individually under the broad scope of section 61 and the theory of assignment of income. While the Tax Court recognized the principle that a taxpayer is free to arrange his business affairs to minimize taxes,[69] it cited *Lucas* for the proposition that income should be taxed to the taxable entity that actually earns it.[70] According to the court, where the corporation is not a mere sham and is admittedly a separate taxpayer, the issue is whether the corporation has been given sufficient corporate substance and sufficient control over the earning of the income.[71] The court held that the control of the income remained with the taxpayer, and therefore, under the doctrine of assignment of income, Foglesong should be taxed on it.[72] The Tax Court stated that since it found for the Commissioner using the assignment of income approach, it was unnecessary to rule on the Commissioner's argument that the income should be allocated to Foglesong under section 482.

The Seventh Circuit reversed the Tax Court and remanded in *Foglesong II*,[73] observing that it is inappropriate to use the assignment of income doctrine to achieve the same result as would follow if the corporation were treated as a sham. According "considerable deference" to Judge Friendly's holding in *Rubin*, the court stated:

> An attempt to strike a balance between tax avoidance motives and 'legitimate' business purposes is an unproductive and inappropriate exercise. Such an approach places too low a value on the policy of the law to recognize corporations as economic actors except in exceptional circumstances. This is true whether the analysis used to dismantle the corporation pursues the rubric of assignment of income or substance over form. Here there are other more precise devices for

63. *Id.*
64. *Id.*
65. In one year, for example, the corporation received $156,176 in income but paid the taxpayer only $41,500 in compensation. *Id.*
66. *Id.* at 1312.
67. *Id.* at 1311.
68. *Id.* at 1313.
69. *See* Commissioner v. First Sec. Bank, 405 U.S. 394, 398 n.4 (1972).
70. *Foglesong I*, 35 T.C.M. (CCH) at 1312.
71. *Id.*
72. *Id.* at 1314.
73. 621 F.2d 865, 866 (7th Cir. 1980).

> coping with the unacceptable tax avoidance which is unquestionably present in this case. But there is no need to crack walnuts with a sledgehammer. In the instant case, section 482 . . . appears available . . . .[74]

The court noted that when income is split artificially among several entities, the impact of the graduated income tax system is eroded.[75] Although the decision specifically required the Tax Court to reconsider the case under section 482, the court did not preclude the use of other "statutory provisions and 'common law' doctrines . . . to remedy potential tax abuse."[76]

Thus, the Second Circuit in *Rubin* and the Seventh Circuit in *Foglesong II* both have stated that using the assignment of income doctrine to determine that an employee of a personal service corporation is the "true earner" of the income for tax purposes is improper except in the most extreme cases. Under the rationale of these two cases, exercising the assignment of income theory is equivalent to holding that the corporations did not exist for tax purposes.

Two examples of "extreme" cases where the Commissioner may still prevail on the assignment of income theory are *Roubik v. Commissioner*[77] and *Jones v. Commissioner*.[78] In these cases, the determination was made that the taxpayer, not the corporation, really earned the income and the taxpayer was merely attempting to assign that income for tax purposes to the corporation. In *Roubik*, the Commissioner was successful in challenging the taxation of a professional radiology corporation on the theory that the business of the corporation was actually carried on by the individual doctors and the corporation was virtually ignored.[79] Four radiologists who did not practice together formed a professional corporation which adopted retirement and insurance plans.[80] Although each doctor signed an employment contract with the corporation, each continued to engage in his separate private practice.[81] The Commissioner did not challenge the corporate status of the corporation, but alleged that the corporation did not earn the income and the income should therefore be taxed to the individual doctors.[82] The Tax Court agreed, finding that individual doctors were the "true earners" of the income and the corporation merely served as a conduit for income and expenses.[83]

In *Jones v. Commissioner*, the taxpayer, an official federal court reporter, formed a corporation to conduct his business.[84] Federal law, however, required official court reporters to be individuals, not corporations.[85]

---

74. *Id.* at 872.
75. *Id.* at 868.
76. *Id.* at 872.
77. 53 T.C. 365 (1969).
78. 64 T.C. 1066 (1975).
79. *Roubik*, 53 T.C. at 379.
80. *Id.* at 368.
81. *Id.* at 372.
82. *Id.* at 378.
83. *Id.* at 379-81.
84. Jones v. Commissioner, 64 T.C. 1066, 1069 (1975).
85. *Id.* at 1076.

Since the corporation could not engage in court reporting, the Tax Court held that Jones assigned his court reporting income to the corporation in order to take advantage of the lower corporate tax rates.[86] Jones, not the corporation, earned the income and was held taxable on it.[87] Acknowledging that a corporation is not a "sham" if it was organized for legitimate business purposes or if it engages in a substantial business activity, the court stated,

> Recognition of the corporation as a viable tax entity does not completely bridge petitioner's journey over the pitfalls of Section 61(a) because petitioner's scheme was no more than an assignment of income earned by Mr. Jones.[88]

The assignment of income theory was further relied upon by the IRS in a letter ruling issued in April 1980,[89] to tax a physician for income earned by his medical corporation. The corporation observed corporate formalities and adopted a medical expense reimbursement plan and an employee stock ownership plan. The IRS determined, however, that the individual taxpayer "controlled" the income and therefore should be taxed on it.[90]

The letter ruling noted that in a small, closely held corporation, the issue is complicated when the corporation can only act through its agents, who are usually the controlling shareholders. The question is not who has control of the proceeds or who receives the income in the first instance, but "who is in control of the enterprise or of the capacity to earn the income."[91] Among the several factors which persuaded the IRS that the taxpayer personally retained control over the income was the fact that the corporation did not distribute all of its income.[92] Instead, it retained the income, which was taxed at lower rates, and made a substantial shareholder loan.[93] The corporation was therefore being used improperly to shift income to the lowest brackets for both taxpayers.[94]

Four days after this letter ruling was issued, the Seventh Circuit announced its decision in *Foglesong II*, which held the use of the assignment of income doctrine and section 61 "inappropriate" except in "exceptional circumstances" which don't seem apparent in this ruling.

RECENT CASES

Several cases decided within the past year would seem to have settled the assignment of income and section 482 issues in favor of the taxpayers except in unusual circumstances. Three cases, *Keller v. Commissioner*,[95]

86. *Id.*
87. *Id.* at 1077.
88. *Id.* at 1076.
89. CCH IRS Letter Rulings Reports No. 180, Aug. 13, 1980, Letter Ruling 8031028.
90. *Id.* The IRS applied section 61 and the principle that income should be taxed to the one who earns it.
91. *Id.*
92. *Id.*
93. *Id.*
94. *Id.*
95. 77 T.C. 1014 (1981).

