

10-1-1984

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Recommended Citation

John Connors, *The Role of Self-incorporation by Professional Athletes in Today's Tax Climate - After TEFRA And TRA '84*, 2 U. Miami Ent. & Sports L. Rev. 1 (1984)

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ENTERTAINMENT & SPORTS LAW JOURNAL

THE ROLE OF SELF-INCORPORATION BY PROFESSIONAL ATHLETES IN TODAY'S TAX CLIMATE — AFTER TEFRA AND TRA '84

JOHN CONNORS*

After reviewing the various strategies that the Internal Revenue Service employs to attack those Personal Service Corporations which it perceives as a tax subterfuge, the author details the changes brought by the Tax Reform Act of 1984 and especially the Tax Equity and Fiscal Responsibility Act of 1982. Analyses cover new section 269A as well as the various provisions which have generally eliminated the disparity between corporate and non-corporate retirement plans. The article concludes by exploring the continuing role of self-incorporation, primarily in the area of family planning.

INTRODUCTION

The enactment of the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982¹ changed the role of the Personal Service Corporation² (PSC) as a planning tool. TEFRA installed section

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

2. Corporations which generate income primarily by providing outsiders with the services performed by their controlling shareholders. Typically capital is not a material income-producing factor. See, e.g., Bailey, *Section 482 and the Aftermath of Foglesong: The Beginning of the End for the Personal Service Corporation*, 15 IND. L. REV. 639 (1983); Feuer, *Section 482, Assignment of Income Principles and Personal Service Corporations*, 59 TAXES 564 (1981); Manning, *The Service Corporation: Who is Taxable on its Income: Reconciling Assignment of Income Principles, Section 482, and Section 351*, 37 U. MIAMI L. REV. 657 (1983).

269A³ as the Internal Revenue Service's (IRS's or Service's) newest device for combatting those PSC's which the Service perceives as a tax subterfuge. For a very limited group of PSC's, section 269A gives the Service the power to allocate all of the income to the employee/owner instead of to the PSC. Various pension provisions have now generally eliminated the disparity between corporate and non-corporate retirement plans for self-employed individuals, formerly the major inducement to self-incorporating.⁴ A variety of tax and non-tax advantages to operating in corporate form remain, but any tax savings is bought at the price of potential confrontation with the IRS, and may be lost. Proper planning can head off this confrontation as well as maximize savings.

A PSC might be defined as a corporation whose principal income producing activity is the performance of services by its founder, typically the principal shareholder.⁵ Frequently the PSC retains income by paying its employee/owner less than it is receiving as compensation for providing services, and little or no dividends. Since by definition any income retained by the PSC is the direct result of personal efforts of its employee/owner, the question arises whether that income should rightfully be taxed to the employee/owner. Because corporations are taxed at lower rates than individuals,⁶ the greater the leniency afforded the PSC to retain income generated by the employee/owner, the more the IRS sees it as undermining the graduated income tax structure — unless the separate existence of the PSC can be explained by legitimate business purposes.

PSC's became the vogue during the 1930's mostly at the hands of entertainers, inventors, and other creative types⁷ seeking to have

3. I.R.C. § 269A (1982). See Wood, *The Keller, Foglesong, and Pacella Cases: 482 Allocations, Assignment of Income, and New Section 269A*, 10 J. CORP. TAX 65 (1983).

4. See Hira, *Self-Employed Retirement Plans: TEFRA Brings Parity, but Disparities Remain*, 10 J. PENS. PLAN. & COMP. 225 (1984); Weiss, *Pension Changes Under TEFRA*, 27 B. BAR. J. 8 (1983).

5. See *supra* note 2.

6. The effective tax rate on the first \$100,000 of taxable income to the corporation is 25.75% for tax years beginning after 1982, as compared with an effective tax rate on the first \$100,000 of taxable income to the individual of 38% for taxable years beginning in 1984. Furthermore, this dramatically lower rate (i.e., approximately a 33% decrease) applies after:

1). paying the shareholder/employee a salary and receiving a full corporate reduction for it, and

2). especially after any additional amounts have been deferred by funding various retirement plans (i.e., up to \$30,000 for defined contribution plans and under defined benefit plans, up to \$90,000).

