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SECTION 482: REALLOCATION OF PERSONAL SERVICE CORPORATION INCOME TO SHAREHOLDERS

Paul G. Marcotte, Jr.

Whether income earned by an incorporated personal service business is taxable to the individual or to the corporation is often the subject of reallocation proceedings brought by the Internal Revenue Service. In this article the author discusses the theories underlying income reallocation and the applicable Internal Revenue Code sections, focusing on section 482. The author analyzes in detail the factors courts consider in permitting or denying reallocation and identifies the conflicts among the circuits in the interpretation and application of section 482.

I. INTRODUCTION

It is a generally accepted rule of tax law that an individual is entitled to arrange his business affairs so as to minimize his overall tax liability. The classic statement of this principle is Judge Learned Hand's comment:

Over and over again courts have said that there is nothing sinister to so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.

Because of various nontax, as well as tax, considerations, individuals often choose to incorporate their personal service businesses.

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2. Traditional nontax reasons for incorporating one's business include limited legal liability, continuity of ownership and centralized management. See infra note 16.

3. Formerly, the principal tax advantages to be gained by incorporating one's business included the lower overall corporate income tax rates and the more generous
However, the many substantial tax advantages gained by incorporating one’s personal service business have made such arrangements vulnerable to Internal Revenue Service (IRS) attack on the theory that the retirement plan contributions available under corporate-sponsored retirement plans. However, recent legislation has dramatically reduced these advantages.

For tax years prior to 1982, the upper tax bracket for individual taxpayers reached 70%, while the upper tax bracket imposed on corporate taxpayers was 46%. This disparity was greatly reduced by the Economic Recovery Tax Act of 1981 (ERTA), Pub. L. No. 97-34, 95 Stat. 172 (1981). Section 101 of ERTA reduced the top tax bracket on individuals to 50%, effective for 1982 and years thereafter. The top corporate tax rate was left unchanged at 46%. For business taxpayers, there is a disparity of only 4% in the maximum tax rates between incorporated and unincorporated businesses. However, within certain income levels, incorporation can still reduce overall income tax liability even after ERTA. See infra note 4.

A substantial reason for the incorporation of many personal service businesses (particularly professional persons) has been eliminated by legislation. The Tax Equity and Fiscal Responsibility Act (TEFRA), Pub. L. No. 97-248, 96 Stat. 324 (1982), provides for parity between retirement plans established by corporations and unincorporated businesses. Currently, self-employed taxpayers are allowed to contribute to a Keogh or H.R. 10 retirement plan up to 15% of earned income, not to exceed $15,000 per year. I.R.C. § 404(e)(1) [hereinafter, all references will be to the Internal Revenue Code of 1954, as amended, unless otherwise indicated]. In contrast to a defined contribution retirement plan, a corporate taxpayer can currently contribute to a pension or profit sharing plan on behalf of an employee up to a maximum of $45,475.00. Id. § 415(c)(1)(A). If a defined benefit plan is established by a corporate taxpayer, the maximum contribution permitted is the amount calculated to provide the retiree-employee with an annuity not exceeding $136,425.00 annually. Id. § 415(b)(1). These contribution limitations are adjusted upward annually for any increase in the cost of living. Id. § 415(d).

TEFRA reduced the contribution limitations for qualified retirement plans maintained by corporations. The maximum contribution that can be made to a defined contribution retirement plan was reduced from $45,475.00 to $30,000.00. TEFRA, Pub. L. No. 97-248, § 235(a), 96 Stat. 324 (1982). The maximum contribution that can be made to a defined benefit pension plan was reduced from $136,425.00 to $90,000.00. The cost of living adjustment for the maximum contribution limitation is frozen for years before 1986. Id. § 235(c). At the same time, the contribution limitation formerly imposed on Keogh or H.R. 10 plans maintained by self-employed individuals was repealed. Id. § 238. These new limitations are effective generally beginning in 1983 for plans already in existence and immediately for new plans. Id. § 235(g).

TEFRA also provides additional requirements for qualified retirement plans which are treated as “top-heavy,” a new term introduced by TEFRA to describe plans which concentrate benefits in favor of key employees. A detailed description of the top-heavy provisions and other pension changes made by TEFRA is beyond the scope of this article. However, the requirements for such plans include minimum contributions for non-key employees and stricter vesting schedules. See id. § 240 for additional requirements.

As a result of TEFRA, there is no longer any practical difference between a corporate versus noncorporate retirement plan. Recognizing that many professionals had incorporated to achieve more favorable retirement plans, Congress has provided a means for many personal service corporations to liquidate without sizable tax liabilities. Section 247 permits personal service corporations to liquidate during 1983 and 1984 under the provisions of I.R.C. § 333 (one month liquidation) without realizing income on liquidation from uncollected receivables if the corporation uses a cash-basis accounting system. TEFRA, Pub. L. No. 97-248, § 247, 96 Stat. 324 (1982).
corporation's income is in fact earned by the individual shareholder and therefore should be taxed as such. As a result, the courts have had to face competing policy considerations. The use of the corporation as a separate taxable entity can reduce the overall impact of the graduated income tax rates, blurring the distinction Congress intended to create between individual and corporate tax rates. At the same time there is strong precedent recognizing the validity of corporations for tax purposes.

4. Assume for example that an individual is earning $40,000 in a sole proprietorship, is single, and has no other income or deductions. As a sole proprietor, this individual would pay federal income tax of $10,968 in 1982. If the individual incorporates his business, overall tax liability changes. Assume further that the corporation earns $40,000 before payment of the shareholder's salary and then pays the shareholder $20,000 as the reasonable value of services he provided to the corporation as an employee. The corporation pays income tax of $3,200 on corporate taxable income of $20,000 ($40,000 income minus $20,000 shareholder's salary) in 1982. The shareholder pays federal income tax of $3,442 on the $20,000 salary, which is his only source of income in 1982. The combined tax liability of the shareholder and corporation is $6,642 as compared to $10,968 if the shareholder operated the business as a sole proprietor. The net tax savings of $4,326 is due to the difference between individual and corporate tax rates.

As the level of business income increases, the benefit of the corporate income tax rates is reduced. As a result of ERTA, the disparity between the top tax bracket for corporate and individual taxpayers has been reduced to a mere 4%. Therefore, as the level of business income increases, there is now a lesser incentive to incorporate. See also supra note 3.

Incorporation can also increase the payroll taxes paid by the business. As a sole proprietor, the hypothetical individual in the example above would pay a self-employment tax of 9.35% on his net earnings from self-employment. By incorporating his business, the former sole proprietor becomes an employee of the business. Compensation paid to the shareholder as an employee of the business would be subject to combined federal social security taxes (FICA) of 13.4%, as well as federal and state unemployment taxes.

5. In Foglesong v. Commissioner, 621 F.2d 865 (7th Cir. 1980), on remand, 77 T.C. 1102 (1981), rev'd and remanded, 691 F.2d 848 (7th Cir. 1982), the Court of Appeals for the Seventh Circuit attempted to balance the competing policy considerations involved in taxing personal service corporation income to its shareholders. On the one hand, the court recognized that the impact of the graduated income tax rates is reduced when income can be divided artificially among several taxpayers. On the other hand, this factor must also be balanced against the policy of favoring recognition of the corporation as a separate legal entity. The following factors were stated by the court to be relevant in this situation:

1) whether the corporation and not the taxpayer is the party to the contracts under which services are performed; (2) whether the corporation is recognized to be a viable, taxable entity and not a mere sham; (3) whether nontax business purposes are present even though tax avoidance is apparently a major concern; (4) whether the corporation has not been formed for the purpose of taking advantage of losses incurred by a separate trade or business; (5) whether the corporate form (and the status of the corporation as an actual operating enterprise) has been consistently honored by the taxpayer and other parties to the transactions giving rise to the income; (6) whether the taxpayer does not render services as an employee to any entity other than the corporation; (7) whether the corporation is not disqualified from performing the services required of it by contract because the law requires these services to be performed by
The IRS has advanced numerous theories to reallocate the income generated by personal service corporations to the shareholders of those enterprises. To date, no one theory has dominated; however, recent case law suggests that reallocation pursuant to section 482 is the more appropriate approach.

This article briefly examines these various theories and focuses upon the use of section 482 as a reallocation vehicle. Analysis of recent case law will highlight the factors relied upon by the courts when deciding whether to permit or to deny income tax deficiency assessments resulting from the reallocation of a corporation's income to its shareholder.

II. INCOME REALLOCATION THEORIES OTHER THAN SECTION 482

The Commissioner of the Internal Revenue is empowered by Congress to reallocate income whenever he determines that such reallocation is necessary to prevent evasion of taxes or to clearly reflect income. Such income reallocation is most frequently triggered by the incorporation of a personal service business which was previously operated as a sole proprietorship. After incorporation, the corporation, rather than the individual shareholder, reports the income and deductions associated with the active conduct of the personal service business. Since there is generally no substantial change in the manner in which the business is conducted after incorporation, the incorporation process may be seen as a mere shuffling of papers. In such cases, it may be difficult to distinguish between the corporation and its shareholder as to the true earner of the income.

an individual; and (8) whether the entities paying or providing the income are not controlled or dominated by the taxpayer.

621 F.2d at 868-69; see also Moline Properties v. Commissioner, 319 U.S. 436 (1943). There the Supreme Court stated:

The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose is 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 . . . .

Id. at 438-39 (citations omitted).

6. I.R.C. § 482.

7. See I.R.C. §§ 61, 269, 482.

8. Operation of the business by an individual prior to incorporation is a common factor in reallocating income. However, this has not been controlling in any case decided to date. See, e.g., Foglesong v. Commissioner, 621 F.2d 865 (7th Cir. 1980), on remand, 77 T.C. 1102 (1981), rev'd and remanded, 691 F.2d 848 (7th Cir. 1982); Ach v. Commissioner, 42 T.C. 114 (1964), aff'd, 358 F.2d 342 (6th Cir.), cert. denied, 385 U.S. 899 (1966); Borge v. Commissioner, 26 Tax Ct. Mem. Dec. (CHI) 816 (1967), aff'd, 405 F.2d 673 (2d Cir. 1968), cert. denied, 395 U.S. 933, reh'g denied, 396 U.S. 869 (1969).
This problem most typically arises in the case of the one person corporation where the shareholder functions as both an owner and employee of the business. Under these circumstances, any separation of control between the owner-employee and the corporation is difficult, if not impossible, to produce. The Commissioner often takes the position that the income generated by the business is properly taxable to the shareholder and not to the corporation, because the shareholder-employee actually controls the earning of the business income.

