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Recent Tax Issues Affecting Foreign Athletes-Playing Hockey in the United States

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RECENT TAX ISSUES AFFECTING FOREIGN ATHLETES—PLAYING HOCKEY IN THE UNITED STATES

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I. INTRODUCTION	71
II. INCOME ALLOCATION: THE <i>FAVELL</i> CASE	72
A. <i>Background</i>	72
B. <i>The Income Allocation Issue</i>	74
C. <i>The Court's Reasoning</i>	77
III. AFTER <i>FAVELL</i> : INCOME RE-ALLOCATION AND PERSONAL SERVICE CORPORATIONS	82
A. <i>Sargent v. Commissioner</i>	82
1. <i>Background</i>	82
2. <i>The Majority Opinion</i>	84
3. <i>The Dissent</i>	87
B. <i>Central Withholding</i>	88
APPENDIX	91

I. INTRODUCTION

This Article surveys recent legislation and caselaw affecting professional athletes, focusing in particular on the tax consequences to professional hockey players. Much of the discussion, however, is also applicable to other athletes and foreigners working in the United States.

The issues of income allocations, income re-allocations, and central withholding agreements are treated extensively. In the area of income allocation, a clear understanding of how courts apply the "time basis" formula to the income determination of a foreign athlete is essential so that proper planning at the time of contract negotiations can result in minimal U.S. tax liability. The Tax Court's recent decision on how income should be re-allocated between an athlete and his personal service corporation demonstrates that income re-allocation is significantly affected by whether an athlete plays a team sport.¹ Finally, this Article discusses how cen-

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1. After the preparation of this Article, this Tax Court case was reversed on appeal. An analysis of this appellate opinion is provided in the appendix to this Article.

tral withholding agreements can reduce rates of withholding, and how recent announcements in this area could prove beneficial to nonresident alien athletes, entertainers, and other similarly-situated individuals.

II. INCOME ALLOCATION: THE FAVELL CASE

Americans take great pride in the ability and development of their professional athletes. Yet in the sport of hockey, they often look to Canada, their contiguous northern neighbor, for a supply of professional hockey players. Thus, a large number of Canadian players often become entangled in the web of the Internal Revenue Code² rules that apply to nonresident aliens conducting a trade or business in the United States. While these foreign athletes live in the glory of their sport, they face tax issues similar to those faced by any self-employed individual.³ Additionally, these athletes encounter tax issues unique to professional hockey players.

The consolidated cases that comprise *Favell v. United States*⁴ present an example of the complex rules encountered by a professional hockey player attempting to compute gross taxable income in the United States. This case is part of an odyssey in which over 197 tax refund cases were filed by professional hockey players.⁵

A. Background

The plaintiffs, Douglas R. Favell, Jr., Gilles Marotte, Frederick E. Speck, Francis W. Speer, and Garnet E. Bailey, represent a sample of 197 cases filed on behalf of professional hockey players claiming an overpayment of taxes.⁶ In 1979, the Court of Claims

2. All section references are to the Internal Revenue Code (I.R.C.) of 1986, as amended, unless otherwise indicated.

3. Courts have recognized that professional hockey is a business. See *Philadelphia World Hockey Club, Inc. v. Philadelphia Hockey Club*, 351 F. Supp. 462, 466 (E.D. Pa. 1972) ("hockey is primarily a multi-state, bi-national business, where the *fundamental* motive is the making of money. . . . Despite the thousands of words uttered . . . about the glory of the sport of hockey and the grandeur of its superstars, the basic factors here are not the sheer exhilaration from observing the speeding puck, but rather the desire to maximize the available buck.") (emphasis added).

4. 89-1 U.S.T.C. (CCH) 87,711 (1989).

5. These cases were originally filed before the predecessor of the United States Claims Court, the United States Court of Claims, on December 20, 1976. *Id.* Subsequent to the enactment of the Federal Courts Improvement Act of 1982, Pub. L. No. 97-164, 96 Stat. 25, the United States Claims Court inherited cases pending before the United States Court of Claims, including these five cases. *Favell*, 89-1 U.S.T.C. at 87,711. See *infra* note 6 and accompanying text.

6. *Id.* This larger group of cases has been referred to as the "hockey player tax refund cases." *Id.*

ordered consolidation of these five cases for purposes of trial.⁷ The remaining 192 hockey-player tax cases were suspended until the present five cases were decided.⁸ The five cases were chosen as "test-cases" or "representative cases" because they typified the factual bases for the legal issues involved in all of the hockey player tax refund cases.⁹ Because the five plaintiffs "seemed unprepared to work together for purposes of the scheduled trial,"¹⁰ Judge Phillip R. Miller ordered them to file a Motion for Summary Judgment on the following issue: "[W]hether, as a matter of law, plaintiffs, who are non-resident aliens, are entitled to exclude from the United States tax liability proportionate income payments allegedly attributable to activities in which they took part during the off-season in Canada (the income allocation issue)."¹¹

The *Favell* court began its discussion by explaining that a professional hockey player's year can be divided into four periods: (1) training camp; (2) regularly scheduled championship games, which generally begin in the first or second week of October and end in April; (3) play-off or Cup games; and (4) the off-season, starting at the close of the competitive playing season and ending with the first day of training camp.¹² The court described these distinct intervals as follows:

Training camp normally commences thirty days prior to the beginning of regularly scheduled championship games, which begin in October of each year. The training camp period is used by each hockey club's coaching staff to form a 'line' which consists of the club's superior players and those players who perform best as a team. Training camp is not used to train or to give individual players thirty days to achieve the best possible physical condition. As required by the terms of the Standard Player's Contracts signed by the players, players are required to arrive at training camp in top physical condition and to be ready to compete for 'line' positions. Furthermore, the players must maintain

7. *Id.* at 87,712. The trial was to take place in Canada in the spring of 1985. *Id.*

8. *Id.*

9. *Id.*

10. *Id.*

11. *Id.* at 87,711. The income allocation issue had already been addressed by the courts. See *Stemkowski v. Commissioner*, 76 T.C. 252 (1981), *aff'd in part, rev'd in part, and remanded*, 690 F.2d 40 (2d Cir. 1982); *Hanna v. Commissioner*, 76 T.C. 252 (1981), *aff'd in part, rev'd in part, and remanded*, 763 F.2d 171 (4th Cir. 1985). The plaintiffs in both *Stemkowski* and *Hanna* lost on the income allocation issue. *Favell*, 89-1 U.S.T.C. at 87,712 n.4. Although this issue was previously addressed by the courts, the *Favell* plaintiffs felt that the hockey players in the earlier cases had lost the income allocation issue on appeal due to a lack of evidence in the trial court record. *Id.* at 87,712.