7. Their tax attorneys.

their income taxed at lower corporate rates. In a sense it was nothing more than an attempt to use the PSC as an *incorporated pocketbook*. As an additional attraction, the taxpayer received corporate deductions not otherwise available to a self-employed individual.⁸ Gradually, the attraction of superior pension and health plan contribution deductions predominated among motivations for self-incorporating⁹ and led to the substitution of the PSC for an individual into a partnership or other association.¹⁰ The resulting divorce of that individual from constraints upon the benefit plans of his or her partners and/or any other fellow employees raised the question of possible discrimination in addition to tax avoidance.

The IRS has been unrelentingly concerned with possible tax avoidance and discrimination achieved by abuse of the PSC form. Tempering the IRS's justification for concern has been, at least in the view of the courts, "the policy in favor of recognizing corporations as separate taxable entities."¹¹ This tension has surfaced in the mixed response to the series of attempted invasions by the IRS into the treasuries of various PSC's: some were successful; others were rebuffed by the courts. Weapons yielded by the IRS have included the sham theory, the assignment of income doctrine, and section 482 of the Code. New section 269A is designed to reach transactions where the other devices fail; its meaning becomes clear in light of their limitations.

I. IRS ATTACKS ON THE PSC

A. The Sham Theory

Initially the IRS used to try to tax an employee/owner on the income retained by its PSC under the *sham theory*. If the Commissioner could show that the PSC was a mere sham, then its existence could be ignored for tax purposes and all income would be

8. Prior to TEFRA, the self-employed professional had only the H.R. 10 or Keogh retirement plan available which was subject to greater restrictions on deductions than corporate plans were. Selectively unfavorable antidiscrimination and Social Security integration rules also made corporate plans more appealing for businesses with a number of employees. See *infra* notes 67, 71, and accompanying text.

9. See Scallen, *Federal Income Taxation of Professional Associations and Corporations*, 49 MINN. L. REV. 603 (1965).

10. *E.g.*, *Keller v. Commissioner*, 77 T.C. 1014 (1981), *aff'd*, 723 F.2d 58 (10th Cir. 1983).

11. *Rubin v. Commissioner*, 51 T.C. 251 (1968), *rev'd*, 429 F.2d 650, 653 (2d Cir. 1970), *on remand*, 56 T.C. 1155 (1971), *aff'd per curiam*, 460 F.2d 1216 (2d Cir. 1972).

attributable to the professional in his or her individual taxpayer capacity. The sham theory reflects the notion that the corporation is a creature of statute,¹² and that recognition of corporate status may demand concessions. The concessions demanded have been relatively few. In 1943, the Supreme Court in *Moline Properties, Inc. v. Commissioner*, enunciated a simple test for ascertaining whether to recognize corporate status.¹³ What has emerged from *Moline* is that only a minimal amount of business activity need occur for the courts to recognize a corporation as a separate legal entity. Consequently, the Service has been reluctant to assert the sham doctrine in recent years, despite situations where it strongly appeared that tax avoidance as a principle reason for self-incorporating.

The case of *Roubik v. Commissioner*, made clear that the sham theory would apply only in extreme cases where corporate formalities have been disregarded.¹⁴ In *Roubik*, four radiologists formed "Dr. Pfeffer & Associates, Chartered." Prior to incorporation, Dr. Pfeffer personally had contracted to employ the three other doctors (including Roubik) as needed to meet his commitment of services to two hospitals. The two hospitals paid Dr. Pfeffer directly; he paid the others. Before and after incorporation, all four doctors also worked for other clinics. The PSC exercised no control over their work assignments or conditions. The only change in practice was that the two hospitals, and then the other clinics, were paying the account of Dr. Pfeffer Associates, instead of the account of Dr. Pfeffer. Stressing the lack of business activity and labelling the PSC a "mere centralization of bookkeeping," the Tax

12. For a list of statutes enabling professional groups to practice as corporations, see Bailey, *supra* note 2, at 639-40. These laws were largely intended to benefit doctors and lawyers who previously were precluded from using the corporate form. A struggle between the IRS and these professional corporations ensued. The IRS issued the "Kintner Regulations" which simply stated that these groups, formed largely to obtain advantageous pension benefits, would not be taxed as corporations. After losing a number of cases, *e.g.*, *O'Neil v. United States*, 410 F.2d 888 (6th Cir. 1969), *Kurzner v. United States*, 413 F.2d 97 (5th Cir. 1969), and *United States v. Empey*, 406 F.2d 157 (10th Cir. 1969), and following the issuance of even amended regulations, the IRS withdrew them on August 8, 1969. For an excellent discussion of the tax origins of the classification (as either partnership or corporation) issue, and the tax status of professional corporations under the Kintner Regulations, see Scallen, *supra* note 9.