The Commissioner relies upon several theories to justify the reallocation of income from a personal service corporation to its shareholder-employees. These theories include: (1) the sham corporation or alter ego theory; (2) the section 269 bar against acquisitions with a tax avoidance purpose; (3) the section 61 assignment of income doctrine; and (4) reallocation under section 482.

A. The Sham or Alter Ego Theory

The Commissioner has consistently attempted to attack personal service corporations by claiming that they are merely shams or the alter egos of their owners. This theory has not, however, been favorably received by the courts. According to the United States Supreme Court,


The theory behind a corporation for business and tax purposes is that the corporation is an entity separate and apart from its owners, the shareholders. Provided the corporation is so operated, it is considered a separate artificial person. The shareholders generally have only an investment interest in the corporation, with management decisions vested in the board of directors and the officers.


11. See, e.g., Epperson v. United States, 490 F.2d 98 (7th Cir. 1973).


15. See, e.g., Epperson v. United States, 490 F.2d 98 (7th Cir. 1973) (failure to follow corporate formalities, income reallocated to shareholder); Phillipp Bros. Chem., Inc. v. Commissioner, 435 F.2d 53 (2d Cir. 1970) (five commonly controlled foreign corporations were regarded as shams and their income was reallocated to the common parent). But cf. Foglesong v. Commissioner, 621 F.2d 865 (7th Cir. 1980) (corporation held not to be a sham despite strong tax avoidance motive), on remand, 77 T.C. 1102 (1981), rev'd and remanded, 691 F.2d 848 (7th Cir. 1982); Ach v. Commissioner, 42 T.C. 114 (1964) (same), aff'd, 358 F.2d 342 (6th Cir.), cert. denied, 385 U.S. 899 (1966).
when a corporation is either organized for a business purpose or actually carrying on a business activity, it remains an entity separate and apart from its shareholders. However, when the shareholders have disregarded the corporate entity and treated the business as their own, the courts have not hesitated to declare the corporation a mere sham and reallocate its entire income to the shareholders.

Such disregard and resulting reallocation is found in *Roubik v. Commissioner.* In *Roubik*, four radiologists formed a professional service corporation and each of the physicians entered into an employment contract with the corporation. After incorporation, however, each physician continued to engage in his individual practice. In fact, no contracts were entered into with local hospitals substituting the corporation for the individual physician as the provider of services. Instead, checks made payable to the physicians were endorsed over to the corporation. The tax court determined that the corporation was not the true earner of the income it reported, but rather a mere shell. As a result, the income allegedly generated by the corporation was reallocated to the four physicians.

**B. Section 269 Tax Avoidance Purpose**

An alternative theory relied upon by the Commissioner to deny the advantages of the corporate form to a personal service business

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16. Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 438-39 (1943) (gains from sale of real estate held properly taxable to corporation rather than to shareholder; corporate entity not ignored as fictitious). Generally, a valid business purpose will be found if one of the reasons for incorporating the business was to limit legal liability, achieve centralized management, or achieve continuity of ownership. The courts have, similarly, indicated that only minimal activity is necessary to satisfy the business activity requirement. See, e.g., Bass v. Commissioner, 50 T.C. 595 (1968), where the corporation's investment in working interests in oil and gas leases was held to be a sufficient business activity. In that case, the tax court indicated that whether a corporation is a sham should not depend upon the personal purpose of the shareholder in forming the corporation; rather, the key test is the purpose to be accomplished through the corporation. If the purpose is to carry on a business activity, or the corporation is in fact carrying on a business activity, it is not to be disregarded. *Id.* at 601-02; see also Siegel v. Commissioner, 45 T.C. 566 (1966) (investment in joint venture engaged in foreign farming operations satisfied business activity requirement), *acq.* 1966-2 C.B. 7; Cukor v. Commissioner, 27 TAX CT. MEM. DEC. (CCH) 89 (1968) (fact that corporation became a partner in a joint venture supported petitioner's contention that the corporation was engaged in a substantial business activity and was not a sham).

17. *See, e.g.,* Patterson v. Commissioner, 25 TAX CT. MEM. DEC. (CCH) 1230, 1235 (1966) (taxpayer's controlled corporation disregarded due to failure to follow corporate formalities; taxpayer held not to have put flesh on bones of corporate skeleton sufficiently for it to be recognized for tax purposes), *aff'd,* 68-2 U.S. TAX CAS. (CCH) ¶ 9471 (2d Cir. 1968).


19. *Id.* at 372. In fact, the hospitals were not notified of the existence of the corporation until the time of trial. *Id.*

20. *Id.* at 379, 381. The tax court likened the corporation to nothing more than "a mere set of bookkeeping entries and bank accounts." *Id.* at 379.
arises under section 269. 21 This section provides that if any person acquires control of a corporation for the principal purpose of evading or avoiding taxes by securing certain benefits the Commissioner may disallow such benefits. 22

The crucial question in applying section 269 to personal service corporations is whether the formation of a corporation to secure the benefits of more favorable retirement plan contributions and other fringe benefits is a tax avoidance purpose. This question was recently answered in Achiro v. Commissioner 23 where it was found that the petitioners' principal purpose in forming a management corporation was to obtain increased retirement plan benefits. 24 The tax court refused to permit reallocation under section 269, specifically stating that the formation of a corporation for the primary purpose of securing the benefits of a retirement plan is not an evasion or avoidance of taxes. 25

In Keller v. Commissioner, 26 a case factually dissimilar to Achiro but also involving the issue of fringe benefits not available to self-employed persons, the tax court again refused to permit reallocation of the corporation's income, stating:

The Code provisions relating to qualified retirement and medical plans are a deliberate Congressional bestowal of

21. Section 269 may be summarized to read:

[I]f any person or . . . corporation acquires . . . control of a corporation . . . and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary may disallow such deduction, credit, or other allowance.

I.R.C. § 269(b). In any such case, the Secretary is authorized to "distribute, apportion, or allocate gross income, and distribute, apportion, or allocate the deductions, credits, or allowances which the benefit of which was sought to be secured, between or among the corporations . . . ." Id.

Although section 269 is generally applied to the acquisition of one corporation by another, the regulations indicate that it is equally applicable to an individual who incorporates. See Treas. Reg. § 1.269-3(b)(2) (1982); see also Coastal Oil Storage Co. v. Commissioner, 242 F.2d 396 (4th Cir. 1957) (section 269 used to deny surtax exemption to newly formed corporation). But cf. Rev. Rul. 76-363, 1976-2 C.B. 90 (section 269 not applicable to deny corporation advantages of Subchapter S).


24. Id. at 888. Although the Commissioner was not permitted to reallocate the corporation's income, the petitioners were denied the retirement benefits for which, among other reasons, they had incorporated. Id. at 905-08.

25. Id. at 900; see also Keller v. Commissioner, 77 T.C. 1014, 1029-30 (1981) (reallocation denied although major purpose for incorporating was to achieve pension plan benefits), appeal docketed, No. 82-1414 (10th Cir. Apr. 7, 1982). See generally Battle, The Use of Corporations by Persons Who Perform Services to Gain Tax Advantages, 57 Taxes 797 (1979) (author suggests that Commissioner is effectively estopped from using section 269 to attack personal service corporations because the section has not been utilized in recent cases) [hereinafter cited as Battle].

26. 77 T.C. 1014 (1981), appeal docketed, No. 82-1414 (10th Cir. Apr. 7, 1982).
benefits upon employers and employees; efforts to obtain the advantages of these benefits, by way of conducting business in the corporate form, are not to be deemed to render the taxpayer culpable of illegal tax avoidance or evasion.\textsuperscript{27}

The trend, at least in the tax court, is clear. Section 269 is not an appropriate vehicle for the reallocation of personal service corporation income when the Commissioner's allegations are based solely upon the shareholder's attempt to obtain or increase fringe benefits. Rather, the Commissioner must utilize the more precise tools within his arsenal.

C. \textit{Section 61 Assignment of Income Doctrine}

The section 61 assignment of income\textsuperscript{28} doctrine is generally argued by the Commissioner in conjunction with another of the reallocation of income theories, particularly section 482.\textsuperscript{29} This doctrine states that income is taxable to the one who earns it, and the tax on that income cannot be avoided by an anticipatory arrangement.\textsuperscript{30} The personal service corporation is attacked on the theory that the shareholder, rather than the corporation, earned the income in question and merely assigned it to the corporation.

An example of the use of this doctrine is found in \textit{Johnson v. Commissioner}\textsuperscript{31} where the taxpayer, a professional basketball player, contracted his services to an unrelated corporation in return for a monthly payment. At the same time, Johnson had an employment contract with a basketball club. Although the corporation was not a party to this contract, the club made payments under it directly to the corporation. Since no contract, express or implied,\textsuperscript{32} existed between the corporation

\textsuperscript{27} 77 T.C. at 1030.
\textsuperscript{28} I.R.C. § 61.
\textsuperscript{30} See I.R.C. § 61. In Lucas v. Earl, 281 U.S. 111, 115 (1930), Justice Holmes made the classic statement of the assignment of income doctrine: that the court would not recognize "arrangements by which the fruits are attributed to a different tree from that on which they grew." Thus, a taxpayer may validly make a gratuitous transfer of his income to another, but he remains liable for the income tax. Subsequent case law generally discusses the doctrine in terms of analogy to fruit of the tree. Generally, if the taxpayer gives up all rights to property that produces income, all income generated after that transfer will be taxed to the recipient and not the transferor. See Helvering v. Horst, 311 U.S. 112 (1940). For a more recent case involving assignment of income principles, see United States v. Basye, 410 U.S. 441 (1973).
\textsuperscript{31} 78 T.C. 882 (1982).
\textsuperscript{32} Id. at 893. In an earlier decision, Pacella v. Commissioner, 78 T.C. 604, 619 (1982), the tax court held that the required contract between the corporation and service user could be oral or implied. However, in \textit{Johnson} no implied contract could be found because the basketball club had specifically refused to contract
and the club regarding the services provided by Johnson, the tax court held that the payments were taxable as income to him. Relying on assignment of income principles, the court viewed the arrangement as a mere anticipatory assignment of income earned by the taxpayer.