12. *Id.* at 87,713.

that excellent physical condition throughout the season. The regularly scheduled league championship games are the regular season games in which the hockey teams compete for play-off positions. The Cup games consist of the play-off games in which the select hockey teams compete to determine which team is the best in the league. The off-season is the period of time between the regular season or play-off games and training camp in which hockey players do not play competitive professional hockey. During the off-season, the players, who are plaintiffs in these cases, returned to their homes in Canada.¹³

Each *Favell* plaintiff was a nonresident alien of the United States, receiving compensation from sources within the United States, for labor and personal services rendered while playing for their hockey clubs.¹⁴ Each player also signed a standard player's contract covering a one-year period.¹⁵

B. The Income Allocation Issue

The specific issue before the court was whether, in accordance with Treasury Regulation section 1.861-4(b),¹⁶ the plaintiff hockey players, who had nonresident alien tax status, should be allowed to exclude from United States taxable income for the tax years in question, that portion of salaries for alleged contractual services performed outside the United States during the off-season.¹⁷

In order to answer this issue, the court was required to determine, as a matter of law, whether conditioning programs, fitness exercises, and similar activities in which plaintiffs participated outside the United States during the off-season should be viewed

13. *Id.* at 87,714.

14. *Id.*

15. *Id.* Each of the plaintiffs had signed a National Hockey League Standard Player's Contract during at least one of the tax years in question. *Id.* Plaintiff Frederick Speck also signed a World Hockey Association Uniform Player's Contract, and Francis Speer signed an American Hockey League Standard Player's Contract. *Id.* at 87,718-19. The Claims Court determined that all these contracts were, in relevant parts, substantially the same. *Id.* at 87,714-19.

16. Treas. Reg. § 1.861-4(b) (1969). Treasury regulations refer to regulations promulgated under the Internal Revenue Code and were in effect during the *Favell* litigation.

17. *Favell*, 89-1 U.S.T.C. at 87,720. The court noted that, on the motion and cross-motion for partial summary judgment, the plaintiffs and the defendant both framed the issue "somewhat differently." *Id.* The plaintiffs stated the issue as whether they were "entitled to the exclusion on the time basis pursuant to Regulation Section 1.861-4(b)-2 [Treas. Reg. § 1.861-4(b) (1969)] for services performed in Canada as a matter of law because their contracts expressly state[d] [they were to be] compensated for such services." *Id.* at 87,720 n.12. The defendant articulated the issue as "[w]hether the salary received by professional hockey players under standard player's contracts was paid, in part, for labor or services performed during the off-season." *Id.*

as contractual conditions, or labor and services required to be performed under the contracts at issue.¹⁸ Because they were nonresident aliens who rendered services both within and outside the United States, "plaintiffs [were] subject to United States federal income tax only on that portion of their income properly attributable to the conduct of a trade or business (including the performance of personal services) performed within the United States."¹⁹ The Treasury Regulations provided that when labor or services were performed properly within and outside the United States, the amount to be included in the gross income was determined by an apportionment based on the number of days of labor or service performed within the United States.²⁰ Because courts have confronted this issue on numerous occasions,²¹ it is commonly referred to as the "income allocation" issue. The mathematical determination of the allocation of income in accordance with the regulations is known as the "time basis" formula.²² The time basis formula multiplies compensation by a fraction; the numerator is the number of days of performance of services within the United States, and the denominator is the total number of days of performance of services for which compensation is received.²³ The controversy at

18. *Id.* at 87,720.

19. *Id.* at 87,722. See 26 U.S.C. § 861(a) (1954).

20. Treasury Regulation § 1.861-4(b)(2) provides as follows:

If a specific amount is paid for labor or personal services performed in the United States, that amount (if income from sources within the United States) shall be included in the gross income. If no accurate allocation or segregation of compensation for labor or personal services performed in the United States can be made, or when such labor or service is performed partly within and partly without the United States, the amount to be included in the gross income shall be determined by an apportionment on the time basis; that is, there shall be included in the gross income an amount which bears the same relation to the total compensation as the number of days of performance of the labor or services within the United States bears to the total number of days of performance of labor or services for which the payment is made.

Treas. Reg. § 1.861-4(b) (1969).

21. See *supra* note 11.

22. *Favell*, 89-1 U.S.T.C. at 87,722. The "time basis" formula can be expressed as follows:

$$\frac{\text{Number of days of performance of services within the United States}}{\text{Total number of days of performance of services for which hockey player is compensated}} \times \text{Total contract compensation} = \text{Amount included in United States taxable income}$$

Id.

23. See *supra* note 20.

issue in *Favell* focused on the correct number to be used as the time basis formula's denominator—the total number of days of performance of labor or services for which the plaintiffs received their salaries under the relevant contracts. The plaintiffs claimed that they were paid compensation for “services performed throughout the entire [twelve] month year (including the off-season), and the proper denominator [was] thus 365 days.”²⁴ The rationale for the plaintiffs’ position was that each plaintiff, during the off-season, was contractually bound to do various things, such as maintaining physical fitness sufficient to report to training camp in “good physical condition,” to participate in promotional activities, and to refrain from engaging in certain activities involving contact sports or improper conduct.²⁵ Therefore, the plaintiffs asserted they were acting under the terms of the contract each day of the year.

Consequently, the plaintiffs claimed that under the time basis formula, they were entitled, as nonresident aliens, “to apportion their salaries on an annual basis and thus exclude from United States taxable income, income earned during the time activities were performed outside the United States, including any services performed during the off-season.”²⁶ The government countered with the argument that even if the plaintiffs “assumed obligations or responsibilities which extended into the off-season, such duties were conditions of employment for which no compensation was to be paid.”²⁷

The plaintiffs relied upon two factors to establish their case: off-season mandatory conditioning programs and off-season hockey club supervision or control over their time and activities.²⁸ These factors evidenced that they were paid each and every day of the year. The government argued that the contract provisions requiring that hockey players “arrive in training camp in good physical condition should be read as a condition of each contract, not as a promise to perform services for the benefit of the hockey club during the off-season.”²⁹ Therefore, the contemplated contractual service term did not include the off-season because the players’ contractual salaries were not intended as compensation for off-season

24. *Favell*, 89-1 U.S.T.C. at 87,723.

25. *Id.*

26. *Id.* at 87,724.