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

319 U.S. 436, 438-39 (1943) (footnotes omitted).

14. 53 T.C. 365 (1969).

Court upheld findings of deficiencies to each doctor, but the majority did not specifically apply the sham theory. Instead, it looked through the form to the substance of the transaction for the "true earner" of the income involved — the assignment of income approach.¹⁵

B. Assignment of Income and Section 61

The assignment of income doctrine is the second major argument the IRS has often used to attribute income to the professional instead of to the PSC.¹⁶ It evolved from the now famous case of *Lucas v. Earl*, in which the Supreme Court declared that income must be taxed to its "true earner," and that such taxation cannot "be escaped by anticipatory arrangements and contracts however skillfully devised."¹⁷ Its basic premise is that one taxpayer cannot assign income to another person or entity in order to secure a tax advantage, and it embraces the substance over form approach consistent with section 61 of the Internal Revenue Code (Code) which states: "gross income means all income from whatever source derived."¹⁸ In the context of the PSC, the IRS has tailored the *Lucas* argument to claim that since the employee/owner is the true earner of any income retained by the PSC, it is the employee/owner who should be taxed on it.

A thorough understanding of assignment of income principles reveals that there are three distinct kinds of possible transfers.¹⁹ Since this article concerns the shifting of income for planning purposes from a principal wage earner to other lower bracket taxpayer-

15. Both the court's and the concurring opinion distinguished the classification issue. For the court, the issue was whether the corporation "earned" the income. *Id.* at 378-79. The concurring opinion was also concerned with recognition of corporate status: "The professional service corporation acts . . . did not relieve the corporation of the obligation of performing some meaningful business function in order to gain recognition." *Id.* at 382.

16. See *supra* note 2.

17. 281 U.S. 111, 115 (1930).

18. I.R.C. § 61 (1982).

19. (1) the gratuitous assignment of income (usually income not yet earned economically)—principally a question of to whom income is taxed; (2) the transfer of rights to income that has been earned economically but not yet recognized for tax purposes— frequently a question of whether income will escape taxation because of tax accounting principles; and (3) the transfer of rights to income for consideration in transactions that seek to convert ordinary income into capital gain—a question of the character of income to the taxpayer at the time of receipt.

Manning, *supra* note 2, at 667. The difference between the questions raised by the first two kinds of transfers stems from the former involving a carryover basis and the latter a stepped-up or market value at time of transfer basis. *Id.* at 667-76.

ers (usually family members), the only kind of transfer involved is the "gratuitous assignment of income earned or to be earned," and the important question is, who is to be taxed on the income?²⁰ *Lucas* dealt directly with this situation of gratuitously transferring the right to future wages.

The case of *Helvering v. Horst*, extended the reach of the doctrine to cover gratuitous assignments of property income.²¹ No legal effect can be given to an "arrangement by which the fruits are attributed to a different tree from that on which they grew."²² Nevertheless, it is relatively easy to do planning when one can physically divest himself of the underlying income-producing property. What happens when the wage earner is the income-producing property? It may be that in structuring transfers of income to lower bracket taxpayers via their share ownership in a PSC, the crux is to make sure that a legitimate portion of stock was obtained initially by purchasing goodwill. The courts have yet to explore this exact question. In determining whether there has been an improper assignment of income to the PSC, and whether the PSC is conducting any legitimate business activity, the courts have looked for the exercise of some control by the PSC over the performance of services by its employee/owner(s).