Achiro v. Commissioner,[96] and *Pacella v. Commissioner*[97] sanction formation of personal service corporations to take advantage of corporate benefits for employees, including retirement plans, provided that all corporate formalities are complied with and the corporation is respected by all parties. As stated by the Tax Court in *Achiro*,

> The keynote in respondent's present position under sections 482, 269 and 61 is his contention that incorporation for the principal purpose of taking advantage of corporate pension and profit-sharing plans amounts to an evasion or avoidance of income taxes, an unclear reflection of income, and/or an assignment of income. We disagree.[98]

The Tax Court's decision on remand in *Foglesong v. Commissioner*[99] (*Foglesong III*) held that section 482 could be used to reallocate income from a personal service corporation to the individual where the employee's compensation package was less after incorporation than his income would have been absent incorporation. However, the Seventh Circuit reversed *Foglesong III* in *Foglesong v. Commissioner*[100] (*Foglesong IV*), holding section 482 inapplicable where the employee works exclusively for the corporation. On the other hand, *Johnson v. Commissioner*[101] is a recent example of the unusual case where the assignment of income may still be applicable.

In *Keller v. Commissioner*,[102] the taxpayer, a pathologist, was a partner with ten other physicians in a partnership ("MAL") which provided pathology services to many hospitals and physicians.[103] The partnership received its laboratory and technical support from a separate corporation ("MAL, Inc.") owned by the partners.[104] Approximately four years after Dr. Keller joined the partnership, he incorporated Keller, Inc. to take advantage of various benefits available to corporate employees.[105] Dr. Keller withdrew from the partnership and Keller, Inc. was substituted pursuant to a written agreement.[106] Dr. Keller agreed to personally guarantee all obligations arising out of the relationship.[107] He signed an employment agreement with his corporation and devoted all his professional time and effort

96. 77 T.C. 881 (1981).
97. 78 T.C. 604 (1982).
98. *Achiro*, 77 T.C. at 895.
99. 77 T.C. 1102 (1981).
100. 82-2 U.S. TAX CAS. (CCH) ¶ 9650 (7th Cir. Oct. 29, 1982).
101. 78 T.C. 882 (1982).
102. 77 T.C. 1014 (1981).
103. *Id.* at 1015.
104. *Id.*
105. *Id.* at 1016.
106. Dr. Keller entered into a similar arrangement with MAL, Inc. whereby Keller, Inc. was to receive the compensation for services rendered to MAL, Inc. This agreement, however, was not executed until more than one year after incorporation of Keller, Inc. The court held that Keller was personally taxable on such income from the date of incorporation to the date of the contract between Keller, Inc. and MAL, Inc. stating, "due to the contractual arrangement, petitioner performed the supervisory services for MAL, Inc. in his individual capacity. Thus, petitioner was the 'true earner' of this income and he, not Keller, Inc., must be directly taxed on it." *Id.* at 1027 n.14 (citation omitted).
107. *Id.* at 1017.

to this employment.[108]

Separate books and records of account were kept for Keller, Inc. and substantial care was taken to observe all corporate formalities.[109] Keller, Inc.'s name was substituted for Keller's on MAL's door, letterheads and test reports. Keller, Inc., however, owned no property, incurred no debt, had no employees except Dr. Keller and his wife and leased only one asset, an automobile.[110] The corporation adopted a medical reimbursement plan, a wage continuation plan, and a qualified defined benefit pension plan.[111] Substantially all of the income earned by the corporation was distributed to Dr. Keller as compensation, including salary, payments made on his behalf to the pension plan and payments made to him under the medical reimbursement plan.[112] Dr. Keller was the sole shareholder, sole director, and the principal beneficiary of the employee benefit plans.[113]

Relying on section 61, the assignment of income doctrine, and section 482, the Commissioner sought to tax Keller directly on 100% of Keller, Inc.'s income. The Tax Court held that section 482 rather than the assignment of income doctrine was the proper theory to be used in the case but that under section 482, the Commissioner's attempt to shift all of the corporation's income to Keller was arbitrary and capricious.[114] The issue under a section 482 analysis is whether Dr. Keller and the corporation would have entered into their financial relationship had they been unrelated parties dealing at arm's length. The court stated,

> the relevant inquiry is whether the total compensation (taking into account current salary as well as pension plan contributions and the medical expense reimbursements), which was paid to petitioner or contributed on his behalf after the incorporation of Keller, Inc. was essentially equivalent to that which he would have received absent incorporation.[115]

The court found that even though the total compensation to Keller was less than the income he would have received had the corporation not been formed, it was "not so off-the-mark as to bespeak a non-arm's length transaction."[116] The court recognized that Dr. Keller's *taxable* income was significantly reduced because of the corporation's contributions to benefit plans on his behalf, which were not included in his taxable income. This reduction, however, resulted from I.R.C. provisions which specifically provide for deferral and nonrecognition of income.[117] Since Keller's total compensation was approximately what it would have been had he not incorporated, it was not appropriate under such circumstances to use section

108. *Id.* at 1018.
109. *Id.* at 1020.
110. *Id.* at 1019.
111. *Id.* at 1026.
112. *Id.* at 1028.
113. *Id.* at 1016.
114. *Id.* at 1025. A small amount of income, however, was properly reallocated to Dr. Keller. *See supra* note 106.
115. *Keller*, 77 T.C. at 1025.
116. *Id.* at 1029.
117. *Id.*

482 to reallocate the income from the corporation to the individual.[118]

The court rejected the Commissioner's arguments, based on the doctrines of lack of business purpose and of substance over form, that the income should be taxed to Dr. Keller.[119] Efforts to obtain benefits such as retirement plans, which are a deliberate bestowal of benefits upon corporate employers and employees, do not render the taxpayer guilty of illegal tax avoidance or evasion.[120]

The Commissioner fared no better with his argument that under the doctrine of assignment of income, Keller should be taxed on Keller, Inc.'s receipts. The policy favoring recognition of corporations as entities independent of their shareholders requires that the corporate form not be ignored so long as the corporation actually conducts business.[121] The Tax Court found that Keller, Inc. clearly carried on the business of providing medical services.[122] The assignment of income doctrine continues to be an essential tool in cases such as *Roubik* and *Jones*,[123] where the corporation is not respected by the taxpayer/shareholder as a separate entity which carries on business activities. The doctrine has no effect, however, in a case such as *Keller*, where the corporation is respected as an independent entity and the stockholder/employee's compensation is based on a free bargain.[124]

In *Keller*, six judges joined in a strong dissent.[125] Noting that Keller, Inc. owned no equipment; employed no technicians or nurses; incurred no debts for rent, office or medical supplies; and had no medical records, business records, or any other item or paraphernalia of business whatsoever, the dissent felt that Dr. Keller was the "true earner," who simply assigned the income to a corporate shell he created.[126] Prior to the incorporation of Keller, Inc., Dr. Keller's pathology practice had already been divided in two with one-half of the income going to MAL, Inc. and the other half to the MAL partnership.[127] In the dissent's opinion,