27. *Id.*

28. *Id.* The plaintiffs submitted that these activities were intended to be compensated contractual services under the Standard Player's Contract. *Id.*

29. *Id.*

preparation for contract performance while players lived outside the United States.³⁰

C. *The Court's Reasoning*

The *Favell* court stated the issue as follows: "[W]hether or not the Standard Player's Contracts at issue compensate the hockey player for off-season activities, which would in turn allow the off-season period to be included in the time basis or income allocation formula and thereby reduce the hockey player's gross taxable United States income."³¹ The court noted that general principles of contract interpretation demanded that when interpreting a promise or agreement, that interpretation or agreement which gives a reasonable, lawful and effective meaning to all the terms is preferred to an unreasonable or unlawful interpretation without effect.³² Furthermore, "[u]nder recognized rules of contract interpretation, words are to be given their plain and ordinary meaning."³³ Finally, "the provisions of a contract must be construed so as to effectuate the spirit and purpose the [sic] contract . . . and interpreted so as to harmonize and give meaning to all its provisions."³⁴

The Standard Player's Contracts at issue, covering twelve-month periods, specified that hockey players were to be paid certain salaries.³⁵ The contracts also provided that if the players were not in good physical condition, thereby rendering them unfit to play hockey at the commencement of the season, the Club had the right to suspend them without pay.³⁶ Additionally, these agreements provided that if the player was not employed by the Club

30. *Id.*

31. *Id.* at 87,725.

32. *Id.* (citing RESTATEMENT (SECOND) OF CONTRACTS § 203(a) (1981)).

33. *Id.* at 87,727 (quoting *Tester Corp. v. United States*, 1 Cl. Ct. 370, 373 (1982)).

34. *Id.* (quoting *Thanet Corp. v. United States*, 591 F.2d 629, 633, 219 Cl. Ct. 75, 82 (Ct. Cl. 1979)).

35. *Id.* at 87,726.

36. *Id.* The relevant provision of the Standard Player's Contract is as follows: The Club may from time to time during the continuance of this contract establish rules governing the conduct and conditioning of the Player, and such rules shall form part of this contract as fully as if herein written. For violation of any such rules or for any conduct impairing the thorough and faithful discharge of the duties incumbent upon the Player, the Club may impose a reasonable fine upon the player and deduct the amount thereof from any money due to the Player. The Club may also suspend the Player for violation of any such rules. When the Player is fined or suspended he shall be given notice in writing stating the amount of the fine and/or the duration of the suspension and the reason therefore.

Id. at 87,715.

for the entire regular season, the contract salary would be prorated "based upon the ratio of the number of days he was so employed to the total number of days in the league championship schedule."³⁷ There would be no specific allocations attributable to the total salary compensation.³⁸

The *Favell* court differentiated between contractual promises and contractual conditions:

Contract promises and conditions are both means by which the parties to a contract bring about certain desired actions of another party. A contractual condition is to be distinguished from a promise, obligation, or covenant in that a condition creates no right or duty in and of itself, but merely acts as a limiting or modifying contract provision. 'A condition is an event, not certain to occur, which must occur, unless its non-occurrence is excused, before performance under a contract becomes due.' If a condition does not occur, whether through breach or other cause, the party fails to meet the condition, and acquires no right to enforce the promise. A contractual promise or obligation, on the other hand, raises a duty to perform a service and its breach subjects the promisor to liability and damages, but does not necessarily excuse performance by the other contracting party.³⁹

The court pointed out that, under the Standard Player's Contract, the signing player promised to report to training camp in "good physical condition."⁴⁰ Failure by the player to report to training

37. *Id.* at 87,726. The Standard Player's Contract compensation provision reads, in pertinent part:

Payment of [agreed upon] salary shall be in consecutive semi-monthly installments [sic] following the commencement of the regular League Championship Schedule of games or following the date of reporting, whichever is later; provided, however, that if the player is not in the employ of the Club for the whole period of the Club's games in the National Hockey League Championship Schedule, then he shall receive only part of the salary in the ratio of the number of days of actual employment to the number of days of the League Championship Schedule of games.

Id. at 87,714.

38. *Id.* at 87,726.

39. *Id.* (citations omitted).

40. *Id.* The relevant provision of the Standard Player's Contract reads as follows: The Player . . . agrees,

(a) to report to the Club training camp at the time and place fixed by the Club, in good physical condition,

(b) to keep himself in good physical condition at all times during the season,

(c) to give his best services and loyalty to the Club and to play hockey only for the Club unless his contract is released, assigned, exchanged or loaned by the Club,

(d) to co-operate with the Club and participate in any and all promotional activ-

camp would result in a material breach of the contract by the player.⁴¹ A failure to fulfill the condition of fitness, however, would be tantamount to the non-occurrence of an event, which would give the hockey club the option to excuse the occurrence, terminate the contract, fine and/or suspend the player, or simply not fulfill the Club's obligation to renew the contract.⁴²

The court then engaged in an analysis of punctuation regarding the relevant contractual clauses and concluded that the obligation of the player to arrive "in good physical condition" was a condition, not a promise.⁴³ In accordance with paragraph 2(a) of the National Hockey League Standard Player's Contract, the hockey player agreed "to report to the club training camp at the time and place fixed by the club, in good physical condition."⁴⁴ The *Favell* court explained:

A plain reading of this contract clause and specifically focusing on the punctuation of the clause, could only lead a reasonable person to conclude that the words 'in good physical condition' modify the remainder of the clause, 'to report to the Club training camp at the time and place fixed by the Club,' and describe the *condition* placed upon the hockey player upon arrival at the training camp.⁴⁵

The words "in good physical condition," set off from the remainder of the paragraph by use of a comma before the word "in," indicated that when reading paragraph 2(a) as a whole, reference to the latter clause "in good physical condition" was used as a contractual condition and not as a specific obligation upon the hockey player to perform a particular service to arrive at training camp "in good physical condition."⁴⁶

ities of the Club and the League which will in the opinion of the Club promote the welfare of the Club or professional hockey generally,

(e) to conduct himself on and off the rink according to the highest standards of honesty, morality, fair play and sportsmanship, and to refrain from conduct detrimental to the best interests of the Club, the League or professional hockey generally.

Id. at 87,715.

41. *Id.* at 87,727.

42. *Id.*

43. *Id.*

44. *Id.* at 87,715.

45. *Id.* at 87,727 (emphasis added).

46. *Id.* The plaintiffs asserted that the contract in question required their participation in off-season conditioning programs, and that such participation should be compensated contractual obligations. *Id.* at 87,726. The *Favell* court explained:

The contractual obligation placed upon the hockey player by this paragraph is that the player must 'report' to the training camp at the fixed time arranged by

The court noted that its conclusion that paragraph 2(a) of the player's contract described a condition of fitness as attached to a contractual promise was supported by other provisions of the agreement.⁴⁷ For example, paragraph 3 of the contract addressed the requirement that the player be fit and in a condition to properly perform his duties.⁴⁸ Because paragraph 2(a) requires the player to report in "good physical condition," the court concluded that "fitness" as referred to in paragraph 3 should be considered "good physical condition," thereby making the latter a contractual condition of employment.⁴⁹ Paragraph 4 of the player's contract gave the Club the prerogative to prescribe the player's conditioning plan.⁵⁰ The Club could impose a fine and/or suspension for the failure to comply with the rules of conditioning because such a failure would impair "the thorough and faithful duties incumbent upon the player" to perform.⁵¹ The court found the only duties this paragraph could refer to were the player's obligations to play hockey, a duty for which good physical fitness was a condition precedent.⁵² The court also recognized that nowhere in the contract itself did the contract refer to conditioning or training as a promise, obligation, or duty.⁵³ Writing that it was "unpersuaded by

the hockey club. Contrary to the plaintiffs' contentions, this paragraph, on its face, obligates the player to 'report' to training camp at the prearranged time, having fulfilled the fitness condition, 'in good physical condition.'