A split of authority exists, however, as to whether the assignment of income doctrine can be used to tax shareholders on corporate earnings. The Second Circuit has held that section 482 is the preferable approach in reallocating the income of a personal service corporation to its shareholders. The tax court, on the other hand, has indicated that the assignment of income doctrine may be used to reach the same result as would a section 482 reallocation. The issue has been further confused by two conflicting Seventh Circuit decisions rendered in the same case, Foglesong v. Commissioner. In its first opinion, the Sev-

with a party other than the taxpayer. Johnson v. Commissioner, 78 T.C. 882, 893 (1982).

American Sav. Bank v. Commissioner, 56 T.C. 828 (1971), presents another fact pattern. In this case, two individuals held all of the stock in a corporation which sold life insurance through outside agents. In addition, the two shareholders furnished management services to a local bank in return for fees which were paid to the same wholly-owned corporation. The management corporation did not pay any compensation for the services of the two nor did they enter into any employment contracts. The tax court decided the case on assignment of income principles, refusing to permit reallocation of the insurance commissions because the income was actually earned by the corporation through outside agents. With respect to the management services income, however, the court concluded that such income was properly taxable to the shareholders because they, not the corporation, controlled the earning of the management fees. Id. at 842.

34. See Rubin v. Commissioner, 429 F.2d 650 (2d Cir. 1970), on remand, 56 T.C. 1155 (1971), aff'd per curiam, 460 F.2d 1216 (2d Cir. 1972). In its first opinion, the Second Circuit stated:

We believe the Tax Court erred in its approach to the problem. Resort to 'common law' doctrines of taxation and the broad sweep of §61 may occasionally be useful in connection with 'transactions heavily freighted with tax motives' which cannot be satisfactorily handled in other ways. [B]ut they have no place where, as here, there is a statutory provision adequate to deal with the problem presented . . . . Resort to section 482 is clearly superior to the blunt tool employed by the Tax Court 429 F.2d at 653.

35. See Keller v. Commissioner, 77 T.C. 1014 (1981), appeal docketed, No. 82-1414 (10th Cir. Apr. 7, 1982). In Keller, the tax court suggested that the assignment of income doctrine leads to substantially the same result as an allocation under section 482, and that the assignment of income doctrine can be used in a situation where the corporation is not respected by the taxpayer-shareholder as a separate entity. But cf. Morrison v. Commissioner, 44 TAX CT. MEM. DEC. (CCH) 1459, 1468 (1982). (court specifically refused to invoke assignment of income doctrine which would effectively disregard the corporation).

36. 35 TAX CT. MEM. DEC. (CCH) 1309 (1976), rev'd and remanded, 621 F.2d 865 (7th Cir. 1980), on remand, 77 T.C. 1102 (1981), rev'd and remanded, 691 F.2d 848 (7th Cir. 1982). In Foglesong, a taxpayer who was a sales representative for two steel tubing companies incorporated his personal service business. The common stock in the corporation was owned entirely by the taxpayer, his wife, and a small percentage by his accountant. The corporation issued preferred stock entirely to the
enth Circuit held section 482 to be "generally" applicable, and in regard to the applicability of the assignment of income doctrine, stated:

We believe that, where the issue is application of the assignment of income doctrine to effectively set aside the corporation, ... 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. ... Here there are other more precise devices for coping with the unacceptable tax avoidance which is unquestionably present in this case. But there is no need to crack walnuts with a sledge hammer. ...

**Foglesong I** was remanded to the tax court for consideration of the issues surrounding the Commissioner's claim under section 482 and the applicability of other more precise theories.\(^{38}\)

On remand, the tax court held section 482 to be the appropriate reallocation authority\(^{39}\) and the case was again appealed to the Seventh Circuit. **In Foglesong II** the Seventh Circuit appears to have reversed

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37. 621 F.2d at 872. The Seventh Circuit stated that although section 482 appeared available to the Commissioner for purposes of reallocating the income of the personal service corporation to its shareholder, other statutory and common law doctrines with a more limited application are also available to combat abusive situations. \(\text{Id.}\)

38. \(\text{Id.}\)

39. 77 T.C. at 1106-07.
its decision in *Foglesong I*. In this second opinion the court held section 482 to be inapplicable and remanded the case, once again, for consideration of whether assignment of income principles would be available to combat the tax abuse alleged to exist in that case.\(^40\) Because of the confusion and conflict regarding the proper use of section 482 and the assignment of income doctrine, it appears that this issue is ripe for Supreme Court review.

III. SECTION 482 IN GENERAL

Section 482 is a model of brevity seldom paralleled in the Internal Revenue Code. It simply states:

> In 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 [Commissioner] 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 such organizations, trades, or businesses.\(^41\)

The Treasury Regulations state that the purpose of section 482 is to place a controlled taxpayer on the same basis in respect to the computation of true taxable income as an uncontrolled taxpayer, meaning that the corporation and taxpayer must deal at arm’s length to avoid reallocation.\(^42\)

\(\text{A. Requirements and Burden of Proof for Application of Section 482}\)

Three requirements must generally be met in order to reallocate income under section 482: (1) there must be two or more organizations, trades, or businesses; (2) such enterprises must be owned or controlled by the same interests; and (3) reallocation of income among the enter-

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\(^40\) 691 F.2d at 853.

\(^41\) I.R.C. § 482. This section is derived from section 240(d) of the Revenue Act of 1921, which gave the IRS authority to consolidate the accounts of related trades or businesses to prevent the arbitrary shifting of profits. *See* Revenue Act of 1921, ch. 136, § 240(d), 42 Stat. 260. This provision was reenacted as section 240(f) of the Revenue Act of 1926 which gave taxpayers the right to require consolidation of accounts. *See* Revenue Act of 1926, ch. 27, § 240(f), 44 Stat. 46. However, section 45 of the Revenue Act of 1928 eliminated this taxpayer right because taxpayers, who would not otherwise be eligible to do so, were given the right to file consolidated returns. *See* Revenue Act of 1928, ch. 852, § 45, 45 Stat. 806. After the Revenue Act of 1928, few changes were made to the statute. However, a significant change was made in the Revenue Act of 1934 which added the term “organizations” to the classification of “trades or businesses” to broaden the scope of that section. *See* Revenue Act of 1934, ch. 277, § 45, 48 Stat. 695.

prises must be necessary in order to prevent the evasion of taxes or to clearly reflect their respective income. The courts have generally held that proof of a tax avoidance motive on the part of the taxpayer is not required in order to utilize section 482. Nevertheless these requirements have posed little obstacle to the IRS in reallocating personal service income.

The requirement that there be at least two organizations, trades, or businesses raises the question of whether the employment relationship between the shareholder-employee and the corporation qualifies as a trade or business for purposes of a section 482 reallocation. The treasury regulation states that the term "organization" means "any organization of any kind, whether it be a sole proprietorship, a partnership, a trust, . . . or a corporation, . . . irrespective of the place where organized, where operated, or where its trade or business is conducted, . . . ." The regulation also broadly defines the phrase "trade or business" to include: "any trade or business activity of any kind, regardless of whether or where organized, whether owned individually or otherwise, and regardless of the place where carried on." The legislative history of section 482 supports a broad construction of the phrase "trade, business, or organization." Despite arguments to the contrary, the courts have construed these broad definitions to include the

43. See Wilson v. United States, 530 F.2d 772, 777 (8th Cir. 1976) (tax avoidance motive not required before section 482 can be invoked when stock of corporation providing consulting services was eventually transferred to children of taxpayer and taxpayer received inconsequential compensation for his services); Rubin v. Commissioner, 460 F.2d 1216, 1218 (2d Cir. 1972) (tax avoidance motive immaterial); see also Treas. Reg. § 1.482-1(c) (1981) (Commissioner not restricted under section 482 to cases of fraudulent, sham or avoidance-type activities).

However, at least one case has held to the contrary. See Ruddick Corp. v. United States, 643 F.2d 747 (Ct. Cl. 1981) (in absence of tax evasion or avoidance motive, section 482 cannot be used to modify a transaction merely because some income distortion may occur); see also Fuller, Section 482 Revisited, 31 Tax. L. Rev. 475, 529 (1976) (restraint in applying section 482 by Commissioner is necessary and such restraint may take the form of distinguishing business and tax motivated transactions) [hereinafter cited as Fuller].

45. Id. (a)(2).
46. The Report of the Ways and Means Committee states:

Under Section 45 of the existing law, the Commissioner has authority to allocate items of income or deductions between trades or businesses which are owned or controlled by the same interest, when such allocation is necessary to prevent evasion of taxes. While it is believed that the language of the present law is broad enough to include "organizations," this word is added to remove any doubt as to the application of this Section to all kinds of business activity.

H.R. Rep. No. 704, 73d Cong., 2d Sess. (1934), reprinted in 1939-1 C.B. 545, 572 (emphasis added). See also supra note 41. The legislative history provides some support to the courts in allocating the income of a personal service corporation to a shareholder-employee, if the individual is considered an organization separate and apart from the corporation.