> The addition of petitioner's corporation is one slice too many, tissue paper thin, without functional reality or economic substance. . . . [It] 'was nothing more than a few incorporating papers lying in a desk drawer of no significance except when a tax return is due.' (citation omitted) . . . Here the attenuated subtleties triumph over economic substance and practical reality, and form and artifice reclaim center stage of our tax laws.[128]

---

118. *Id.* at 1028.
119. *Id.* at 1030.
120. *Id.*
121. Moline Properties v. Commissioner, 319 U.S. 436, 439 (1943).
122. *Keller*, 77 T.C. at 1031.
123. *See supra* notes 77-88 and accompanying text.
124. *Keller*, 77 T.C. at 1033. The court also noted that the assignment of income doctrine applies to viable corporations in other contexts and it is one such application of this doctrine which required allocating to the individual the income received by the corporation for services performed by Dr. Keller before the contract between Keller, Inc. and MAL, Inc. was executed. *See supra* note 106.
125. *Keller*, 77 T.C. at 1035.
126. *Id.* at 1036.
127. *Id.*
128. *Id.* at 1036, 1039 (dissenting opinion).

The dissent cited *Lucas* for the proposition that cases should not turn on "attenuated subtleties."[129] In *Keller*, the dissent noted there was nothing but an "empty shell" having no control over business income and no reason to hold the corporation immune from application of the assignment of income doctrine. While the dissent correctly noted that the majority opinion cannot be reconciled with the assignment of income principles set forth in *Rubin* and *Foglesong I*,[130] those cases simply do not represent the current state of the law after having been reversed on appeal.

In *Achiro v. Commissioner*,[131] a case involving many of the same issues as *Keller*, the taxpayers, the two principal stockholders of two scavenger operating corporations, formed a third corporation ("A & R") to provide management services to the scavenger companies.[132] The taxpayers entered into an exclusive employment arrangement with A & R,[133] which in turn contracted with the scavenger operating companies to provide management services.[134] A & R was formed for the principal purpose of providing the taxpayers with the benefits of a qualified retirement plan.[135] The Commissioner asserted that all of A & R's income should be allocated to the scavenger corporations pursuant to sections 482 and 61, the assignment of income doctrine, the sham corporation theory or alternatively, under section 269.[136]

The Tax Court stated that the Commissioner's theories represented a frontal attack on a taxpayer's use of a personal service corporation,[137] and held that none of the income should be reallocated under any theory. The court conceded that while "a mere corporate skeleton, standing alone and without any flesh on its bones, will not suffice to provide its shareholder-employees with corporate retirement benefits,"[138] once a corporation is formed and all organizational and operational requirements are met, it should be recognized for tax purposes.[139] Section 61 had no application because A & R's rendition of management services amounted to carrying on business as a management company; therefore, under *Moline Properties*, the corporation must be recognized as a separate entity.

Using the "arms-length" test enunciated in *Keller*, the *Achiro* court

129. *Id.* at 1042 (dissenting opinion).

130. *Id.* at 1045. *See supra* notes 35-76 and accompanying text. The *Keller* dissent did criticize the Second Circuit's opinion in *Rubin* for dealing with "a half century of Supreme Court [assignment of income] decisions so cavalierly." 77 T.C. at 1043 n.9 (dissenting opinion).

131. 77 T.C. 881 (1981).

132. *Id.* at 885.

133. *Id.* at 886.

134. *Id.* at 885.

135. *Id.* at 888. The taxpayers issued only 48% of the stock of A & R to themselves and the remaining 52% to a brother of one of the taxpayers in an unsuccessful attempt to avoid the rules of § 414(b). Section 414(b) would have required A & R's pension to cover all of the rank and file employees of the scavenger corporations.

136. I.R.C. § 269 (1976), entitled "Acquisitions Made to Evade or Avoid Income Tax." Generally, if any person or corporation acquires either directly or indirectly, the property of another corporation and the principal purpose for which such acquisition was made is evasion or avoidance of federal income tax, then the Commissioner may disallow a resulting deduction, credit, or other allowance.

137. *Achiro*, 77 T.C. at 892.

138. *Id.* at 895.

139. *Id.* at 896.

found the management fee paid to A & R was reasonable; thus, the court refused to allocate A & R's income to the scavenger operating companies under section 482.[140] As in *Keller*, the court stressed that incorporation for the purpose of obtaining the benefits of a retirement plan does not in itself justify the imposition of section 482 allocations.[141]

The court employed similar reasoning in rejecting the Commissioner's attempted use of section 269.[142] This section disallows a deduction where a person acquires control of a corporation for the principal purpose of evading or avoiding income tax by securing the benefit of a deduction or credit which would not otherwise be enjoyed. According to the *Achiro* court, forming a corporation for the principal purpose of securing the tax benefits of employee retirement plans is not an evasion or avoidance of taxes; therefore, the section does not apply in such circumstances.[143]

The third recent Tax Court decision in favor of the taxpayer, *Pacella v. Commissioner*,[144] involved a New York psychiatrist who incorporated his practice to take advantage of corporate fringe benefits and to facilitate the eventual transfer of part of his practice to his children, who were also psychiatrists.[145] Finding that the corporation actually carried on business and the compensation which the taxpayer received from the corporation closely reflected what he would have received from an unrelated party, the court, following *Keller* and *Achiro*, refused to reallocate any income from the corporation to the doctor under section 61 or 482.[146]

Approximately one month after deciding *Keller* and *Achiro*, the Tax Court on remand in *Foglesong III*[147] held that section 482 may be used to allocate income between a corporation and its controlling shareholder/employee where financial relations between them fail to reflect arm's length dealings between uncontrolled parties.[148] The court observed that Foglesong would have recognized approximately $212,000 in additional income had he not incorporated.[149] If he had been dealing at arm's length with the corporation, the court opined he would not have accepted

140. *Id.* at 900.
141. *Id.* at 895.
142. *Id.* at 900.
143. The court acknowledged a private letter ruling (CCH IRS Letter Ruling Reports No. 135, May 8, 1979, Letter Ruling 7939003) which held that the formation of a corporation for the principal purpose of obtaining the benefits of a medical reimbursement plan or a corporate retirement plan amounts to tax avoidance for purposes of § 269. Private letter rulings, however, have no precedential authority, I.R.C. § 6110(j)(3) (1976), so the court did not adhere to the holding of this letter ruling. *But see* I.R.C. § 269A (added by sec. 250 of TEFRA, *supra* note 1) *infra* note 248.
144. 78 T.C. 604 (1982).
145. *Id.* at 606.
146. Although Dr. Pacella received total compensation of approximately $6,000 or $7,000 per year more prior to incorporation, the court cited *Keller* for the proposition that pension plan contributions may be worth more to a high-bracket taxpayer than outright taxable payments of an equivalent amount. The court stated: "We think it quite likely that a taxpayer in Dr. Pacella's position would value the tax deferral of roughly $20,000 in pension plan contributions a year at $6,000 or $7,000, and consequently, would have accepted employment with an uncontrolled corporation at such a lower salary." *Id.* at 621.
147. 77 T.C. 1102 (1981).
148. *Id.* at 1105.
149. *Id.* at 1106.