Id. at 87,727.

47. *Id.* at 87,728.

48. *Id.* Paragraph 3 of the Standard Player's Contract states, in relevant part: In order that the Player shall be fit and in proper condition for the performance of his duties as required by this contract the Player agrees to report for practice at such time and place as the Club may designate and participate in such exhibition games as may be arranged by the Club within thirty days prior to the first scheduled Championship game.

Id. at 87,714.

49. *Id.* at 87,728.

50. The full text of paragraph 4 is as follows:

The Club may from time to time during the continuance of this contract establish rules governing the conduct and conditioning of the Player, and such rules shall form part of this contract as fully as if herein written. For violation of any such rules or for any conduct impairing the thorough and faithful discharge of the duties incumbent upon the Player, the Club may impose a reasonable fine upon the Player and deduct the amount thereof from any money due or to become due to the Player. The Club may also suspend the Player for violation of any such rules. When the Player is fined or suspended he shall be given notice in writing stating the amount of the fine and/or the duration of the suspension and the reason therefore.

Id. at 87,715.

51. *Id.* at 87,728.

52. *Id.*

53. *Id.*

plaintiffs' position that off-season activities [were] to be compensated under the contract. . . ."⁵⁴ The *Favell* court held that the off-season days were not part of the time basis formula's denominator.⁵⁵

In holding that fitness was a condition of the hockey player's employment, the *Favell* court expressed its adoption of the reasoning of the Second Circuit in *Stemkowski v. Commissioner*.⁵⁶ The Claims Court noted that the plaintiffs' attempts to distinguish *Stemkowski* were based on an assertion of insufficient evidence at the trial level in that case.⁵⁷ The Claims Court disagreed with this position, and interpreted the Second Circuit's reference to an absence of evidence as an indication that there was no evidence that the players were compensated and required by their individual contracts to perform any conditioning or exercise programs.⁵⁸

The *Favell* court also addressed the plaintiffs' claim that their salaries covered a twelve-month period "because of all of the general covenants to which plaintiffs obligated themselves during the entire period of the contracts in question."⁵⁹ The Claims Court

54. *Id.* at 87,729.

55. *Id.* ("Given the words of the standard form contracts themselves, a reasonable reader must conclude that the plaintiffs were being employed, and more important, compensated for their performances as professional hockey players."). See *supra* note 22 and accompanying text.

56. 690 F.2d 40 (2d Cir. 1982). *Stemkowski* involved the taxability of a nonresident alien who played professional hockey for the National Hockey League. *Id.* at 42. As a Canadian citizen, Stemkowski was subject to taxation in the United States on the portion of his income associated with his performance of services in the United States, with the expenditures relating to that income subject to deduction. *Id.* He claimed that his contract salary compensated him for training camp, play-off, and off-season services, and that the days he spent in Canada during training camp, play-offs, and the off-season were applicable to the foreign-source exclusion from income. *Id.* at 44, 45. The Second Circuit held that, while the contract did not cover off-season services, "the [lower court's] finding that the contract [did] not compensate for training camp and the play-offs as well as the regular season [was] clearly erroneous." *Id.* at 45. In finding that the off-season was not covered by the contract, the Second Circuit wrote:

During the off-season, the contract imposes no specific obligations on a player. Stemkowski argues that the obligation to appear at training camp 'in good condition' makes off-season conditioning a contractual obligation. Fitness is not a service performed in fulfillment of the contract but a condition of employment. There was no evidence that Stemkowski was required to follow any mandatory conditioning program or was under any club supervision during the off-season. He was required to observe, if anything, only general obligations, applicable as well throughout the year, to conduct himself with loyalty to the club and the league and to participate only in approved promotional activities.

Id. at 46.

57. *Favell*, 89-1 U.S.T.C. at 87,712. See *supra* note 11 and accompanying text.

58. *Id.*

59. *Id.*

concluded that "no universally mandatory, off-season conditioning programs were required by the contract and . . . the contract [did] not obligate the performance of the claimed off-season conditioning programs as asserted by the plaintiffs."⁶⁰

The lesson of *Favell*, *Stemkowski*, and *Hanna*⁶¹ is clear: if off-season training programs are going to be considered compensated contractual obligations, the hockey player's contract must be drafted to create an *obligation* upon the players to engage in specific training activities.

III. AFTER *FAVELL*: INCOME RE-ALLOCATION AND PERSONAL SERVICE CORPORATIONS

A. *Sargent v. Commissioner*

1. Background

In the case of the athlete playing a team sport, the United States Tax Court in *Sargent v. Commissioner*⁶² adopted a test for determining whether income should be re-allocated between a corporation and its sole service-performer that makes it virtually impossible for an athlete to use a personal service corporation.⁶³

Plaintiff, Gary A. Sargent, was drafted by the professional hockey team, Los Angeles Kings, in 1976.⁶⁴ Sargent then solicited advice from an attorney regarding the potential benefits of self-incorporation.⁶⁵ His attorney informed him that the advantages of incorporation included increased bargaining power and the possibility of setting aside money in a pension plan.⁶⁶ In 1978, Sargent formed Chiefy-Cat, Inc., with himself as the sole shareholder, pres-

60. *Id.* In so concluding, the *Favell* court concurred with the Tax Court's treatment of the issue in *Stemkowski*: "[N]egative covenants in the employment contracts were designed to further the primary purpose of the contract, *i.e.*, playing hockey." *Id.* (quoting *Stemkowski v. Commissioner*, 76 T.C. 252, 298 (1981)).

61. See *supra* note 11.

62. 93 T.C. 572 (1989). In addition to the named plaintiffs, Gary Sargent and Janice B. Sargent, the court consolidated the cases of Steven M. Christoff and Tami Jo Christoff. Although the Tax Court presented and discussed the facts of all the consolidated cases, this Article discusses only the facts relating to Sargent because of the close factual similarity of all the consolidated cases.

63. After the preparation of this Article, the Eighth Circuit Court of Appeals reversed the Tax Court's decision in *Sargent* and rejected the "team" analysis used by the Tax Court. A brief discussion of the Eighth Circuit's opinion is presented as an appendix to this Article.