47. See infra note 88 and accompanying text.
employment relationship.\footnote{48}

However, at least one court has held that the mere employment relationship between a shareholder and a personal service corporation does not satisfy the dual business requirement. In the second opinion rendered in \textit{Foglesong v. Commissioner},\footnote{49} the Seventh Circuit reasoned that section 482 could not be applied when a shareholder renders services exclusively to his corporation because the individual is not engaged in business apart from the corporation.\footnote{50} Therefore, section 482 is potentially applicable only when the shareholder does not work exclusively for his corporation. By its holding in \textit{Foglesong II}, the Seventh Circuit refused to extend the scope of section 482 beyond the original intentions of Congress. Whether other courts will follow the lead of the Seventh Circuit remains to be seen.\footnote{51}

The control requirement has similarly provided little assistance to the shareholder-employee seeking to avoid an income reallocation. Under the regulations control includes any kind of control, whether direct or indirect and whether exercised or exercisable.\footnote{52} The courts have interpreted control expansively, requiring only the ability to control a corporation, not actual control, as a prerequisite to application of section 482.\footnote{53} Because of this interpretation, commentators suggest

\footnotesize{\begin{itemize}
\item \footnote{48} See, e.g., Keller v. Commissioner, 77 T.C. 1014, 1022 (1981) (the dual business or organization requirement is to be broadly construed), appeal docketed, No. 82-1414 (10th Cir. Apr. 7, 1982); Rubin v. Commissioner, 56 T.C. 1155, 1162 (1971) (tax court held that assignment of income doctrine may be used for the limited purpose of finding an employee to be engaged in a trade or business separate and apart from a corporation which employs him), \textit{aff'd per curiam}, 460 F.2d 1216 (2d Cir. 1972); Ach v. Commissioner, 42 T.C. 114, 124 (1964) (taxpayer held to be a separate organization for purposes of section 482), \textit{aff'd}, 358 F.2d 342 (6th Cir.), \textit{cert. denied}, 385 U.S. 899 (1966).
\item \footnote{49} 691 F.2d 848 (7th Cir. 1982).
\item \footnote{50} Id. at 851.
\item \footnote{51} The Second Circuit, in Rubin v. Commissioner, 460 F.2d 1216 (2d Cir. 1972) (per curiam), has taken a contrary view of the issue. The court approved the decision of the tax court that the taxpayer's rendering of management services through his controlled corporation was the equivalent of a trade or business for purposes of the dual business requirement of section 482. \textit{Id.} at 1218. Since both the Second and Seventh Circuits are split on this issue, review by the Supreme Court is probably not far off.
\item \footnote{52} Treas. Reg. \textsection 1.482-1(b)(1) (1981) states that a prerequisite to the application of section 482 is common ownership or control by the taxpayers. The treasury regulation defines control as follows:

\begin{quote}
The term "controlled" includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.
\end{quote}

\textit{Id.} (a)(3).
\item \footnote{53} See, e.g., Ach v. Commissioner, 42 T.C. 114 (1964) (fact that all stock was held in corporation by taxpayer's relatives was irrelevant as taxpayer had sufficient control to have such stock transferred to her without consideration; actual control, not record ownership, is the proper test), \textit{aff'd}, 358 F.2d 342 (6th Cir.), \textit{cert. denied}, 385 U.S. 899 (1966); \textit{see also} Achiro v. Commissioner, 77 T.C. 881 (1981) (54% of
that the control requirement is largely irrelevant in the case of personal service corporations, where typically only a few individuals will be vested with management powers.\textsuperscript{54}

The third requirement, that reallocation be necessary to prevent the evasion of taxes or to clearly reflect income, appears to be presumptively met from the very outset. Section 482 is used when income or deductions are arbitrarily shifted between a taxpayer and his corporation. The necessity of a section 482 reallocation is measured by whether the shareholder deals with his controlled personal service corporation as he would if it were uncontrolled.\textsuperscript{55}

This presumption flows from the burden of proof which generally favors the Commissioner in section 482 reallocation disputes. The Commissioner is vested with broad discretion under the tax law; his determination will be overturned only if the taxpayer can show that reallocation is arbitrary, capricious, or unreasonable.\textsuperscript{56} Whether the

54 \textit{See generally Seieroe & Gerber, Section 482 — Still Growing at the Age of 50, 46 Taxes} 893 (1968) (trend of cases suggests that control will be found when necessary to sustain allocation) [hereinafter cited as Seieroe & Gerber].


56 \textit{See Wilson v. United States}, 530 F.2d 772, 776 (8th Cir. 1976); Philipp Bros. Chem. Inc. v. Commissioner, 435 F.2d 53, 57 (2d Cir. 1970); Ballentine Motor Co. v. Commissioner, 321 F.2d 796, 800 (4th Cir. 1963).

This burden of proof has been criticized as too strict with respect to a taxpayer defending against a section 482 reallocation. \textit{See Erbacher, Are Courts Making It Harder to Overturn an I.R.S. Allocation Under Section 482?}, 46 J. Tax’n 286, 290 (1977) (questions propriety of permitting Commissioner's determi-
Commissioner has exceeded or abused his discretion is, therefore, a question of fact subject only to a limited review by appellate tribunals. 57

B. Benefits of Section 482

Although a section 482 reallocation may be difficult to defend against, it may subject the taxpayer to a lesser tax deficiency than if a reallocation under section 61 is permitted. 58 Typically, in an assignment of income case, 100% of the income involved is reallocated. 59 Section 482, however, may result in the reallocation of only a portion of the income involved. 60 This is particularly true when some part of the corporate income sought to be reallocated is derived from invested capital rather than from personal services rendered by a shareholder. 61 Furthermore, when the Commissioner asserts the section 61 assignment of income doctrine, only the gross income generated by an activity is reallocated. 62 Under the statutory authority embodied in section 482, however, the Commissioner is empowered to reallocate not only income, but deductions and credits as well. 63 Recent cases indicate a tendency on the part of the Commissioner simply to reallocate net income under section 482, rather than allocate income, deductions and credits


58. If income is reallocated from a personal service corporation to its shareholder under authority of section 482, the shareholder may withdraw such funds from the corporation without having the distribution taxed again as a dividend. See Rev. Proc. 72-53, 1972-1 C.B. 198; Rev. Proc. 65-17, 1965-1 C.B. 112.

A reallocation under section 482 may, however, have severe collateral consequences to the taxpayer. For example, if the income to be reallocated consists of passive income, a potential personal holding company tax problem arises. For a Subchapter S corporation, the reallocation of passive income may serve to terminate a Subchapter S election. Although these problems will seldom arise in the case of a personal service corporation and its shareholder, the tax counselor should be aware of possible collateral effects. See Seieroe & Gerber, supra note 54 at 904-06 (collateral effects may also include extension of the normal statute of limitations from three to six years under I.R.C. § 6501(e) if the unreported income which is reallocated exceeds 25% of the income reported on the taxpayer's return).


60. See, e.g., Ach v. Commissioner, 42 T.C. 114, 127 (1964) (70% of corporation's income reallocated to shareholder), aff'd, 358 F.2d 342 (6th Cir.), cert. denied, 385 U.S. 899 (1966); see also Morrison v. Commissioner, 44 TAX CT. MEM. DEC. (CCH) 1459 (1982) (only income from one of four tax years at issue reallocated under section 482).

61. See, e.g., Davis v. Commissioner, 64 T.C. 1034 (1975).

62. See cases cited supra note 59.

Finally, although the statute speaks of "income," it has been held that the Commissioner has the authority under section 482 to reallocate losses between commonly controlled enterprises as well.  

IV. MISAPPLICATIONS OF SECTION 482

The various code provisions under which the Commissioner may reallocate corporate income have distinct and differing requirements. However, the Commissioner's practice of arguing the applicability of several theories in conjunction with section 482 has blurred these distinctions, making it difficult to determine the fact pattern to which section 482 will apply. The courts have added to this confusion by sanctioning the Commissioner's combination approach and by failing to specify the precise theories upon which their own decisions are based.

Analysis of the following three cases indicates that the courts have often mistakenly relied upon section 482 when another code section would have reached the same result. The primary argument raised by the taxpayer in each case was that since other legislative safeguards had been enacted to cover income allocation between a corporation and its shareholders, Congress did not intend section 482 to apply. A commentator has put forth this same argument, calling attention to the obvious awareness by Congress of the tax advantages inherent in the use of personal service corporations, since it modified other tax provisions to include income derived from personal service contracts.

64. See, e.g., Ballentine Motor Co. v. Commissioner, 321 F.2d 796 (4th Cir. 1963) (net income allocation approved); Marc's Big Boy Prospect v. Commissioner, 52 T.C. 1073 (1969) (taxpayer corporations have burden of demonstrating that total reallocation of income of subsidiaries was unreasonable or arbitrary where various segments of franchised restaurant business were interdependent), aff'd sub nom. Big Boy Corp. v. Commissioner, 452 F.2d 137 (7th Cir. 1971); Hamburgers York Road, Inc. v. Commissioner, 41 T.C. 821 (1964) (all taxable income of suburban branch of store included in the income of the downtown store), acq. 1965-62 C.B. 5.

65. See Davis v. Commissioner, 585 F.2d 807, 813 (6th Cir. 1978).

66. See generally Delsi, Section 482 Allocation of Income to Stockholders for Services Rendered to Closely-Held Corporations, 72 UTAH L. REV. 491, 492 (1972) (discussion of cases failing to disclose specific rule of law relied upon to reallocate income).