such a low level of compensation.[150]

Foglesong argued that section 482 could not apply to him because he was merely a corporate employee, not a separate trade or business as required by statute.[151] The court rejected this contention and held that section 482 is to be applied broadly and encompasses all kinds of business activity.[152] The taxpayer/employee and the corporation are separate taxable entities and separate trades or businesses; therefore, the requirement of section 482 that there be at least two organizations, trades or businesses, is met.[153]

The *Foglesong III* court observed that it is appropriate to use the corporate form to take advantage of certain tax benefits intended for corporations, such as retirement plans and medical reimbursement plans.[154] Foglesong, however, never adopted a retirement plan.[155] The corporation paid him approximately one-half of its income as compensation, paid his daughters preferred dividends and retained the balance, taxed at the lower corporate rates, for investment in the stock market.[156]

On October 29, 1982, the Seventh Circuit decided *Foglesong IV*[157] which reversed the Tax Court again, holding section 482 inapplicable because the "two businesses" requirement of the statute is not satisfied. According to the court, recent Tax Court decisions such as *Keller* have improperly applied section 482 to any type of entity which has independent tax significance. Thus, a corporation and its sole employee have been held to be separate trades or businesses for purposes of section 482 even though the employee works exclusively for the corporation and engages in no other business activity. Section 482 was intended to prevent profits of one business from being offset against the losses of another to reduce or escape tax liability. The section does not apply to one who works exclusively for his own corporation.[158] Although Foglesong had no employment contract with his corporation, the court stated, "we find his actual performance—exclusive work for the company—far more significant than any paper obligation.[159] The Seventh Circuit acknowledged that once the "two businesses" test is met, the proper test for the application of section 482 is "whether the compensation package the individual received from the corporation was less than what he would have received absent incorporation," citing *Pacella* and *Keller*.[160] However, section 482 is simply not applicable if the corporate employee works exclusively for his corporation.

The assignment of income doctrine may still be available to the Commissioner where the taxpayer makes an attempt to shift income. For ex-

150. *Id.*
151. *Id.* at 1104. .
152. *Id.*
153. *Id.*
154. *Id.* at 1106.
155. *Id.*
156. *Foglesong I*, 35 T.C.M. (CCH) 1309, 1311 (1976).
157. *Foglesong IV*, 82-2 U.S. TAX CAS. (CCH) ¶ 9650 (7th Cir. Oct. 29, 1982).
158. *Id.* at 85,371.
159. *Id.* at 85,373.
160. *Id.* at 85,371-372.

ample, Foglesong personally earned some commissions prior to incorporation but had them paid to the corporation. Furthermore, the corporation paid preferred dividends of $38,000 to his children on stock for which a total consideration of $400 was paid by Foglesong. The Seventh Circuit remanded the case to the Tax Court to determine if the assignment of income theory may be used to reallocate the dividends and compensation earned prior to incorporation to Foglesong individually.[161]

Another situation in which the assignment of income may still be applicable is where the corporate entity is not respected by the consumer of the corporation's services. For example, in *Johnson v. Commissioner*,[162] the taxpayer, a professional basketball player with the San Francisco Warriors, signed a contract with an unrelated Panamanian corporation, giving it exclusive "commercial and economic control" over his services.[163] In return, the taxpayer was to receive compensation in an amount far less than the corporation was receiving for his services.[164] In addition, the corporation agreed to make him interest-free loans.[165] The Warriors refused to sign a contract with the corporation, insisting that the taxpayer personally sign the standard player contract.[166] The team did agree to remit the taxpayer's compensation to the corporation if the taxpayer legally assigned the payments, which he did.[167] The taxpayer reported the amounts he received from the corporation as business income, but reported no wages or salary.[168] The Commissioner contended that the taxpayer was the "true earner" of the income received by the corporation and therefore should be taxed under the doctrine of assignment of income,[169] citing *Lucas*. In finding for the Commissioner, the Tax Court warned against an over-simplistic application of *Lucas* "whereby the true earner may be identified by merely pointing to the one actually turning the spade or dribbling the ball."[170] All corporations rely on the personal services of their employees to generate their income. The court stated:

> When a corporate employee performs labors which give rise to income, it solves little merely to identify the actual laborer. Thus a tension has evolved between the basic tenets of *Lucas v. Earl* and recognition of the nature of the corporate business form. . . . That tension is most acute when a corporation operates a personal service business and has as its sole or principal employee its sole or principal shareholder. . . . [T]he "who is taxed" . . . test may easily become sheer sophistry when the "who" choices are a corporation or its

161. *Id.* at 85,373.
162. 78 T.C. 882 (1982).
163. *Id.* at 886.
164. *Id.* at 885-86.
165. *Id.* at 887.
166. *Id.* at 884.
167. *Id.* at 885.
168. *Id.* at 889.
169. *Id.* The Commissioner had to rely on the assignment of income theory in *Johnson* because § 482 was inapplicable. Section 482 only applies when two or more businesses are controlled by the same person; in this case, the taxpayer did not control the Panamanian corporation. The court acknowledged that in cases where § 482 applies, it provides a "smoother route" to the same "who is taxed" result, citing *Pacella* and *Keller*. *Id.* at 890 n.13.
170. *Id.* at 890.

employees.[171]

The court noted that a better test is "who controls the earning of the income."[172] There is a two-part test in determining whether the corporation, rather than the employee, controls the income.[173] First, the service-performer must be a true employee of the corporation and the corporation must have the right to direct or control him or her in some meaningful sense. The court assumed, *arguendo*, that this standard was met in this case. Second, there must be a contract or agreement between the corporation and the person or entity using the services, recognizing the corporation's controlling position. This standard was not met in this case because the Warriors specifically refused to acknowledge that the corporation controlled Johnson's services.[174] Consequently, the taxpayer controlled the income and must be taxed on it.