64. *Id.* at 573.

65. *Id.* at 574.

66. *Id.*

ident, and director.⁶⁷ He then entered into an employment contract with the corporation, wherein he "agreed to perform services as a professional hockey player and consultant exclusively for Chiefy-Cat for the period July 1, 1978, to June 30, 1984."⁶⁸ Sargent also entered into a memorandum of agreement with the Northstar Hockey Partnership (Club), wherein Chiefy-Cat agreed, among other things, "to furnish the services of Sargent as hockey player and consultant to the Club" in exchange for specified remunerations from the years 1978 through 1982.⁶⁹ Additionally, the Club, Chiefy-Cat, and Sargent executed an agreement in which Chiefy-Cat reserved the right "to cause Sargent to perform services on its behalf and that it would cause Sargent to perform his services in order to enable it to fulfill its contractual obligation to the Club."⁷⁰ Further, Sargent guaranteed the Club the performance of all Chiefy-Cat obligations.⁷¹

On March 5, 1980, the Internal Revenue Service determined that the pension plan covering Sargent was a qualified pension plan,⁷² and that Sargent was deficient in his federal income taxes.⁷³ During the years at issue, Sargent was not considered an employee of the Club for purposes of the National Hockey League Players' pension plan; nevertheless the Club paid Chiefy-Cat the amounts that it would otherwise have contributed to the plan on behalf of Sargent.⁷⁴ The amounts at issue related to amounts paid by the Club and subsequently contributed by Chiefy-Cat to its pension plan on behalf of Sargent.

67. *Id.*

68. *Id.*

69. *Id.* Under the memorandum of agreement, the Northstar Partnership agreed to pay to Chiefy-Cat \$85,000 during the 1978 playing season, \$115,000 during the 1979 season, \$120,000 during the 1980 season, and \$130,000 during the 1981 season. *Id.* Under the agreement, the Club reserved the right to sell, transfer or assign, or loan out the services of Sargent. *Id.* at 577. Moreover, Sargent could not, without the Club's consent, participate in any other athletic sport or make any public appearances or sponsorships relating to services performed for the Club. *Id.*

70. *Id.* The scheduling of games was controlled by the Club. *Id.* at 577. The Club's coach determined the strategy of play during the games, which players would play, and for how long they would play. *Id.* The coach also conducted mandatory practices and ran the training camps with the general manager's assistance. *Id.*

71. *Id.* at 574.

72. *Id.* The self-employment contract between Sargent and Chiefy-Cat provided that the corporation was to pay Sargent \$60,000 in the first year and \$95,000 for the following years. *Id.* Chiefy-Cat withheld and paid the proper federal and state taxes, employment, and unemployment taxes. *Id.* During the years 1978 and 1982, Chiefy-Cat contributed a total of \$100,416 to Sargent's pension plan. *Id.* at 575.

73. *Id.* at 573.

74. *Id.* at 576, 77.

2. The Majority Opinion

The court stated that the issue before it was the "taxability of sums earned through the performance of personal services as between the individual who performs the services and the personal service corporation created by that individual."⁷⁵ The IRS argued that, by virtue of the common law rules for determining the existence of an employer/employee relationship, Sargent was an employee of the Club and not Chiefy-Cat, and that the amounts which Chiefy-Cat received from the Club should be taxable to Sargent under sections 61⁷⁶ or 482⁷⁷ of the Internal Revenue Code.⁷⁸ Sargent argued that he was not an employee of the Club, and that neither section 61 nor section 482 applied.⁷⁹

In order to determine whether Chiefy-Cat or the Club was Sargent's employer, the court used principles developed in cases addressing whether an individual was an employee or an indepen-

75. *Id.* at 577.

76. I.R.C. § 61 (1985) provides:

Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

- (1) Compensation for services, including fees, commissions, and similar items;
- (2) Gross income derived from business;
- (3) Gains derived from dealings in property;
- (4) Interest;
- (5) Rents;
- (6) Royalties;
- (7) Dividends;
- (8) Alimony and separate maintenance payments;
- (9) Annuities;
- (10) Income from life insurance and endowment contracts;
- (11) Pensions;
- (12) Income from discharge of indebtedness;
- (13) Distributive share of partnership gross income;
- (14) Income in respect of a decedent; and
- (15) Income from an interest in an estate or trust.

I.R.C. § 61 (1985).

77. I.R.C. § 482 (1986) provides:

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 Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

I.R.C. § 482 (1986).

78. *Sargent*, 93 T.C. at 578.

79. *Id.*

dent contractor.⁸⁰ The court did not examine the legal relationship of Sargent to his corporation, but instead focused on his relationship to the Club.⁸¹

The court recognized that, as in the case of determining employee/independent contractor status, the issue before it was to be resolved based on all the facts and circumstances involved.⁸² In evaluating the relevant facts, the court adopted the "fundamental" test for determining whether an individual is an independent contractor or an employee—"whether the person for whom the work is performed has the right to control the activities of the individuals whose status is in issue, not only as to results but also as to the means and method to be used for accomplishing the result."⁸³

The IRS maintained that "the very nature of a hockey player's position as a member of a team, renders impossible the relationship which petitioners seek to establish between themselves and their corporations."⁸⁴ Sargent, however, argued that by virtue of his talents, he retained control over how he should play in order to accomplish the strategy developed by the coach during training

80. *Id.*

81. This approach is a marked departure from that employed by the Tax Court in similar cases. For example, in *Johnson v. Commissioner*, 78 T.C. 882 (1982), *aff'd*, 734 F.2d 20 (9th Cir.), *cert. denied*, 469 U.S. 857 (1984), a professional basketball player, under contract with the NBA team the San Francisco Warriors, executed an additional contract with Presentaciones Musicales, S.A. (PMSA), a Panamanian corporation. *Id.* at 884. In this agreement, the player, Johnson, gave PMSA the right to his services in professional sports for a limited time, and the corporation agreed to pay him a monthly sum. *Id.* Later, PMSA licensed its rights and obligations under this agreement to EST International (EST), a British Virgin Islands limited liability company. *Id.* The following year Johnson executed an Assignment of Contract Rights, wherein he assigned his contract payments from the Warriors to EST. *Id.* at 885. In *Johnson*, the Tax Court articulated the issue as "whether amounts paid by the Warriors with respect to petitioner's services as a basketball player [were] income to petitioner or to the corporation to which the amounts were remitted." *Id.* at 889. The court stated:

Given the inherent impossibility of logical application of a per se actual earner test, a more refined inquiry has arisen in the form of who controls the earnings of the income. An examination of the case law . . . reveals two necessary elements before the corporation, rather than its service-performer employee, may be considered the controller of the income. First, the service-performer employee must be just that—an employee of the corporation whom the corporation has the right to direct or control in some meaningful sense. Second, there must exist between the corporation and the person or entity using the services a contract or similar indicium recognizing the corporation's controlling position.