68. See Battle, supra note 25, at 801-02 (Congressional recognition of validity of personal service corporation can be inferred from enactment of section 543(a)(7) dealing with personal holding company tax and personal service contracts). Section 543(a)(7) reads, in pertinent part, as follows:

(a) GENERAL RULE.—For purposes of this subtitle, the term "personal holding company" means the portion of the adjusted ordinary gross income which consists of:
cal conclusion is that Congress intended to permit personal service corporations to take advantage of tax benefits without being subject to attack under section 482 and that the courts, by expanding the "dual business" requirement to include shareholder-employees, have defeated the intentions of Congress.\textsuperscript{69}

A. Ach v. Commissioner

One of the landmark reallocation decisions, Ach v. Commissioner,\textsuperscript{70} involved the transfer of a profitable dressmaking business to a corporation having a history of substantial losses. The taxpayer, Pauline Ach, was the sole proprietor of a profitable dressmaking business while other family members operated a dairy corporation which had sustained substantial operating losses. In 1953, the dairy sold almost all of its assets to an unrelated corporation.\textsuperscript{71} The taxpayer became president and chairman of the board of the corporation while her sons, who did not participate in the management of the business, owned all of the corporation's stock. The taxpayer then sold her dressmaking business to the corporation at book value, receiving in exchange a noninterest

\begin{itemize}
\item (7) PERSONAL SERVICE CONTRACTS.—
\begin{enumerate}
\item Amount received under a contract under which the corporation is to furnish personal services; if some person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or if the individual who is to perform the services is designated (by name or by description) in the contract; and
\item Amounts received from the sale or other disposition of such a contract.
\end{enumerate}
I.R.C. § 543(a)(7).
\end{itemize}

Further support is given to this argument by I.R.C. § 531 which imposes a penalty tax on the accumulated profits of any corporation if the purpose of the accumulation is tax avoidance. Personal service corporations are restricted to an accumulation of $150,000. ERTA, however, increased the accumulated earning tax credit to $250,000 for nonservice corporations. I.R.C. § 535(c)(2). In addition, the restrictions found in the Tax Equity and Fiscal Responsibility Act of 1982 buttress this argument. See infra notes 148-51 and accompanying text. While Congress clearly is aware of the controversy surrounding personal service corporations, it has not taken direct steps to halt their use.

\textsuperscript{69} At least one court has agreed with this proposition. In its second opinion in Foglesong v. Commissioner, 691 F.2d 848 (7th Cir. 1982), the Seventh Circuit stated: "A history of legislation targeted at personal service corporations, the absence of any special exclusion of such corporations from corporate taxation and the personal holding company tax provisions indicate that, to some extent, Congress has sanctioned the incorporation of service businesses for tax purposes." \textit{Id.} at 873.

The Second Circuit and the tax court, however, have held that the legislation involving personal service corporations does not provide a clear expression of Congressional intent to limit the scope of section 482. \textit{See} Borge v. Commissioner, 405 F.2d 673, 676-77 (2d Cir. 1968) (fact that other legislation was enacted does not mean Commissioner is restricted in application of Section 482), \textit{cert. denied}, 395 U.S. 933, \textit{reh'g denied}, 396 U.S. 869 (1969); Rubin v. Commissioner, 56 T.C. 1155, 1160 (1971) (same), \textit{aff'd per curiam}, 460 F.2d 1216 (2d Cir. 1972).


\textsuperscript{71} 42 T.C. at 117.
bearing note. After this transaction, the taxpayer continued to manage
the dressmaking business but received no compensation for her ef-
forts. The profits generated by the corporation from the dressmaking
enterprise were completely offset by net operating loss carryforwards
unused in prior years by the dairy business. In 1959, upon the request
of the taxpayer and for no consideration, the sons transferred their cor-
porate stock to her.

The Commissioner relied upon four basic arguments to reallocate
the entire income of the dressmaking business to Ach for the years 1954
through 1958: (1) section 61 assignment of income; (2) sham corpora-
tion theory; (3) section 482 reallocation; and (4) section 269 bar against
tax avoidance acquisitions. Although a strong tax avoidance motive
was clearly indicated by the sale of the highly profitable dressmaking
business at book value in exchange for a noninterest bearing note, the
tax court did not regard the corporate entity as a sham. Instead, the
court relied upon section 482 to reallocate the income back to the
taxpayer.

It is beyond dispute that Ach met the control requirement of sec-
tion 482. However, the question of whether the taxpayer could be
considered a trade, business or organization separate from the corpo-
rathon remained. Judge Raum, writing for the tax court, found that Ach
did not cease to be a separate business or organization for purposes of
section 482 merely by selling the tangible assets of the dressmaking
business to the corporation. This finding was predicated upon the
fact that the assets transferred to the corporation did not include the
right to the taxpayer's services. The tax court concluded, therefore,
that Ach continued in the dressmaking business even after its assets
were transferred to the corporation; in essence, she was considered an
organization separate and apart from the corporation. Although rely-
ing upon section 482, the tax court stated that section 269 would be

72. Id. at 121.
73. Id. at 122.
74. Id. at 122-23, 127.
75. The tax avoidance purpose was to utilize the net operating losses of the corpora-
tion to offset the profits generated by the dress business.
76. Id. at 126-27. In addressing the alternative theories advanced by the Commis-
sioner, the court stated that the corporation was not a sham because there was a
genuine transfer of assets that were used in the corporation, the corporation had
salaried employees, and paid its federal and state tax obligations (including work-
men's compensation and social security). Id. at 123-24. The court, however, did
not directly address why section 61 would not be applicable.
77. The court felt that the fact that all the stock was held by the taxpayer's sons was
irrelevant since the taxpayer had sufficient control to have the stock transferred to
her without consideration. Id. at 125.
78. Id. at 124. The tax court described the transfer of assets by Ach to the corporation
as a "sale of naked assets" because no intangible assets were included. Id.
79. Id. at 124-25.
80. Id. at 125. This result was evidently arrived at because no employment contract
had been entered into between Ach and the corporation, and there was no cove-
equally applicable, since the taxpayer had a clear tax avoidance purpose in transferring the dressmaking business assets to the corporation.\textsuperscript{81} Had \textit{Ach} been decided solely upon the basis of section 269, the unnecessary expansion of the dual business requirement of section 482 would have been avoided.\textsuperscript{82}

\textbf{B. Borge v. Commissioner}

In \textit{Borge v. Commissioner},\textsuperscript{83} a famous entertainer derived substantial income from his lucrative career while, at the same time, operating a poultry business at a substantial loss. Borge was advised by a tax consultant that the Commissioner might disallow the losses from the poultry business under a then-existing provision of the Internal Revenue Code which limited hobby losses.\textsuperscript{84} To avoid this possibility, Borge transferred the assets of his poultry business to a newly formed corporation in exchange for all of the corporation's stock. Borge contracted with the corporation, giving it the right to his entertainment and promotional services in return for compensation in an amount clearly

\begin{itemize}
\item nant not to compete in existence. The tax court failed to consider the fact that an employment contract and covenant not to compete are illusory in such a situation.
\item The tax court further found that the intangible assets of the sole proprietorship, such as tradenames, were not transferred to the corporation. \textit{Id.} at 124. However, it is generally understood that when a business is sold, the intangible assets follow the tangible; such intangibles do not exist separate and apart from the tangible assets of a going concern.
\item To its credit, the tax court did not reallocate 100\% of the income generated by the corporation to Ach. Rather, it arbitrarily estimated that 30\% of the income was not attributable to the services provided by Ach, but to the dressmaking assets owned by the corporation. \textit{Id.} at 127. Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930) was cited as authority for the estimate. Estimates of income subject to reallocation under section 482 would appear imprecise at best. The better rule would require the Commissioner to prove the exact amount of income to be reallocated.
\end{itemize}


\textsuperscript{82} For example, the Sixth Circuit reached the same result on appeal by relying on section 269 and looking to the apparent tax avoidance motive of the transaction. 358 F.2d at 346. The troublesome "dual business" issue was never reached by the appellate court, although subsequent decisions have relied upon this aspect of \textit{Ach}. \textit{See}, e.g., Cooper v. Commissioner, 64 T.C. 576 (1975). In \textit{Cooper}, the taxpayers incorporated a sole proprietorship engaged in construction. The assets transferred into the corporation did not include buildings and equipment previously used in the sole proprietorship. Such assets were made available to the corporation rent-free with the corporation paying for repairs and maintenance. The corporation did not acquire any depreciable assets of its own. The tax court upheld a section 482 reallocation whereby a reasonable rental charge was imputed from the corporation to the taxpayers. As part of its opinion, the tax court found that the taxpayers continued in business independently after the formation of the corporation, citing \textit{Ach} as authority. \textit{Id.} at 580. The finding in \textit{Cooper} of a dual business also appears questionable.

\textsuperscript{83} 26 \textsc{TAX CT. MEM. DEC. (CCH) 816 (1967), aff'd,} 405 F.2d 673 (2d Cir. 1968), \textit{cert. denied}, 395 U.S. 933, \textit{reh'g denied}, 396 U.S. 869 (1969).

\textsuperscript{84} 405 F.2d at 674 n.4.
disproportionate to the income generated by those services. The corporation then offset the losses sustained by the poultry business against the profits generated by the entertainment business.

The Commissioner, relying upon sections 482 and 269, sought to reallocate the income reported by the corporation to Borge. The tax court found, and the Second Circuit affirmed, that: (1) Borge was actively engaged in the entertainment business and assigned that income to his corporation; (2) the corporation did nothing to earn or to assist Borge in earning the entertainment income; and (3) the employment contract between Borge and his corporation did not reflect an arm's-length agreement because the entertainment services Borge provided were worth substantially more than the salary he was paid by the corporation. Therefore, it was determined that Borge was engaged in a separate business and was in control of dual businesses for purposes of section 482.

It appears that the overwhelming tax avoidance purpose of the

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85. *Id.* at 675.
86. *Id.*
87. *Id.* at n.6. The corporation reported the following income from entertainment activities, before a deduction for the taxpayer's salary, for the years at issue:

<table>
<thead>
<tr>
<th>Fiscal Year Ending Feb. 28</th>
<th>Net Entertainment Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>1959</td>
<td>$141,441</td>
</tr>
<tr>
<td>1960</td>
<td>146,402</td>
</tr>
<tr>
<td>1961</td>
<td>143,826</td>
</tr>
<tr>
<td>1962</td>
<td>283,315</td>
</tr>
<tr>
<td>1963</td>
<td>117,340</td>
</tr>
</tbody>
</table>

However, the taxpayer received only $50,000 annual salary from the corporation during the above years, a sum clearly disproportionate to the income generated by his services.

88. *Id.* at 676. Borge argued that section 482 could not properly be applied to him since he could not be considered an "organization, trade or business," citing Whipple v. Commissioner, 373 U.S. 193 (1963). In *Whipple*, the Supreme Court held that a shareholder who rendered services to a corporation for purposes of enhancing his investment could not be considered as engaging in a trade or business. However, *Whipple* is distinguishable from *Borge*. The Second Circuit found that Borge did not devote his time and energies to the corporation; rather, he continued to carry on his entertainment career in exactly the same manner as before the corporation was formed.