It was this second standard which the court used to distinguish the *Fox* and *Laughton* cases cited by the taxpayer. In each of these two cases, although the amount the corporation received greatly exceeded the amount the corporation paid to the taxpayer, the court held that the excess amounts were not the taxpayer's income. In *Fox*, the employment relationship existed between the cartoonist taxpayer's corporation and the syndicate using the cartoons. Similarly, in *Laughton*, the actor taxpayer's corporation executed the contracts with the film studios. The *Johnson* court specifically pointed out, however, that the opinion is not meant to imply that the taxpayer would have prevailed had the team recognized the corporation and executed a contract with it.[175]

The following conclusions may be drawn from the foregoing cases. First, the corporation must act like a corporation and shareholders, employees and third parties must treat it as such. The requisite corporate formalities must be meticulously observed: dotting all the "i"s is critical. Second, a corporation may be recognized and taxed as a corporation even if the sole purpose of incorporation is to take advantage of various corporate benefit plans. Third, until the Seventh Circuit's decision in *Foglesong IV*, it appeared as if the courts would not sanction the use of a corporation to take advantage of lower corporate tax rates. However, if the corporation is truly engaging in business, and if the corporate employee works exclusively for his corporation and has no separate trade or business, it now appears, in the Seventh Circuit at least, that neither section 61, the assignment of income doctrine, nor section 482 is available to the Commissioner to reallocate income from the corporation to the individual taxpayer. *Foglesong IV* may open the door to more expanded use of the personal service corporation. Finally, even if the taxpayer does not work exclusively for his corporation, if he receives compensation from the corporation (which includes payments to benefit plans on his behalf) in an

171. *Id.* at 890 & n.13.
172. *Id.* at 891.
173. *Id.*
174. *Id.* at 893.
175. *Id.* at 893 n.21.

amount essentially equivalent to that which he would have received absent incorporation, the arrangement should be sustained.

THE IMPACT OF TEFRA ON CORPORATE RETIREMENT PLANS

Historically, the generous pension plan benefits available to corporate employees were probably one of the strongest inducements to incorporation of personal service corporations.[176] A corporate employee was permitted to shelter far more income from tax through corporate retirement plan contributions than was a self-employed person.

Since 1962, a self-employed person has been permitted to make tax-deductible contributions to a self-employed retirement plan, known as a Keogh Plan or an H.R. 10 plan.[177] The Economic Recovery Tax Act of 1981[178] increased the maximum annual contribution to such a plan from $7,500 to $15,000.[179] By contrast, in 1982, the maximum annual contribution a corporation can make on behalf of an employee to a defined contribution plan is $45,475.[180] Furthermore, the corporate maximum was indexed for inflation[181] while the self-employed maximum was not; therefore, this $30,475 advantage for corporate employees in 1982 would have increased in future years.

TEFRA, however, substantially changes corporate pension plans and self-employed Keogh retirement plans[182] to create parity between corporate employees and the self-employed.[183] One significant change is the equalization of contribution limits for both plans. The maximum dollar limitation on annual contributions to corporate defined contribution plans has been reduced to the lesser of twenty-five percent of compensation or $30,000[184] effective for years beginning after December 31, 1982, for plans in existence on July 1, 1982.[185] On the other hand, the existing limitation on contributions to self-employed plans (fifteen percent of earned income up to a maximum of $15,000)[186] has been repealed and the new corporate

176. *See, e.g.*, Battle, *supra* note 9, at 798; Nolan, *supra* note 9, at 161.

177. Self-Employed Individuals Tax Retirement Act of 1962, Pub. L. No. 87-792, 76 Stat. 809 (codified in scattered sections of 26 U.S.C.).

178. Pub. L. No. 97-34, 95 Stat. 172 (to be codified in scattered sections of 26 U.S.C.) [hereinafter cited as ERTA].

179. ERTA, *supra* note 178, at sec. 312(a) (amending I.R.C. § 404(e)). The maximum contribution equals the lesser of 15% of earned income or $15,000.

180. I.R.C. § 415(c)-(d) (West Supp. 1982); IR-82-18 (Feb. 3, 1982). This dollar limitation was $25,000 when enacted, I.R.C. § 415(c)(1); however, the maximum is indexed for changes in the consumer price index, I.R.C. § 415(d).

181. I.R.C. § 415(d) (West Supp. 1982).

182. TEFRA, *supra* note 1, at secs. 235-54.

183. The Conference Report accompanying the Tax Equity and Fiscal Responsibility Act of 1982 states: "The conference agreement generally eliminates distinctions in the tax law between qualified pension, etc., plans of corporations and those of self-employed individuals (H.R. 10 plans)." H.R. REP. No. 97-760, 97th Cong., 2nd Sess. 621 (1982). The American Bar Association's Standing Committee on Retirement of Lawyers and its Section of Taxation have worked to achieve equality of treatment between self-employed persons and corporate employees. *See* Nolan, *supra* note 9, at 158.

184. TEFRA, *supra* note 1, at sec. 235(a)(2) (amending I.R.C. § 415(c)(1)(A)).

185. TEFRA, *supra* note 1, at sec. 235(g). This change becomes effective for years ending after July 1, 1982 for plans not in existence on July 1, 1982.

186. TEFRA, *supra* note 1, at sec. 238(a) (amending I.R.C. § 404(e)).

limit (twenty-five percent of earned income up to a maximum of $30,000) has been made applicable to self-employed plans for years beginning after 1983.[187]

In the case of a defined benefit plan, a corporation may fund a pension for an employee equal to 100% of the average of his highest three years of compensation. Under current law, the maximum annual benefit that may be funded is $136,425[188] but TEFRA reduces this amount to $90,000.[189] The effective dates are the same as for the defined contribution plan changes. Under present law, a self-employed person was effectively prevented from funding such a plan at the same level as a corporate employee because of the special rules limiting benefit accruals found in section 401(j). TEFRA, however, repealed section 401(j);[190] therefore, employees and self-employed persons are now subject to the same limits on contributions and benefits for defined benefit plans.

Certain special qualification rules for Keogh plans under present law are repealed by TEFRA. For example, Keogh plans will no longer be required to have a bank or other approved financial institution serve as trustee[191] and need no longer benefit all employees with at least three years of service.[192] In addition, the section prohibiting owner-employees from making voluntary contributions to their plans[193] was repealed and such voluntary contributions will now be subject to the same limitations as for corporate employees.[194]

TEFRA extends certain present Keogh restrictions, such as the distribution rules[195] and the Social Security integration rules[196] to all qualified plans. Furthermore, TEFRA introduced a whole new set of rules for "top-heavy plans" (plans that provide more than sixty percent of the benefits to key employees), such as faster vesting schedules and minimum benefits for non-key employees.[197]

While a comprehensive discussion of these new rules is beyond the scope of this Article,[198] suffice it to say that TEFRA eliminates any advantage which a corporate employee might previously have enjoyed over his self-employed colleague.

---

187. TEFRA, *supra* note 1, at sec. 238(d) (amending I.R.C. § 401(c)(1)).

188. I.R.C. § 415(b), (d) (West Supp. 1982); IR-82-18 (Feb. 3, 1982).

189. TEFRA *supra* note 1, at sec. 235(a) (amending I.R.C. § 415(b)(1)(A)). However, TEFRA sec. 235(g)(4) allows excessive current benefits to be maintained for participants in the plan prior to 1983 if the plan was in existence on July 1, 1982 and the I.R.C. § 415 limits were observed for all earlier years.