Id. at 891 (citations and footnotes omitted). Obviously, the two-step test outlined in *Johnson* was not followed in the *Sargent* case.

82. *Sargent*, 93 T.C. at 578.

83. *Id.*

84. *Id.* at 579.

camp, practice, and actual game play.⁸⁵ "In short, plaintiff[] contend[ed] that the same frame of reference should apply to [his] situation as would be applicable to a player of individual sports."⁸⁶

The *Sargent* court disagreed with this position.⁸⁷ The court determined that the nature of team sports was a "critical element which must be taken into account in determining the existence of an employer/employee relationship in accordance with common law principles."⁸⁸ Furthermore, it expressed its satisfaction with the fact that "the nature of the team sport of hockey involve[d] a high level of control over player activity by coaches and managers that such control [could not] simply be ignored or disguised as mere strategy."⁸⁹ The court, therefore, held that *Sargent* was an employee of the Club and not of his personal service corporation.⁹⁰

Having concluded that *Sargent* was an employee of the Club, the court directed its attention to the determination of whether amounts paid to Chiefy-Cat, his personal service corporation, were taxable to him by virtue of sections 61 and 482 of the Internal

85. *Id.*

86. *Id.*

87. *Id.*

88. *Id.*

89. *Id.* at 580. As the *Sargent* dissent indicated, this position is difficult to understand in light of the *Johnson* case, in which the Tax Court assumed that a basketball player (i.e., a team player) could be an employee of a corporation. *Id.* at 584 (Wells, J., dissenting) (citing *Johnson v. Commissioner*, 78 T.C. 882, 892 (1982)). In his dissent, Judge Wells wrote:

In *Johnson v. Commissioner*, we considered a situation in which a professional 'team player,' more specifically, a basketball player, assigned the rights to his services and payment therefor to certain corporations in exchange for fixed monthly fees. In analyzing that situation, we set forth 'the two requirements that must be met before a corporation, rather than its service-performer employee, will be considered the controller of the income and taxable thereon.' Those requirements are:

(1) the service-performer employee must be an employee of the corporation whom the corporation has the right to direct or control in some meaningful way; and

(2) there must exist between the corporation and the person or entity using the services a contract or similar indicium recognizing the corporation's controlling position.

The majority's analysis in the instant case renders the first requirement of *Johnson* a nullity in the very context in which it was articulated—namely, that of team sports. In *Johnson*, we assumed *arguendo* that a basketball player's contractual arrangement with a corporation satisfied the first requirement of *Johnson*, thus conveying the impression that a team player could potentially meet such a requirement. The majority, however, without directly confronting the issue, now appears to conclude that a team player and his PSC [Personal Service Corporation] can *never*, as a matter of law, satisfy the first requirement of *Johnson*.

Id. at 584-85 (citations and footnotes omitted) (emphasis in original).

90. *Sargent*, 93 T.C. at 580.

Revenue Code.⁹¹ The court distinguished other cases which recognized that a personal service corporation had a separate existence,⁹² stating that those cases had no bearing on the instant case because those cases set forth the requirements of an employer/employee relationship between the taxpayer and his personal service corporation and assumed the existence of such a relationship.⁹³ The court also dismissed any congressional intention to bestow benefits on qualified retirement plans, as such reasoning applied only to the distinguished cases.⁹⁴

In sum, the *Sargent* court concluded that "the instant case [was] a classic situation for the application of the assignment of income doctrine . . . and that the amounts received by Chiefy-Cat . . . for services rendered . . . to the Club should be includable in [Sargent's] income under section 61."⁹⁵

3. The Dissent

In a strident dissent to the Tax Court's opinion, Judge Wells argued that the majority "brushed aside" the traditional test of determining when income should be re-allocated from a personal service corporation to its sole service-performer.⁹⁶ Judge Wells wrote:

The majority disregards the separateness of the PSC's by analyzing the issue in the framework of whether petitioners are 'common-law employees' of the Club. Even though the agreements in the instant case were apparently the subject of arms-length negotiations, the majority fails to analyze whether, under those agreements, the Club gave up its right to 'common-law' control of the petitioners. Indeed, it appears that the Club agreed to deal with petitioners only pursuant to the contractual arrangements provided under the agreements. Although the ma-

91. *Id.* at 581. See *supra* notes 76-77.

92. *Id.* at 582. The *Sargent* court discussed that, in *Keller v. Commissioner*, 77 T.C. 1014 (1981), *aff'd*, 723 F.2d 58 (10th Cir. 1983), it had held:

[W]here the personal service corporation had a recognized separate existence and there were clearly established and observed arrangements between the entities and individual involved, the entire income of that corporation could not be allocated to the taxpayer-shareholder, even though the purpose of forming the corporation was to obtain tax benefits, such as the ability to make contributions to a pension plan.

Sargent, 93 T.C. at 582.

93. *Id.*

94. *Id.*

95. *Id.* at 583.

96. *Id.* at 584 (Wells, J., dissenting).

majority purports to decide merely whether petitioners were the 'employees' of their PSC's, the distinction between finding that petitioners were *not* the PSC's employees, and disregarding the existence of the PSC entirely, is 'largely semantic rather than substantive.'⁹⁷

In summary, under *Sargent*, it would be virtually impossible for an athlete playing a team sport to use a personal service corporation. Fortunately, however, due to changes in the pension laws, athletes no longer have a strong economic and retirement incentive to make use of such corporations.⁹⁸

B. Central Withholding

In a recent Revenue Procedure enactment,⁹⁹ the Internal Revenue Service provided instruction to nonresident alien athletes, entertainers and similarly-situated individuals regarding the procedures for requesting central withholding agreements and qualifying for reduced rates of withholding under Treasury Regulation 1.1441-4(b)(3) of 1986.¹⁰⁰

Section 1441(a) of the Internal Revenue Code of 1986 requires all persons having the control, receipt, custody, disposal, or payment of certain items of income from sources within the United States of any nonresident alien individual to deduct and withhold from such items a withholding tax equal to thirty percent thereof.¹⁰¹ This requirement applies to passive as well as earned income items including interest, dividends, rent, salaries, wages, compensations, remunerations, and emoluments.¹⁰²

Treasury Regulation section 1.1441-4(b)(3),¹⁰³ however, provides:

Compensation for personal services of a nonresident alien individual who is engaged during the taxable year in the conduct of a trade or business within the United States may be wholly or partially exempted from the withholding required by § 1.1441-1 if an agreement is reached between the Director of the Foreign

97. *Id.* at 587-88 (footnotes and citations omitted) (emphasis in original).