Borge also argued that Congress, in enacting the personal holding company, I.R.C. §§ 541-47, and collapsible corporation, I.R.C. § 341, provisions of the code, did not intend for section 482 to be applied to circumstances such as those involved in *Borge*. The Second Circuit, however, refused to so construe the legislative history of those respective provisions:

In every case in which [section 482] is applied its application will necessarily result in an apparent conflict with the literal requirements of some other provision of the [Internal Revenue Code]. If this were not so, Section 482 would be wholly superfluous. The fact that similar, but not identical, factual situations have been dealt with by legislation does not mean that this situation, because it was not also specifically dealt with by legislation, cannot be reached even by a general code provision.

taxpayer in Borge resulted in imprecise legal reasoning by both the tax and the appellate courts. If Congress had intended to include shareholding-employees under section 482, it could easily have done so by simply including "persons" in addition to organizations, trades, or businesses. A proper holding in the case would have been to rely exclusively upon section 269 or the assignment of income doctrine. The section 482 reallocation in this case represents an unwarranted extension of that section beyond the scope of Congressional intent.

C. Rubin v. Commissioner

Whether a shareholder-employee can be considered to be engaged in a trade or business for purposes of section 482 was again raised in Rubin v. Commissioner. While a shareholder and officer of Rubin Brothers Corporation, the taxpayer obtained an option to acquire a controlling interest in the stock of Dorman Mills, Inc., a corporation engaged in the manufacture of textiles and a substantial customer of Rubin Brothers. During the time period involved, Dorman Mills had continually sustained operating losses, but the taxpayer believed that with better management Dorman Mills could be made to operate profitably. Accordingly, a contract for the rendition of management services was entered into between Dorman Mills and another corporation, Park, which had been recently organized by the taxpayer. Park agreed to provide management services to Dorman Mills for a period of four years in return for compensation equal to twenty-five percent of Park's net profits in excess of $25,000.

During the term of the management contract, all management fees paid by Dorman Mills to Park were attributable to services performed solely by Rubin. Although Rubin generally respected the existence of Park, Dorman Mills often ignored its existence and held Rubin out as part of its own management, particularly when dealing with banking and other financial institutions. As a result, parties dealing with Dorman Mills were unaware of the existence of Park.

The Commissioner issued a notice of deficiency to the taxpayer, reallocating the management fee income reported by Park to Rubin. The theory first advanced by the Commissioner was the assignment of income doctrine. Prior to trial, however, the Commissioner amended his answer to include a section 482 argument.

90. 51 T.C. 251 (1968), rev'd and remanded, 429 F.2d 650 (2d Cir. 1970), on remand, 56 T.C. 1155 (1971), aff'd per curiam, 460 F.2d 1216 (2d Cir. 1972).
91. 51 T.C. at 253-54.
92. Id. at 255.
93. Id. at 263.
94. The validity of the corporation was not challenged by the Commissioner, but the burden of proof with respect to the section 61 assignment of income issue was on the taxpayer. On remand from the Second Circuit, the tax court failed to consider
The tax court concluded that the assignment of income doctrine was applicable. Although the corporation generated substantial income in management fees, the income greatly exceeded the compensation paid to the taxpayer. The Commissioner argued that the substance of the arrangement was really an assignment by Rubin to Park of the income derived from Rubin's direct services to Dorman Mills. The tax court stated that the taxpayer had the burden of proving that there was a substantial economic purpose for casting the transaction in the form chosen, but he had failed to meet it.

On appeal, Judge Friendly, writing for the Second Circuit, stated that "the broad sweep of section 61" has no applicability when "there is a statutory provision adequate to deal with the problem presented . . . ." In remanding the case, the court stated:

Resort to section 482 is clearly superior to the blunt tool employed by the Tax Court. References to "substance over form" and the "true earner" of income merely restate the issue in cases like this: Who is the "true earner?" . . . . The language of section 482 more clearly commands analysis of the facts in terms of the competing policies outlined above. Section 482 has other advantages. It provides greater flexibility than the all or nothing approach used by the Tax Court. It is also accompanied by relief provisions to avoid the hardship of the result reached by the Tax Court in this case,

the question of whether the burden of proof had shifted to the Commissioner after amending his answer to include a new issue. See 56 T.C. at 1155.

95. 51 T.C. at 265-66.
96. Id. at 265.
97. Id. at 265-69. The tax court relied upon the fact that the taxpayer had not agreed to render services exclusively to Park. However, it has been suggested that the presence or absence of a covenant not to compete in a closely held or one-man corporation is largely irrelevant. Since the shareholder-employee in a one-man corporation is both employee and owner, the exclusivity of a contract is unenforceable and without substance. Nevertheless, emphasis is still placed upon the presence or absence of this agreement. See, e.g., Ach v. Commissioner, 42 T.C. 114, 128 (1964) (taxpayer never entered into employment contract or issued a covenant not to compete to corporation, therefore taxpayer continued as a business separate from the corporation), aff'd, 358 F.2d 342 (6th Cir.), cert. denied, 385 U.S. 899 (1966); see also Borge v. Commissioner, 26 Tax Ct. Mem. Dec. (CCH) 816, 818 (1967) (taxpayer never agreed to provide his services on an exclusive basis to his corporation), aff'd, 405 F.2d 673 (2d Cir. 1968), cert. denied, 395 U.S. 933, reh'g denied, 396 U.S. 869 (1969). But cf: Fogleston v. Commissioner, 621 F.2d 865, 872 (7th Cir. 1980) (absence of employment contract or covenant not to compete is irrelevant in case of a one-man corporation because such agreements can be rescinded at will; rather, controlling factor was that shareholder worked exclusively for his corporation at all times), on remand, 77 T.C. 1102 (1981), rev'd and remanded, 691 F.2d 848 (7th Cir. 1982); Keller v. Commissioner, 77 T.C. 1014, 1031 (1981) (lack of a covenant not to compete is irrelevant when one-man corporation is involved and employment relationship was maintained at all times), appeal docketed, No. 82-1414 (10th Cir. Apr. 7, 1982).
which would require Rubin to pay taxes on money he has never received and could not now obtain without paying income taxes on the receipt . . . .

The Second Circuit did not, however, address the issue of whether the taxpayer in Rubin could be considered as engaging in a separate trade or business or be classified as an organization for purposes of applying section 482.

On remand, the tax court relied upon the decisions in Ach and Borge, holding that the income received by Park was properly subject to reallocation under section 482. The tax court placed emphasis upon the fact that the taxpayer was an officer of Dorman Mills prior to the formation of Park and drew an analogy to Ach and Borge which involved individuals engaged in a separate business prior to incorporation.

The decision of the tax court on remand was again appealed to the Second Circuit. Finding no substantial difference between Rubin and the earlier decisions of Ach and Borge, the Second Circuit held that the taxpayer's rendition of management services to Dorman Mills was a trade or business factually similar to the furnishing of entertainment by the taxpayer in Borge, and hence within the scope of section 482.

Taxpayers who incorporate their personal service business may draw hope from the second holding of the Seventh Circuit in Foglesong v. Commissioner. The court held that section 482 is inapplicable when an employee works exclusively for his corporation because the threshold "dual business" requirement is not met. The impact of this decision, however, is unclear. The Seventh Circuit recognized the apparent conflict between its holding in Foglesong II and the decisions of the Second Circuit in Rubin and Borge and the Sixth Circuit in Ach. However, it distinguished and approved those decisions instead of criticizing them.

99. 429 F.2d at 653.
100. 56 T.C. at 1162.
101. Id. at 1159-62. The tax court deviated somewhat from the opinion of the Second Circuit by stating:

We merely hold, as is the clear import of both the Ach and Borge decisions, that 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 . . . .

Id. at 1161.
102. 460 F.2d at 1218.
103. 691 F.2d 848 (7th Cir. 1982).
104. Id. at 851.
105. Borge and Rubin were distinguished on the basis that the taxpayers did not work exclusively for their corporations and were, therefore, engaged in separate businesses. Ach, in which the taxpayer did work exclusively for her corporation, was distinguished on the ground that the taxpayer retained sufficient aspects of her sole proprietor business to meet the dual business requirement. Id. at 852.
V. AVOIDING A SECTION 482 REALLOCATION

The key to avoiding a reallocation of personal service income is proper corporate planning and adherence to the policies and procedures which such planning entails. The following sections analyze the factors which the courts have considered in determining the legitimacy of reallocation. While the cases are grouped according to the factor primarily at issue in each, no one factor is ever determinative and the cases necessarily overlap.

A. Components of Proper Planning

1. Corporate Formalities

The advisability of following all corporate formalities is emphasized by the decision in *Gettler v. Commissioner*. The petitioner was an attorney who formed a law partnership with two other attorneys specializing in the practice of labor law. Petitioner, one of the other partners, and a lay individual formed a corporation to handle labor matters for employers. The corporation was formed for two reasons: to permit the representation of management in labor matters, and to permit the inclusion of a lay individual who could not ethically be a partner in the law partnership.

The corporation had only three clients, operated out of the same offices as the partnership, and utilized secretarial services provided by the partnership. However, the corporation paid rent to the partnership for the office space, and corporate formalities were always followed. For example, receipts of the partnership and the corporation were segregated and maintained in separate bank accounts, and separate stationery was used. Additionally, the fees received by the corporation were not paid out in full as expenses, but instead a large percentage was retained to purchase art investments as a sideline activity of the corporation.

The Commissioner argued that, under the assignment of income doctrine and section 482, the income in question was earned by the partnership and not by the corporation. The tax court, however, refused to adopt this position and held that a taxpayer may validly divide his business, provided each unit is operated independently of the other and a business purpose is shown for such an arrangement. In *Gettler*, the corporation was formed for substantial nontax considerations.