190. TEFRA, *supra* note 1, at sec. 238(b) (repealing I.R.C. § 401(j)).

191. TEFRA, *supra* note 1, at sec. 237(a) (amending I.R.C. § 401(d)).

192. *Id.* The age and service requirements of I.R.C. § 401(a)(1) will now apply.

193. I.R.C. § 401(d)(5)(A)-(B) (West Supp. 1982).

194. I.R.C. § 415(c) (West Supp. 1982).

195. TEFRA, *supra* note 1, at sec. 242 (amending I.R.C. § 401(a)(9)).

196. TEFRA, *supra* note 1, at sec. 249 (adding new I.R.C. § 401(*l*).

197. TEFRA, *supra* note 1, at sec. 240 (adding new I.R.C. § 416).

198. *See generally*, *Tax Equity and Fiscal Responsibility Act of 1981, Law and Explanation*, STAND. FED. TAX REP. (CCH) (Aug. 25, 1982); *Concise Explanation of the Tax Equity and Fiscal Responsibility Act of 1982*, 63 FED. TAXES (P-H) Report Bulletin 36 (Aug. 23, 1982).

POST-TEFRA TAX ADVANTAGES OF CORPORATIONS

Although TEFRA removed the single most significant tax advantage, corporate retirement benefits, there are still substantial benefits for corporate employees of personal service corporations.[199] Most of these benefits are fully deductible to the corporation and excludible from the employee's gross income, but would not be deductible by the individual if self-employed.[200]

Medical Expense Reimbursement Plans

This benefit alone may make incorporation worthwhile and TEFRA indirectly makes it potentially more attractive. Under present law, an individual may deduct only medical expenses which exceed three percent of adjusted gross income.[201] TEFRA raises this floor to five percent of adjusted gross income for years beginning after 1982.[202] Therefore, after 1982, a taxpayer with adjusted gross income of $150,000 may not deduct the first $7,500 of medical expenses.

A corporation, on the other hand, may adopt a medical expense reimbursement plan under which it reimburses employees and their dependents for medical expenses, although the plan must not discriminate in favor of highly compensated individuals.[203] The corporation may then deduct the reimbursed medical expenses in full and without limitation,[204] while the employee may exclude these reimbursements from his gross income.[205] In other words, nondeductible medical expenses of the self-employed taxpayer up to five percent of his adjusted gross income would be fully deductible to the corporation through the reimbursement plan.

Other Insurance Plans

The corporation may acquire for its employees and deduct[206] the cost of up to $50,000 of group term life insurance with the cost of such insurance excluded from the employee's gross income.[207] TEFRA adds a new provision, however, which prohibits this exclusion if the plan discriminates in favor of key employees.[208] The corporation may also provide disability and health insurance, the costs of which are also excluded from the employee's gross income.[209] Under present law, a $5,000 death benefit paid to a corporate employee is excluded from gross income.[210] TEFRA ex-

199. *See generally*, R. WESTIN, MIDDLE INCOME TAX PLANNING AND SHELTERS ch. 10 (1982).
200. The Treasury Department is prohibited from issuing any fringe benefit regulations until after December 31, 1983. ERTA, *supra* note 178, at sec. 801.
201. I.R.C. § 213(a)(1) (1976).
202. TEFRA, *supra* note 1, at sec. 202 (amending I.R.C. § 213(a)).
203. I.R.C. § 105(h) (West Supp. 1982).
204. I.R.C. § 162 (West 1978 & West Supp. 1982).
205. I.R.C. § 105(b) (1976).
206. I.R.C. § 162 (West Supp. 1982).
207. I.R.C. § 79 (1976).
208. TEFRA, *supra* note 1, at sec. 244 (adding I.R.C. § 79(d)).
209. I.R.C. § 106 (1976).
210. I.R.C. § 101(b) (1976).

tends this exclusion to the self-employed for decedents dying after 1983.[211]

Rates

Corporate income tax rates are more favorable than individual rates, especially at lower income amounts. In 1982, the corporate tax rate on the first $25,000 of income is sixteen percent,[212] and this rate will go down to fifteen percent for tax years beginning after 1982.[213] The total income tax on the first $100,000 of corporate income is $26,250 in 1982 and $25,750 in later years.[214] The corporate rate on taxable income over $100,000 is forty-six percent.[215] A taxpayer could take advantage of the lower corporate rates by withdrawing a small salary and leaving the balance of the income in the corporation, to be taxed at the lower corporate rates. The corporate tax on the first $25,000 of the corporation's taxable income will be only $3,750 after 1982. Furthermore, it might even be possible to convert this remaining income into capital gain income, taxable at the effective rate of twenty percent, by a subsequent corporate liquidation or sale of stock.

In addition, a corporation receives a deduction equal to eighty-five percent of dividends received from domestic corporations.[216] Therefore, if the corporation invests in stock or even money market mutual funds, only fifteen percent of the dividends received are included in the corporation's gross income.

Fiscal Year

Another tax advantage is the possibility of deferring indefinitely one year's tax by the careful selection of the fiscal year for the corporation. Assume that the corporation adopts a fiscal year-end of January 31. The corporation can pay the employee a small salary from February through December and then pay a large bonus after December 31. The employee will report in his calendar year return only the nominal salary he received and will report the large bonus on his next year's return. The benefit of this deferral can be substantial. Deferring tax has the effect of borrowing money, interest-free, from the government. As one commentator noted,[217] if one year's tax liability of $20,000 can be deferred and invested to yield nine percent after tax, the deferral will be worth $152,461.54 in twenty-five years. Furthermore, as income increases through the years, the value of the deferral will increase.

It should be pointed out, however, that an attempt to manipulate income in this manner was one of the fatal flaws in *Foglesong III*.[218] Furthermore, in *Keller*, the Commissioner attacked the selection of the

211. TEFRA, *supra* note 1, at sec. 239 (amending I.R.C. § 101(b)(3)).
212. I.R.C. § 11(b) (West Supp. 1980).
213. *Id.*
214. *Id.*
215. *Id.*
216. I.R.C. § 243 (West 1978 & Supp. 1982).
217. Battle, *supra* note 9, at 799.
218. 77 T.C. 1102, 1107 (1981).

corporate fiscal year.[219] The *Keller* court noted that the corporation was not a party in the proceeding and left "for another day" the determination whether section 706(b)(2) required the corporation to adopt the taxpayer's calendar year.[220] The court observed, however, that since the corporation was a new taxpayer, it was free to adopt any taxable year it desired so long as the requirements of section 441 were satisfied.[221]

NON-TAX ADVANTAGES OF CORPORATIONS

In addition to tax benefits, the corporate form affords other advantages over a proprietorship or a partnership. A corporation affords easy transferability of ownership: sales or gifts of stock are easier to accomplish than transferring ownership of the assets of a proprietorship or admitting a new partner. In addition, the corporation may elect perpetual life. In contrast, a proprietorship terminates with the death of the proprietor, while a partnership dissolves with the addition or withdrawal of a partner.