98. The Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324, generally eliminated the disparity between tax-qualified corporate and tax-qualified self-employment retirement plans. See Hira, *Self-Employed Retirement Plans: TEFRA Brings Parity, But Disparities Remain*, J. PENSION PLAN. & COMPLIANCE 225 (June 1984).

99. Rev. Proc. 89-47, 1989-2 C.B. 598.

100. *Id.*

101. I.R.C. § 1441(a) (1986).

102. *Id.*

103. Treas. Reg. § 1.1441-4(b)(3) (1986).

Operations District and the alien individual with respect to the amount of withholding required.¹⁰⁴

The newly enacted procedure provides that the Internal Revenue Service will consider entering into a withholding agreement permitting withholding on projected net income at the thirty percent rate or at a graduated rate, provided that certain requirements are met.¹⁰⁵ In no event, however, will a central withholding agreement reduce the amount of withheld taxes to an amount less than the anticipated income tax liability.¹⁰⁶

Specifically, the taxpayer must submit to the IRS: (1) a list of the nonresident aliens to be covered by the agreement; (2) copies of all contracts¹⁰⁷ regarding terms and events to be covered by the agreement; (3) an itinerary of dates and locations of all performances scheduled during the period to be covered by the agreement; (4) a proposed budget containing itemized estimates including substantiation of all gross income and expenses for the period; and (5) the name and address of a person to be contacted if additional information or documentation is required.¹⁰⁸ Also, the IRS must be provided with the name, address and employer identification number of the central withholding agent.¹⁰⁹

According to Revenue Procedure 89-47, when the IRS approves the estimated budget and designated central withholding agents, the Associate Chief Counsel is to prepare a withholding agreement that must be signed by each withholding agent, each covered alien, and the Assistant Commissioner.¹¹⁰ The remainder of the procedure is as follows:

Ordinarily, each withholding agent will be required to agree to withhold income tax from payments to the covered alien; to pay over the withheld tax to the Service on the dates and in the amounts specified in the agreement; and to have the Service apply the payments of withheld tax to the withholding agent's Form 1042 account. Each withholding agent will also be re-

104. *Id.*

105. Rev. Proc. 89-47, 1989-2 C.B. 598.

106. *Id.*

107. The Revenue Procedure lists "all" contracts as including (but not limited to) "contracts with employers, agents, and promoters; exhibition halls and the like; persons providing lodging, transportation, and advertising; and accompanying personnel such as band members or trainers." Rev. Proc. 89-47, 1989-2 C.B. 598.

108. *Id.*

109. *Id.* A central withholding agent "receives contract payments, keeps books of account for the covered aliens, and pays expenses (including tax liabilities) of the covered aliens during the period covered by the agreement." *Id.*

110. *Id.*

quired to file Form 1042 and Form 1042S for each tax year in which income is paid to a covered alien with respect to the period and events covered by the agreement. The Service will credit the withheld tax payments, posted to the withholding agent's Form 1042 account, in accordance with the Form 1042S. Each covered alien must agree to file Form 1040C.¹¹¹

While the process of obtaining a central withholding agreement may appear to be cumbersome and time-consuming, the benefit of reduced withholding may be well worth the effort.

111. *Id.*

APPENDIX

Discussion of the Eighth Circuit Court of Appeals'
Opinion Reversing the Tax Court's Decision in
Sargent v. Commissioner

In its decision filed April 2, 1991, the United States Court of Appeals for the Eighth Circuit reversed the Tax Court's decision in *Sargent*.¹¹² The court noted that this appeal presented a case of first impression.¹¹³ The court also pointed out that the decision of the Tax Court would be reviewed under a standard of review whereby the trial judge's findings of fact will not be set aside unless clearly erroneous.¹¹⁴

The Eighth Circuit held that Sargent was an employee of his PSC because the PSC had the contractual right to "control" him; whereas the Tax Court had determined that Sargent was an employee of the club and not his PSC because the club, and not the PSC, exercised "control" over him. The court flatly rejected the Tax Court's reasoning that because Sargent was a member of a hockey "team," the requisite control over him—for purposes of taxation—was lodged in the hockey club and not in his PSC.¹¹⁵

The court quoted Treasury Regulation Section 31.3121(d)-1(c)(2) (1980) which states that, "[i]n connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if it has the right to do so."¹¹⁶ The appellate court rejected the Tax Court's reliance on the "team" factor to be determinative of whether there existed the control element necessary for an employment relationship.¹¹⁷

The appellate court pointed out that there were two requirements which must be met before the PSC rather than the service-recipient may be considered to be the true controller of the service-provider. First, the service-provider must be an employee of the corporation and that corporation must have the right to exercise some meaningful control. Second, there must exist between

112. 929 F.2d 1252 (1991).

113. *Id.* at 1253.

114. *Id.* at 1254.

115. The appellate court stated:

The Tax Court takes the position that because Sargent and Christoff were members of a hockey "team," the requisite control over them—for purposes of taxation—was lodged in the hockey club and not the respective PSCs, with which they had a contractual employment relationship. We reject this contention.

Id.

116. *Id.* at 1256.

117. *Id.* The court stated that "[s]uch an arbitrary approach is specious at best." *Id.*

the PSC and the service-recipient a similar indicium recognizing the corporation's controlling position.¹¹⁸

The appellate court pointed out that the Tax Court did not focus on this "team" element when it had previously decided *Johnson* which involved a basketball player.¹¹⁹ Further, the appellate court stated that the Tax Court's "team" analysis "further breaks down when one looks at a decision handed down by the Tax Court just one day after the case before us."¹²⁰ The court examined the Tax Court's decision in *Pflug v. Commissioner*.¹²¹ There, an actress entered into an exclusive employment contract with her husband's corporation. Subsequently, that corporation entered into a contract with a major film studio, agreeing to provide the services of Ms. Pflug for a new television series. In order to determine the case, the Tax Court was first required to decide whether Ms. Pflug was an employee of that corporation.¹²² The court pointed out that the Tax Court held that the contracts between the respective parties were dispositive of this issue because those contracts provided the corporation with dominion and control over its employee, Mrs. Pflug.¹²³

The court stated that it was "perplexed" to find that existence of the contractual arrangements which were dispositive of the issue of "control" in *Pflug* were summarily discarded in *Sargent*¹²⁴ and that the same "team" factors which were dispositive of the issue of

118. Accordingly, within Regulation §31.3121(d)-(1)(c)(2), two necessary elements must be met before the corporation, rather than the service-recipient, in this case the North Stars Hockey Club, may be considered the true controller of the service-provider. First, the service-provider must be just that—an employee of the corporation whom the corporation has the right to direct or control on some meaningful sense. See *Vnuk v. Comm'r*, 621 F.2d 1318, 1320-21 (8th Cir. 1980); *Johnson v. Comm'r*, 78 T.C. 882 (1982). Second, there must exist between the corporation and the person or entity (Club) using the services of a contract or similar indicium recognizing the corporation's controlling position. See *Pacella v. Comm'r*, 78 T.C. 604 (1982); *Keller v. Comm'r*, 77 T.C. 1014 (1981), *aff'd*, 723 F.2d 58 (10th Cir. 1983); *Johnson*, 78 T.C. 882 (1982).