C. Section 482

The third weapon in the arsenal of the IRS is section 482.²³

20. Cf. *Keller v. Commissioner*, *supra* note 10, distinguishing between gratuitous assignment of income and apportionment between ordinary income and tax preferred. There, I.R.C. provisions had created the deferrals so that no income would ultimately escape taxation. The Tax Court found no issue of gratuitous assignment of income also because the employee/owner owned all of the stock in the PSC and substantially all, except for the deferred portions, of the PSC income was redistributed to the employee/owner. See *Manning*, *supra* note 2, at 685. TEFRA has amended the pension provisions so that no such increased deferral is created by incorporating. Section 269A now also allows the IRS to allocate income to the employee/owner where tax benefits are otherwise secured by incorporating, if the PSC is performing substantially all services for one client.

21. 311 U.S. 112 (1940). A father detached interest coupons from bonds that he continued to own and gave them to his son. The father, instead of the son, was taxed on the interest.

22. See generally *Lyon & Eustice, Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case*, 14 MAJOR TAX PLAN. 47 (1962).

23. In any case of two or more organizations, trades or businesses (whether or not incorporated, . . .) 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 . . . if he determines that such distribution . . . is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

Under cover of section 482, the Commissioner may apportion income between two or more commonly controlled organizations, trades, or businesses if necessary to prevent tax evasion or clearly to reflect income. Allocation of income proceeds under an *arm's length* transaction test. If the income, which would have resulted to the controlled taxpayer (in our case the employee/owner) had it dealt at arm's length, is the same as the income which did result, then no allocation is necessary.²⁴ The Commissioner has broad discretion in applying section 482 and is not reversed on appeal unless his determinations are found to be an abuse of discretion, i.e., arbitrary, capricious, or unreasonable.

Threshold issues in applying section 482 to the PSC are whether an employee/owner as an employee qualifies as a separate trade or business, and if so, whether the business is controlled by the *same interests*.²⁵ In applying the arm's length transaction test to the PSC, courts have recognized that total compensation to the employee/owner includes benefit and medical reimbursement plan contributions and that deferrals are worth more to a high tax bracket individual than to a low one.²⁶

D. Interplay

The celebrated case of *Foglesong v. Commissioner*,²⁷ illustrates the interplay between the sham theory, the assignment of income doctrine, and section 482. Fred Foglesong was a sales representative who marketed steel tubing for two separate manufac-

I.R.C. § 482 (1982).

24. The purpose underlying section 482 "is to place a controlled tax payer on a tax parity with an uncontrolled tax payer, by determining . . . the true taxable income of a controlled tax payer." Treas. Reg. § 1.482-1(b)(1). See e.g., *Pacella v. Commissioner*, 78 T.C. 604 (1982). See also *supra* note 2.

25. The Tax Court has generally recognized that section 482 even applies to situations where the employee/owner wholly owns and controls the PSC. *Fatland v. Commissioner*, 48 T.C.M. (CCH) 1107, 1110 n.7 (1984). But see *Foglesong v. Commissioner*, 77 T.C. 1102 (1981), *rev'd*, 691 F.2d 848 (7th Cir. 1982). The issue of whether the existence controlling family members or other controlling shareholders may defeat the "same interests" requirement has been raised by commentators advocating a need for resort to the assignment of income doctrine due to the inadequacy of section 482 in certain cases, e.g., *Manning supra* note 2, at 677-79.

26. In *Pacella*, *supra* note 24, the Tax Court reasoned that although Dr. Pacella received about \$6,000 or \$7,000 more per year in total compensation for treatment services prior to incorporating, he was able to defer roughly \$20,000 per year in pension plan contributions after incorporating, and since the value of a \$20,000 deferral to a taxpayer in Dr. Pacella's income bracket was equivalent to about \$6,000 or \$7,000, his economic position had not changed significantly. 78 T.C. at 620-21.

27. 35 T.C.M. (CCH) 1309 (1976), *rev'd*, 621 F.2d 865 (7th Cir. 1980), *on remand*, 77 T.C. 1102 (1981), *rev'd*, 691 F.2d 848 (7th Cir. 1982). See also *supra* note 2.

turers. He self-incorporated and issued 98% of the common stock to himself, and 1% each to his wife and to his accountant. He paid for four hundred dollars worth of preferred stock to be issued to his children. He informed the two manufacturers to mail checks directly to the PSC. Employment contracts between himself and the PSC, and more importantly, between the PSC and the two manufacturers, were not executed until a few years later. The PSC hired a secretary, paid sales expenses, carried insurance, and issued thirty-eight thousand dollars worth of preferred dividends over a four year span to the children on their four hundred dollars worth of stock.