Limited liability is another non-tax advantage of incorporation which should be considered. One of the traditional reasons for forming a corporation is to limit personal liability. Typically, contractual or tortious liability is limited to the extent of the assets of the corporation.[222] State law usually restricts limitation of liability for corporations which provide professional services, such as medical or legal corporations, and the professional will remain personally liable for his acts of malpractice and the negligence of employees under his control or supervision.[223] On the other hand, a shareholder in a professional corporation will usually not be liable for the negligence of a fellow professional and may enjoy limited liability for non-tortious claims.[224]

DISADVANTAGES OF INCORPORATION

There are several potential disadvantages to incorporation. For example, employment taxes will be somewhat higher; the self-employment tax for 1982 is 9.35%,[225] while the combined employer-employee tax for a corporate employee is 13.4%.[226] In 1982, with the wage base set at $32,400, the potential maximum difference is $1,312.20. Since the employer's share is deductible,[227] however, this differential is somewhat reduced.

In addition, the corporation will have to pay federal and state unemployment taxes, license fees, filing fees and franchise taxes. These expenses are usually relatively small. Another disadvantage is the cost of maintaining separate books and records, accounting ledgers, corporate minutes and by-laws and the cost of compliance with other corporate for-

219. Keller v. Commissioner, 77 T.C. 1014, 1034 (1981).
220. *Id.*
221. *Id.*
222. *See generally*, 18 C.J.S. Corporations § 580 (1939).
223. *See, e.g.*, ILL. REV. STAT. ch. 32, § 415-18 (1981).
224. *Id.*
225. I.R.C. § 1401 (Supp. IV 1980).
226. I.R.C. §§ 1301, 1311 (1976).
227. I.R.C. § 162 (West Supp. 1982).

malities. While the involved costs are not substantial, many find the burden of additional record-keeping substantial.

Another potential disadvantage is the double taxation of corporate income. If most of the corporate income is distributed in salary and benefits, however, there will be little corporate income left subject to taxation. To the extent that income is retained and subject to the corporate tax, it will, of course, be taxed again when and if distributed as dividends.

If an existing partnership incorporates, there may be an undesirable bunching of income where the partnership has a fiscal year-end. For example, if the partnership's year ends on June 30 and a corporation is formed on July 1, the taxpayer will include in his calendar year return the full year's income from the partnership plus his salary for six months. This bunching can be avoided by paying the corporate employee a lower salary for the first calendar year of the corporation's existence although such an attempt to "stabilize" income was a problem in *Foglesong I*.[228]

Unreasonable Compensation

May a personal service corporation pay out all of its earnings, less working capital needs, as compensation without encountering IRS objection on the basis of "unreasonable compensation"? The issue of unreasonable compensation is still unresolved with respect to personal service corporations.[229] Section 162(a)(1) allows a deduction for "reasonable" salaries or other compensation for personal services actually rendered; implementing regulations require that the salaries must not only be reasonable, but must also be payments "purely for services."[230] Generally, if there is capital invested in the corporation, a dividend, representing a reasonable return on the investment, should be paid. In a personal service corporation, however, there is usually little capital investment.[231] Nevertheless, the Code and regulations attempt to prevent a nondeductible "disguised dividend" from being deducted as compensation.[232] To the extent that a portion of the deduction is disallowed, double taxation will ensue: both the corporation and the recipient of the dividend distribution will be taxed on the income.

In a single shareholder/employee professional corporation, it would seem that the Commissioner would have a difficult time in contending that payments to the corporation's sole employee are unreasonable. The employee generated all of the income, which would have been compensation

228. 35 T.C.M. (CCH) 1309, 1313 (1976).

229. *See generally* Rosenbaum, *The Court of Claims Holding on a Legal PC's Reasonable Compensation: Problems Remain*, 55 J. TAX'N 138 (1981); Battle, *supra* note 9, at 808; Nolan, *supra* note 9, at 169.

230. Treas. Reg. § 1.162-7(a) (1960).

231. With computers and word processors becoming more prevalent in the offices of personal service corporations, however, more capital investment may become common. Also, a personal service corporation such as a law firm may possess substantial goodwill, to which some of the income may be attributable.

232. *See, e.g.*, Petro-Chem Marketing Co. v. United States, 602 F.2d 959 (Ct. Cl. 1979); Charles McCandless Tile Serv. v. United States, 422 F.2d 1336 (Ct. Cl. 1970).

earned had he not incorporated.[233] In the case of a corporation with several professionals and employees, however, the situation becomes more complicated. For example, in a large legal corporation, a substantial amount of profit may be attributed to the services of associates and paralegals. If all of this incremental income is paid to the shareholders as compensation, the Commissioner may successfully challenge the salary deduction as unreasonable compensation. If the corporation has a history of paying dividends, however, it can probably resist successfully any challenge of unreasonableness of compensation.

Personal Holding Company Tax

Another theoretical problem for a personal service corporation is the personal holding company tax.[234] The Internal Revenue Code imposes a penalty tax of fifty percent of the undistributed income of a personal holding company.[235] The purpose of the tax is to prevent a corporation from retaining income to take advantage of the lower corporate rates. A corporation must either distribute its income (in the form of compensation or dividends) or be subject to the penalty tax. To the extent that the corporation distributes all of its income, the tax is inapplicable. However, to the extent the corporation does retain some income, the question is whether the income earned by a personal service corporation is income from a personal service contract which would invoke the fifty percent personal holding company tax. The IRS appears to have answered this question in the negative.[236] Furthermore, contracts between the corporation and third parties can usually be drafted "around the statute" by making sure that the corporation retains the right to designate which corporate employee will perform under the contract.

MULTIFORM PARTNERSHIPS

In a relatively recent development in partnerships, many individual partners of partnerships have formed individual corporations and substi-

233. Battle, however, suggests that this proposition may not always be true, giving for example a one-man legal corporation which receives a contingent fee in a multi-million dollar verdict and pays the entire amount to its sole employee as compensation. He cites Petro-Chem Marketing Co., Inc. v. United States, 602 F.2d 959 (Ct. Cl. 1979), for the proposition that if an increase in the corporation's income is due to market conditions rather than solely to personal services, and the shareholder's compensation is significantly increased, the likelihood of an unreasonable compensation problem increases if the shareholder's compensation is significantly increased. In other words, the Commissioner may assert that the large contingent fee was due to the plaintiff's condition, not to the services of the attorney and if paid out, it is not "compensation." Battle, *supra* note 9, at 809.

234. A corporation is a personal holding company if at least 60% of its gross income is personal holding company income. I.R.C. § 542(a)(1) (1976). Personal holding company income includes dividends, interest, rent, royalties and income from "personal service contracts." I.R.C. § 543(a) (1976). A personal service contract is one in which someone other than the corporation has the right to designate who shall perform the services. I.R.C. § 543(a)(7) (1976).