106. 34 TAX CT. MEM. DEC. (CCH) 443 (1975).
107. Since the partnership represented labor unions, the partners felt that it was not practical for them to also represent management. *Id.* at 443-44.
108. Since labor matters could be handled by a corporation, because such representation was not then considered involving the practice of law, a nonlawyer could be a shareholder. *Id.*
109. *Id.* at 443-44, 448.
110. *Id.* at 447-48.
111. *Id.* at 448.
The fact that the corporation had no employees other than the partners and operated out of partnership office space did not, without more, mean that the partnership was the true earner of the income. Thus, proper adherence to corporate formalities and the lack of a substantial tax avoidance purpose defeated the Commissioner's attempt to reallocate the corporation's income.113

2. Employment Contracts and Reasonable Compensation

The existence of an employment contract between a shareholder-employee and his corporation, as well as the payment of reasonable compensation is crucial to avoid a section 482 reallocation. In Jordan v. Commissioner,114 the taxpayer was an individual who organized a corporation for the purpose of selling insurance. Shortly thereafter, another corporation was organized by the taxpayer to provide management services to the insurance corporation. All such services were performed personally by the taxpayer.115 During the years at issue, the insurance company received commissions of approximately $239,000, of which $158,000 was paid to the management company as the fee for its services. However, the taxpayer received no compensation from the corporation.

In his notice of deficiency to the petitioner, the Commissioner reallocated all of the income received by the management company to the petitioner under both the assignment of income doctrine and section 482.116 The tax court upheld the Commissioner's reallocation. The evidence produced at trial established that in addition to the lack of compensation, no employment contract was entered into between the taxpayer and the management corporation, and little regard was given to the separate legal existence of that corporation.117

The importance of employment contracts and receiving reasonable compensation from a controlled personal service corporation is also illustrated in Estate of Cole v. Commissioner.118 The taxpayer was a famous entertainer who organized a foreign corporation to promote his overseas tours. The taxpayer entered into an employment contract with the foreign corporation providing for compensation at the rate of

112. Id. at 449.
113. This result was also reached in Achiro v. Commissioner, 77 T.C. 881, 896-900 (1981) where the only business purpose was to receive increased retirement plan benefits.
114. 60 T.C. 872 (1973), aff'd per curiam, 514 F.2d 1209 (8th Cir. 1975).
115. 60 T.C. at 878.
116. Id. at 882-83.
117. Id. at 883; see also American Sav. Bank v. Commissioner, 56 T.C. 828 (1971) (taxpayers never entered into an employment contract with their corporation and no compensation was ever paid; reallocation upheld). But cf. Keller v. Commissioner, 77 T.C. 1014 (1981) (taxpayer observed all formalities, including an employment contract, and was adequately compensated for his efforts; reallocation reversed), appeal docketed, No. 82-1414 (10th Cir. Apr. 7, 1982).
118. 32 TAX CT. MEM. DEC. (CCH) 313 (1973).
$8,500 per week for personal appearances made overseas.\footnote{119}{Id. at 315.}

The Commissioner sought to reallocate the income earned by the corporation to the taxpayer on the basis of both the assignment of income doctrine and section 482.\footnote{120}{Id. at 320, 324.} In considering the section 482 argument, the tax court held that the Commissioner's determination was unreasonable, arbitrary and capricious.\footnote{121}{Id. at 325.} Reliance was placed upon the fact that an employment contract existed between the parties and that the Commissioner had not challenged the reasonableness of the compensation paid to the taxpayer by the corporation. The court found this compensation to be equivalent to what the taxpayer could have earned from a noncontrolled corporation for essentially the same services. Therefore, the arm's-length standard of section 482 was met.\footnote{122}{Id.}

3. Investment of Capital and Utilization of Nonshareholder Employees

In contrast to personal service businesses, the courts are reluctant to reallocate income when capital and the services of nonshareholder employees are income-producing factors. The case of \textit{Davis v. Commissioner}\footnote{123}{Id. at 1034 (1975).} is illustrative. In \textit{Davis}, the taxpayer was an orthopedic surgeon who acquired an x-ray machine and physical therapy equipment in order to provide treatment for his patients. Anticipating divorce, concerned about the future welfare of his children, and fearful of potential legal liability in the event of a mishap occurring with respect to the x-ray equipment, the taxpayer transferred the x-ray business and the physical therapy activity to two separate corporations.\footnote{124}{Id. at 1035.} Both businesses were established as Subchapter S corporations and all but ten percent of the stock in each was given to Davis' children, with the allocable share of net income from each corporation distributed to savings accounts maintained for each child.\footnote{125}{Id. at 1041.}

The corporation providing x-ray services employed a registered x-ray technician and owned all of its equipment except the x-ray machine, which was leased to it by the taxpayer. The corporation providing physical therapy services employed a registered physical therapist and two aides and owned various pieces of physical therapy equipment. As president and a member of the board of directors of both corporations the taxpayer performed purely administrative services.\footnote{126}{Id. at 1041.}
The Commissioner sought to reallocate the entire income generated by the two corporations to the taxpayer under the assignment of income theory and section 482.\textsuperscript{127} The primary argument advanced by the Commissioner was that the earnings of the two corporations were under the control of the taxpayer, and therefore taxable directly to him.

However, the facts did not support this argument. The income of the two corporations was generated by the services of persons employed, and the equipment owned, by each corporation, not by any services performed by the taxpayer. The Commissioner cited \textit{Ach} as support for the proposition that the taxpayer controlled the income generated by the two corporations. Rejecting the Commissioner's theory, the tax court distinguished \textit{Ach} on the basis that the services of the taxpayer in \textit{Ach} were vital to the corporation, whereas in the present case they were not.\textsuperscript{128}

The decision in \textit{Davis} indicates that when equipment and the services of unrelated employees are utilized by a personal service corporation, it is unlikely that the Commissioner will be able to sustain a reallocation of corporate income. Assuming that all other corporate formalities are followed, the argument that income is earned by the controlling shareholder-employee is weak.

\textbf{B. Tax Court Trends}

The tax court increasingly recognizes the validity of personal service corporations for tax purposes and rejects the Commissioner's attempts to reallocate such income to shareholders when corporate formalities are observed. The decision of the tax court in \textit{Pacella v. Commissioner}\textsuperscript{129} confirms this trend.

In \textit{Pacella}, the taxpayer was a physician specializing in psychiatry. In addition to conducting a private practice, Pacella also operated a private psychiatric hospital as a sole proprietor. Although Pacella assisted in the hospital management, another individual managed its day-to-day affairs. In 1970, Pacella incorporated and became the sole shareholder of his private psychiatric practice due to anticipated tax benefits.\textsuperscript{130} Pacella then entered into an employment contract with the corporation stipulating that he would devote substantially all of his time to the corporation's business. The corporation adopted a pension plan; however, the contributions were largely attributable to coverage of Pacella, since he and a secretary were the only plan participants.

Shortly after incorporation, a meeting was held between Pacella, the hospital administrator, and other staff members. It was agreed that all patients at the hospital treated by Pacella would be billed by his

\textsuperscript{127} \textit{Id.} at 1042.
\textsuperscript{128} \textit{Id.} at 1046.
\textsuperscript{129} 78 T.C. 604 (1982).
\textsuperscript{130} \textit{Id.} at 606.
After this meeting, the corporation submitted bills to the hospital for services rendered by Pacella and the hospital remitted checks payable to the corporation. However, no written agreement was ever executed to reflect this arrangement.

The Commissioner issued a notice of deficiency reallocating the income received by the corporation to Pacella under the assignment of income doctrine and section 482. The tax court held section 482 to be the proper authority and divided its analysis of the case into two steps: (1) whether the corporation controlled the earning of the income sought to be reallocated; and (2) whether the total compensation paid by the corporation to Pacella reflected an arm’s-length agreement.

Under the first step, the corporation, rather than the taxpayer, was found to control the earning of the income. The determinative factor appears to be that the corporation was able to conduct its business only because it had contracted for Pacella’s services. Although Pacella did teach and provide consulting services to other hospitals, these activities did not involve clinical treatment. Therefore, the services were held not to infringe upon the exclusiveness of Pacella’s employment contract with the corporation. The fact that the corporation did not have a written contract with the hospital was not a critical factor either, because the tax court concluded that an oral agreement had

131. *Id.* at 608-09.

132. *Id.* at 609.

133. *Id.* at 61l.

134. The facts of the case are not clear as to the reallocation the Commissioner would require. The tax court indicates that the Commissioner amended his answer to the taxpayer’s petition using figures different than those contained in the notice of deficiency. Apparently, the Commissioner’s reallocation would have required Pacella to include on his individual return all of the income reported by the corporation other than that attributable to billings to the petitioner’s hospital, and would have allowed him to deduct the business expenses claimed by the corporation except for certain items not permitted to a sole proprietor (i.e., increased pension plan contributions). The Commissioner also would have required that Pacella, as a sole proprietor, be denied the deductions claimed on his Schedule C for payments made to the corporation for services rendered to hospital patients. The tax court took a different approach, framing the issue in the case as whether the Commissioner could reallocate the “net income” of the corporation to Pacella. *Id.* at 605. This conforms to the approach taken by some courts — that of making allocations of net income rather than of income and deductions separately. See supra note 64 and accompanying text. In *Pacella* a strict net income allocation would not be proper, since the corporation claimed deductions for pension plan contributions in excess of those that could be claimed by Pacella as a sole proprietor.


136. There was a considerable question at trial as to the authenticity of the employment contract and the corporate minutes. The Commissioner alleged that the documents were backdated and sought to use ink analysis in an attempt to show that the ink used to sign and date the documents was not in existence at the time the documents were allegedly signed. The tax court decided that the state of art in ink analysis was not yet generally accepted by the scientific community and held the documents to be authentic. *Id.* at 614-17.
been made during the meeting held between Pacella's corporation and the hospital.\textsuperscript{137}

The tax court then focused upon whether Pacella was compensated by the corporation in an amount that would have been reasonable had the parties been unrelated.\textsuperscript{138} The test used by the court to determine whether an arm's-length agreement existed was whether the total compensation package approximated that which Pacella could have earned absent incorporation.\textsuperscript{139} Taking into account salary and pension plan contributions made by the corporation on Pacella's behalf, the court concluded that the arm's-length test had been met.\textsuperscript{140} Although Pacella's total income was less than what he could have earned absent incorporation, he gained comparable benefit from the pension plan contributions that were not currently taxable to him.