119. *Sargent*, 929 F.2d at 1256.

120. *Id.* at 1257.

121. 58 T.C.M. 685 (1989).

122. *Sargent*, 929 F.2d at 1257.

123. The appellate court quoted the Tax Court which stated:

The fundamental question is whether Charwool had the right to exercise dominion and control over the activities of [Pflug], not only as to results, but also as to the means and methods used to accomplish the result. We find, by virtue of the contract, [Pflug] entered with Charwool, Charwool had the requisite right to control [Pflug].

Pflug, 58 T.C.M. at 688; *Sargent*, 929 F.2d at 1257.

124. In fact, the Eighth Circuit pointed out that the contracts in *Sargent* were "of a more bona fide nature" because those contracts were in writing, while the contracts in *Pflug* were oral. *Sargent*, 929 F.2d at 1257.

control in *Sargent* were not even discussed in *Pflug*.¹²⁵ The court reasoned that an actress is as much a part of a team "including the case, writers, directors and producers all working toward a common goal" as a hockey player.¹²⁶

Having disposed of the "team" analysis of control advanced by the Tax Court, the Eighth Circuit found "ample Tax Court precedent which upholds the sanctity of contractual relations between taxpayers and their respective personal service corporations."¹²⁷

The court pointed out that by rejecting the Tax Court's "team" test, and by recognizing the viability of the contracts between the athletes and their personal service corporations, it had effectively decided the only issue presented: by whom were the appellants employed.¹²⁸

The court went on to hold that "[b]y embracing the 'contract' theory of this case, we were at the same time discarding the Tax Court's conclusion that this case involves the 'assignment of income' doctrine."¹²⁹ The court held that the situation in *Sargent* was "clearly inapposite to the situation in *Lucas v. Earl*.¹³⁰

The appellate court recognized that the assignment of income doctrine can be overused.¹³¹ The appellate court quoted the Tax Court which had observed in *Johnson* that:

125. *Id.*

126. The appellate court stated:

Was not Joanne Pflug a part of a team every bit as "controlled" as Sargent and Christoff? Like a hockey team in which different players assume different roles to insure success, the members of Pflug's team included the cast, writers, directors and producers all working toward the common goal of producing a successful TV series. More importantly, just as a hockey player has a generalized set of plays tailored to fit his talents and the talents of his teammates, so, too, Ms. Pflug's "plays" included movements carefully choreographed to mesh with other case members, a script prepared for her to follow, cue cards to insure that little or no deviation from the designed "play" occurred, and numerous retakes to guarantee that ultimate control vested in the hands of the studio, not Ms. Pflug's PSC. Nevertheless, the Tax Court concluded that Ms. Pflug was an employee of her PSC.

127. *Id.* at 1258.

128. *Id.*

129. The "assignment of income" doctrine was articulated in *Lucas v. Earl*, 281 U.S. 11 (1930), which involved a contract between a husband and wife that declared all property which they were to receive to be taken by them as joint tenants. The husband received salary and attorneys' fees and was the only party to the contracts by which the salary and the fees were earned. The Supreme Court held that half of the husband's personal service income could not, by the contract, be assigned to the wife for tax purposes. Mr. Justice Holmes noted that the arrangement was one by which "the fruits are attributed to a different tree from that on which they grew." *Id.*

130. *Sargent*, 929 F.2d at 1258.

131. *Id.* at 1259.

However, the realities of the business world present an overly simplistic application of *Lucas v. Earl* rule. Whereby the true earner may be identified by pointing to the one actually turning the spade or dribbling the ball. Recognition must be given to corporations as taxable entities which, to a great extent, rely upon the personal services of their employees to produce corporate income. Where a corporate employee performs labors which give rise to income, it solves little merely to identify the actual laborer. Thus, a tension has evolved between the basic tenets of *Lucas v. Earl* and recognition of the nature of the corporation business form.¹³²

The appellate court relied upon the language of the Supreme Court which stated that the tax advantages which properly flow from incorporation should not be questioned so long as a corporation carries on some form of business.¹³³ Indeed, the appellate court pointed out that the Tax Court had voiced the same conclusion when it stated that "the policy favoring the recognition of corporations as entities independent of their shareholders required that we not ignore the corporate form so long as the corporation actually conducts business."¹³⁴ The appellate court pointed out that, in this case, there had been obvious business activity.¹³⁵

Thus, in view of obvious business activity by the appellant's PSCs, these cases are removed from that type of conduct which is forbidden under the "assignment of income flow doctrine."¹³⁶ Finally, the court pointed out that the fact that "each Appellant has taken steps to enhance his retirement through a richer corporate-sponsored pension plan is of no consequence to this

132. *Id.* (quoting *Johnson*, 78 T.C. at 890).

133. The court quoted the Supreme Court's reasoning:

The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that business is the equivalent of business activity or is followed by the carrying on of the business by the corporation, the corporation remains a separate taxable entity. *Molene Prop. Inc. v. Comm'r*, 319 U.S. 436 (1943).

134. *Sargent*, 929 F.2d at 1259 (quoting the Tax Court in *Keller v. Comm'r*, 77 T.C. 1014, 1031 (1981)).

135. The appellate court stated:

Indeed, at no time has the Commissioner questioned the legitimacy of Appellants' corporate business activities. According to the record, both RIF and Chiefy-Cat withheld income and employment taxes from the salary payments to Appellants; paid contributions to the Chiefy-Cat Pension Plan and the RIF Pension Plan on account of their employment of Sargent and Christoff, respectively; and filed corporate tax returns and paid corporate income taxes.

Id. at 1260.

136. *Id.*

court.”¹³⁷

Whether the Tax Court or other circuit courts will follow the traditional “contract” test followed by the Eighth Circuit Court of Appeals in *Sargent* remains to be seen. What is clear, however, is that if a “team” analysis is adopted by a court, then it is virtually impossible for an individual employed as a member of a team to be treated as an employee of his personal service corporation. What is also unclear is how broadly the term “team” will be applied. For example, could other courts determine that an actress can be employed by a personal service corporation when she is a member of the “team” making the film? Under a “contract” theory, an individual is considered employed by his personal service corporation if there is a contract between the service-provider and his personal service corporation giving the corporation the right to direct or control him in some meaningful sense, and there is a contract between the personal service corporation and the service-recipient (or similar indicium) recognizing the personal service corporation’s controlling position.

137. *Id.*