235. I.R.C. § 541 (West Supp. 1982).

236. *See* Rev. Rul. 75-67, 1975-1 C.B. 169; CCH IRS Letter Ruling Reports No. 281, Apr. 14, 1982, Letter Ruling 8228018; CCH IRS Letter Rulings Reports No. 253, Sept. 25, 1981, Letter Ruling 8151082; CCH IRS Letter Rulings Reports No. 111, Apr. 17, 1979, Letter Ruling 7915042.

tuted these corporations as partners.[237] The partnership then consists of corporate partners and individual partners who chose not to incorporate. The advantage of this approach is to give each partner maximum flexibility in choosing employee benefits, especially retirement plans. In *Keller*, for example, Dr. Keller substituted his corporation for himself in the pathology partnership.[238]

In the late 1970's, two similar cases[239] were decided which gave impetus to this movement. In *Kiddie v. Commissioner*,[240] two doctors incorporated their practices and the corporations became partners in a medical partnership. Each corporation then adopted a retirement plan for the individual doctor. The Commissioner contended that staff employees had to be included in the doctors' corporate plans, to the extent of the corporations' pro rata shares of their compensation.[241] The taxpayers successfully argued that the support personnel were employees of the medical partnership, not of the individual medical corporations, and therefore, the corporations' plans did not have to cover these employees.[242] Congress immediately reacted to the theme of the *Kiddie* decision by adding section 414(m), which requires employees of all "affiliated service organizations" to be treated as employed by a single employer for retirement plan purposes.[243]

In 1981, the IRS issued a revenue ruling which explains the application of section 414(m).[244] This ruling provides guidelines as to when various businesses will be considered to constitute an affiliated service group and how this aggregation affects retirement plans maintained by members of the group. Example 1 of the ruling sets forth a law partnership consisting of three corporate partners and ten individual partners. Thus, it would seem that the IRS implicitly sanctioned not only the procedure wherein lawyers establish one-person professional services corporations, but also the viability of multiform partnerships.[245]

TEFRA, however, makes two major changes in this area. First, TEFRA extends the class of employers which must be treated as a single employer for purposes of retirement plans and medical expense reimbursement plans under section 414(m).[246] As amended, if an organization's principal business is to perform management functions for another organization, the person performing the functions and the organizations for whom the functions are performed are treated as a single employer.

---

237. *See generally* Harnack, *supra* note 3.
238. Keller v. Commissioner, 77 T.C. 1014, 1017 (1981).
239. Garland v. Commissioner, 73 T.C. 5 (1979); Kiddie v. Commissioner, 69 T.C. 1055 (1978).
240. 69 T.C. 1055 (1978).
241. *Id.* at 1057.
242. *Id.* at 1061.
243. *See generally* Neal & Conaway, *New Section 414(m) Limits Qualified Plan Abuse by Affiliated Service Organizations*, 54 J. TAX'N 258 (1981).
244. Rev. Rul. 81-105, 1981-1 C.B. 256.
245. See also CCH IRS Letter Ruling Reports No. 281, Apr. 14, 1982, Letter Ruling 8228018, which provides that the distributive share of a law partnership's income allocable to a corporate partner is not personal holding company income under I.R.C. § 543.
246. TEFRA, *supra* note 1, at sec. 246 (amending I.R.C. § 414(m)).

Second, TEFRA adds a new provision, section 269A,[247] entitled "Personal Service Corporations Formed or Availed of to Avoid or Evade Income Tax,"[248] which is directed at corporations whose principal activity is the performance of personal services for or on behalf of another corporation, partnership or entity. If such a corporation is used for the purpose of "avoiding or evading" income tax by securing for an employee-owner a tax benefit which would not otherwise be allowable, the Commissioner is authorized to reallocate the income, deductions and credits between or among the corporation and the employee-owners involved.[249] The TEFRA Conference Report explains the intent behind this provision:

> The conferees intend that the provisions overturn the results reached in cases like *Keller v. Commissioner*, where the corporation served no meaningful business purpose other than to secure tax benefits which would not otherwise be available.[250]

It is apparent that the Code no longer sanctions the multiform partnership. Congress understood, however, that many personal service corporations had been formed prior to TEFRA and adopted a special transitional rule[251] for such firms. Under this rule, personal service corporations may complete a one-month liquidation under section 333 during 1983 or 1984 without the risk of incurring tax on its unrealized receivables.

CONCLUSION

If required formalities are complied with, and if the corporation is actually engaged in business, the validity of the personal service corporation seems beyond attack by the IRS. *Keller* and *Achiro* indicate that practically any self-employed person may form a corporation to take advantage of the benefits available to corporate employees. This freedom to incorporate allowed the self-employed to end-run the Keogh restrictions if they so chose. Congress responded by eliminating the benefits of the corporate pension plan and by giving the Commissioner authority to reallocate income and deductions in the case of corporations providing personal services to another entity. *Foglesong II* and *IV* hold that if the employee works exclusively for his corporation and the corporation actually engages in business, undistributed corporate income may not be real-

---

247. TEFRA, *supra* note 1, at sec. 250.

248. *Id.* Section 269A(a) provides:

(a) General Rule. If

(1) substantially all of the services of a personal service corporation are performed for (or on behalf of) 1 other corporation, partnership or other entity, and

(2) the principal purpose for forming, or availing of, such personal service corporation is the avoidance or evasion of Federal income tax by reducing the income of, or securing the benefit of any expense, deduction, credit, exclusion, or other allowance for, any employee-owner which would not otherwise be available,

then the Secretary may allocate all income, deductions, credits, exclusions, and other allowances between such personal service corporation and its employee-owners, if such allocation is necessary to prevent avoidance or evasion of Federal income tax or clearly to reflect the income of the personal service corporation or any of its employee-owners.

249. *Id.*

250. H.R. REP. No. 97-760, 97th Cong., 2nd Sess. 634 (1982) (citation omitted).

251. TEFRA, *supra* note 1, at sec. 247.

located for tax purposes to the employee but may remain in the corporation, taxed at the lower corporate tax rates.

Individuals must now assess whether the post-TEFRA benefits of incorporation outweigh the disadvantages. If an individual expects to incur or to pay substantial medical expenses, for example, tax benefits that may be derived from a medical expense reimbursement plan alone may make incorporation worthwhile. In addition, lower corporate rates, the availability of insurance plans, and the possibility of deferring most of one year's tax provide some additional potential benefits. Limited liability, although restricted for a professional corporation by most states, and the other non-tax benefits of corporations provide additional considerations. On the other hand, the potential disadvantages of incorporation are relatively few and inexpensive.

At some future time, Congress may eliminate all tax distinctions between the self-employed and corporate employees. As the law now stands, there remains a viable, albeit somewhat more limited, future for use of the personal service corporation.