This reasoning permits some leeway in designing a compensation package for the shareholder of a personal service corporation. The shareholder-employee may withdraw less from the corporation in total compensation than he would have earned as a sole proprietor if the compensation package includes pension plan contributions made on his behalf.

The trend toward recognizing the validity of personal service corporations is further evidenced by the tax court's decision in \textit{Keller v. Commissioner},\textsuperscript{141} and indirectly by subsequent legislation enacted by Congress to limit the \textit{Keller} decision. The taxpayer, Keller, was a member of a partnership which rendered pathology services to local hospitals and physicians. Keller formed a professional corporation

\textsuperscript{137} \textit{Id.} at 619. The court further held that former patients were on notice that the services were being rendered by the professional corporation, not by Pacella as a sole proprietor. The fact that the corporate name, including the "P.C." designation, was on the sign to the office suite, billheads and office stationery led to the court's conclusion that the patients were those of the corporation. \textit{Id.}

\textsuperscript{138} \textit{Id.} at 620-22.

\textsuperscript{139} \textit{Id.} at 619-20.

\textsuperscript{140} \textit{Id.} at 620-22. However, a recent memorandum decision of the tax court, \textit{Morrison v. Commissioner}, 44 \textit{TAX CT. MEM. DEC. (CCH) 1459 (1982)} illustrates that care must be exercised when the income of the corporation from the personal services of shareholders is increasing while total compensation (including pension plan contributions and other fringe benefits) paid by the corporation to the shareholder remains constant. In \textit{Morrison} the Commissioner sought to reallocate income from a personal service corporation to its sole shareholder Morrison for the years 1974 to 1977, pursuant to section 482. The court sanctioned a reallocation for 1977 only. In the other three years Morrison received compensation which was comparable to what he would have received absent incorporation once pension plan contributions were taken into account. However, in 1977 the total income of the corporation increased by one and one-third while the taxpayer's total compensation remained constant. The tax court determined that the taxpayer would have received more compensation if an arm's-length arrangement existed in 1977 since the increase in income was due solely to Morrison's efforts. \textit{Id.} at 1470-71.

\textsuperscript{141} \textit{Keller v. Commissioner}, 77 T.C. 1014 (1981), \textit{appeal docketed}, No. 82-1414 (10th Cir. Apr. 7, 1982).
under state law and became the sole shareholder. The corporation and Keller then entered into an employment contract in which he agreed to devote his full time and efforts to the corporation in return for an annual salary. The partnership agreement was amended, with the professional corporation substituted for Keller as a partner. Thereafter, the distributive share of partnership income allocated to the corporation was reported by it on its tax return. A pension plan was established by the corporation, and substantial contributions were made on behalf of Keller to the plan. The earnings of the corporation were derived only from the partnership, which did not engage in any other substantial business activity. The Commissioner sought to reallocate the entire income reported by the corporation to Keller under section 482.142

In discussing the major hurdle imposed by the dual business requirement of section 482, the tax court stated:

The dual business requirement is not a preclusive obstacle to the application of [s]ection 482 in this case. It has been noted that the legislative history of the predecessor of [s]ection 482 suggests that the terms 'trade,' 'business,' and 'organization' are to be broadly construed . . . . Furthermore, the regulations promulgated under [s]ection 482 are broadly written so as to cover any type of entity or enterprise which has independent tax significance . . . . Other courts and this court have not been reluctant to rely upon [s]ection 482 in a shareholder/corporation context and in a sole employee/corporation case.143

According to the tax court, section 482 does not authorize an allocation of income which would otherwise disregard the validity of a corporation. The Commissioner was held, therefore, to have exceeded his authority to reallocate income under section 482.144 The key consideration in Keller was whether the total compensation, including retirement plan contributions and other fringe benefits, paid to or on behalf of Keller was substantially equivalent to what he could have received absent incorporation.145 Finding that it was, the tax court held that the

142. 77 T.C. at 1022.
143. Id. at 1022-23 (citations omitted). The holding of the tax court that the dual business requirement imposed by section 482 could be met by a mere employment relationship between a shareholder and his corporation conflicts directly with the most recent decision of the Seventh Circuit in Foglesong v. Commissioner, 691 F.2d 848 (7th Cir. 1982). However, the decision in Keller has been appealed to the Tenth Circuit. Keller v. Commissioner, 77 T.C. 1014 (1981), appeal docketed, No. 82-1414 (10th Cir. Apr. 7, 1982). The Tenth Circuit may follow the approach of the Second Circuit in Rubin v. Commissioner, 460 F.2d 1216 (2d Cir. 1972) in holding section 482 can be applied, or that of the Seventh Circuit in Foglesong finding that the dual business requirement is not met in this situation.
144. Keller v. Commissioner, 77 T.C. 1014, 1025 (1981), appeal docketed, No. 82-1414 (10th Cir. Apr. 7, 1982).
145. 77 T.C. at 1025. The court did not state that the test should be determined by reference to what a similar employee could make in another organization, but
Nevertheless, a portion of the corporation's income was validly reallocated to Keller. After incorporation, the corporation was not immediately substituted as a partner in the medical partnership. Therefore, Keller was held directly taxable on that portion of the income earned prior to the date of the substitution.\(^\text{147}\)

Congress found reason to object to the decision in *Keller*. Without waiting for the final outcome of the case on appeal, it took action to combat the perceived abuse in *Keller* by enacting section 269A.\(^\text{148}\) Section 269A was added to the Internal Revenue Code by TEFRA, Pub. L. No. 97-248, 96 Stat. 324 (1982). It provides in pertinent part:

SEC. 269A. PERSONAL SERVICE CORPORATIONS FORMED OR AVAILED OF TO AVOID OR EVADE INCOME TAX.
(a) GENERAL RULE.—If—

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

(2) the principal purpose for forming, or availing of such personal service corporation is 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.
Section 269A permits the Commissioner to reallocate income and deductions of a corporation which renders substantially all of its services to one other entity, if the principal purpose of forming or utilizing the corporation is to avoid federal taxes or to secure the benefit of a deduction or credit not otherwise allowed to a self-employed individual. Corporations subject to section 269A are those principally providing personal services rendered by employees who, directly or indirectly, own ten percent or more of the corporation's stock.

Section 269A is clearly designed to attack the situation in Keller when the personal service corporation renders substantially all of its services to another organization through an owner-employee. From a practical standpoint such corporations lack independent significance. However, section 269A does not affect the situation where a personal service corporation is providing services to more than one entity or to the general public at large. The implication is that by enacting section 269A, Congress acknowledged the validity of personal service corporations for tax purposes.

(b) DEFINITIONS.—For purposes of this section—

(1) Personal service corporation.—The term 'personal service corporation' means a corporation the principal activity of which is the performance of personal services and such services are substantially performed by employee-owners.

(2) Employee-owner.—The term 'employee-owner' means any employee who owns, on any day during the taxable year, more than 10 percent of the outstanding stock of the personal service corporation. For purposes of the preceding sentence, section 318 shall apply, except that '5 percent' shall be substituted for '50 percent' in section 318(a)(2)(C).

(c) RELATED PERSONS.—All related persons (within the meaning of section 106(b)(6)(C)) shall be treated as one entity.

I.R.C. § 269A. The legislative history indicates that Congress specifically intended to overturn Keller whenever the corporation appears to serve no business purpose other than to generate tax benefits not available to self-employed individuals. H. CONF. REP. NO. 760, 97th Cong., 2d Sess. 634, reprinted in 1982 U.S. CODE CONG. & AD. NEWS 412.

149. I.R.C. § 269A(a).
150. Id. (b)(2).
151. The legislative history also indicates that formation of a corporation to achieve more favorable retirement plan benefits will not be taken into account in later years. Sen. Robert Dole stated on the floor of the Senate that since parity between self-employed and corporate retirement plans will be achieved in 1984, it is expected that the Commissioner will not take a corporation's retirement plan into account in determining the applicability of section 269A. 11 CONG. REC. S10903 (daily ed. Aug. 19, 1982) (remarks of Sen. Dole). Beginning in 1984, one issue addressed by section 269A will no longer be present. As discussed earlier, see supra note 3, TEFRA, Pub. L. No. 97-248, 96 Stat. 324 (1982), has established parity between retirement plans for self-employed individuals and corporations. Therefore, the attainment of more favorable retirement plan benefits will no longer be an underlying reason for incorporation of a personal service business.
VI. CONCLUSION

The principal weapon in the Commissioner's arsenal for combating the spread of personal service corporations is a reallocation of income under section 482. Such a reallocation requires that two or more organizations, trades or businesses be in existence. The courts appear to be split as to whether an employee can be considered a separate trade, business or organization for purposes of an income reallocation. While arguably this is an unwarranted extension of the scope of section 482, to date only the Seventh Circuit has so held.

A section 482 reallocation will be reversed only if the Commissioner's determination is shown to be capricious, arbitrary or unreasonable. The standard of arm's-length dealing must be established to meet this burden of proof. To satisfy the arm's-length standard, compensation paid by the personal service corporation to the shareholder-employee must be reasonable. The tax court has interpreted this to mean that the compensation must be comparable to what the shareholder-employee could have earned if the business had remained unincorporated. However, such compensation may include contributions the corporation makes on the employee's behalf to retirement and other fringe benefit plans.

Strict compliance with all corporate formalities, including use of written employment contracts, covenants not to compete, contracts between the corporation and its customers, and the payment of reasonable compensation should satisfy the arm's-length standard imposed by section 482. This is not to say that the Commissioner will not continue to litigate such cases. Indeed, the proper application of section 482 with respect to the reallocation of a personal service corporation's income is just beginning to be defined. Recent decisions of the tax court and Seventh Circuit do, however, indicate a trend toward recognizing the personal service corporation as a valid tax planning tool.