Initially the Tax Court (Foglesong I) agreed that the main reason for the PSC was tax avoidance but that the PSC was not a sham. Because the PSC had not been given enough control over the actual earning process, the Tax Court assigned the income back to Foglesong. The Seventh Circuit (Foglesong II) reversed and remanded, marking the inappropriateness of using the *Lucas* theory to reach the same result as would occur with a sham. On remand, the Tax Court (Foglesong III) allocated income pursuant to section 482, but on a second appeal a different panel of the Seventh Circuit (Foglesong IV) held that section 482 could not apply because the separate trade or business threshold test had not been met. The court remanded for assignment of income treatment to the dividends paid to his children and for commissions earned before incorporating but paid to the PSC. The case was eventually settled out of court.

The court agreed that the legislative history of section 482 clearly precluded one's employment status alone from being considered sufficient to constitute a basis for having a *separate trade or business* so as to make the section operative for allocation purposes. Thus all monies earned after incorporation were considered those of the service corporation. Foglesong did agree to have pre-incorporation monies earned by him assigned back and included in his income. It was also agreed that the preferred stock dividends would be treated as additional compensation paid by the service corporation to Foglesong. After receiving a deduction for this additional compensation (something that was unavailable when these amounts were treated as dividends), the total amount owed by the taxpayer and his service corporation amounted to a little over \$3,500 plus interest. This compares to over \$300,000 in deficiencies outstanding when the out-of-court settlement process was initially commenced.

E. Cases

The first PSC cases were *Fox v. Commissioner*,²⁸ and *Laughton v. Commissioner*,²⁹ both of which were won by the taxpayer. In the former, Fontaine Fox was a highly compensated cartoonist. After forming a corporation to sell his cartoons, he executed an exclusive employment contract with it and was to receive a fixed monthly salary. Shortly afterwards, the PSC signed syndication contracts for the cartoons and was paid much more than it was in turn paying Fox. The Commissioner sought to attribute all of the PSC's income to Fox. Employing the sham theory and the assignment of income doctrine, the Commissioner asserted that Fox and his PSC were *inseparably intertwined*. The Board of Tax Appeals rejected the sham theory since the PSC had been validly formed pursuant to state law and had adhered to all corporate formalities. Regarding any assignment of income, the Board held that when Fox transferred the cartoons, he transferred income producing property itself, not income earned or to be earned from it.³⁰

The IRS tasted a short-lived success utilizing the assignment of income doctrine in *Rubin v. Commissioner*.³¹ Rubin had been an officer of Rubin Bros. during the late 1950's. Dorman Mills, a client, owed Rubin Bros. some \$60,000 or \$70,000. Rubin and his two brothers formed a PSC which loaned money and provided Rubin's management services to Dorman Mills until it recovered. The management services contract with Dorman Mills was executed by Rubin in his individual capacity before the PSC had even been formed. Dorman Mills was to compensate the PSC with a percentage of its profits. Rubin never entered into an employment contract with the PSC, and the PSC was paid substantially more than it was in turn paying Rubin.

The Commissioner sought to allocate all of the PSC's income to Rubin relying on sections 61 and 482. The Tax Court concluded that, while in form Rubin worked for the PSC, in substance he worked directly for Dorman Mills. Alternatively, the court found that Rubin should be taxed on the PSC's income under the assignment of income doctrine since he controlled its income. Essentially

28. 37 B.T.A. 271 (1938).

29. 113 F.2d 103 (9th Cir. 1939) (upholding the corporation which loaned out the famous English actor as not a sham but remanding on possible application of assignment of income principles). The case was eventually settled out of court with no further resolution on the *Lucas* theory.

30. 37 B.T.A. at 277-78.

31. *Supra* note 11.

the court felt the taxpayer had failed to carry his burden of proof (i.e., that there was substance in, or an economic purpose for, casting his transaction in the form he chose). The IRS victory was quickly overturned, when on appeal, the Second Circuit reversed and remanded. Judge Friendly was distressed at what he perceived as the "all or nothing approach" to the assignment of income doctrine, and the "broad sweep" of section 61.³² He remanded for application of section 482 instead.

The court in *Rubin* mistakenly equated the assignment of income doctrine with the sham theory. The Seventh Circuit in *Foglesong* concluded that since the corporation could not be disregarded, the assignment of income doctrine could not apply.³³ The Tax Court in *Keller v. Commissioner* termed the distinction between "classification as a corporation" and "determination of the true earner" as "largely semantic rather than substantive."³⁴ Out of fear of reversal or possibly out of lack of proper standards to apply, the Tax Court in 1984 crystallized its position in favor of throwing out the assignment of income doctrine with the bathwater:

The effect of assigning income under section 61 is to hold that the personal service corporation is a sham. . . . (T)wo circuits have reversed this Court where we have sought to apply the common law doctrine of assignment of income. Based on this record, the assignment of income doctrine has no place in the personal service context as long as even minimal respect is given to the corporate entity.³⁵

It does not follow, however, that the PSC is totally safe from the assignment of income theory. As late as 1982, the Ninth Circuit upheld the Tax Court's application of section 61 to a professional basketball player.³⁶

Charles Johnson played in the National Basketball Association. He entered into an exclusive employment contract with an already existing PSC for financial planning purposes. It is not clear whether he owned any stock in the PSC. The teams he played for insisted that he personally sign Uniform Players Contracts and refused to deal with the PSC except to remit payments to it. Applying a *refined* control test under *Lucas*, the Court concluded that

32. 429 F.2d at 653.

33. *Supra* note 27 and accompanying text.

34. 77 T.C. at 1019.

35. *Fatland*, 48 T.C.M. (CCH) at 1112.

36. *Johnson v. Commissioner*, 78 T.C. 882, *aff'd*, 698 F.2d 372 (9th Cir. 1982).

the lack of a contract between the PSC and the client teams was critical. The PSC had also loaned money to the taxpayer. The Tax Court in *Johnson* apparently did not believe that section 482 applied, unlike the Seventh Circuit in *Foglesong* and the Second Circuit in *Rubin* — the two courts which reversed the Tax Court and saw section 482 as the preferred alternative.

New section 269A addresses the concern that section 482 may not be able to cover all bases.³⁷ The new section will govern future Johnson-type professional athletes who regularly work for only one team, e.g. football, baseball, basketball, and hockey players.³⁸ It therefore behooves the tax planning advisers to individual players such as tennis and golf professionals to remain aware of the more traditional IRS assaults upon the PSC, like the sham theory and the assignment of income doctrine. Moreover, a proper application of new section 269A may entail a revisit to understanding assignment of income principles. Before turning to section 269A, it is worthwhile to peruse those decisions which have diminished the potency of section 482 as well as of section 61.

In *Keller v. Commissioner*,³⁹ the taxpayer was a physician who, in partnership with ten other doctors, provided pathology services to numerous hospitals and other physicians. Four years after joining the partnership, Dr. Keller self-incorporated and substituted Keller, Inc. as a partner pursuant to a written agreement. Keller, Inc. immediately adopted a medical reimbursement plan, a wage continuation plan, and a qualified benefit plan. There was no dispute that Keller's principle purpose in incorporating was to plan for his family's needs. Separate books and records were maintained and great care was taken to observe corporate formalities. However, the PSC owned no property, incurred no debt, and had only Dr. Keller and his wife as employees.

The Tax Court rejected any proposition that the securing of advantageous pension plans manifested tax avoidance under section 482. Two crucial factors were that Dr. Keller owned all of the PSC's stock, and that substantially all of the PSC's earned income was distributed to him as compensation. While Dr. Keller's taxable income had been substantially reduced due to pension plan contri-

37. "[P]lainly, we will sooner or later be confronted with arrangements between professionals and corporations for which section 482 will be inadequate, and the decision today to so lightly discard the assignment of income doctrine will come home to roost." *Keller v. Commissioner*, 77 T.C. 1014, 1045, *aff'd*, 73 F.2d 58 (10th Cir. 1983) (dissent).

38. Because of the *substantially all services be performed for one client* prerequisite to application of section 269A. See *infra* note 47 and accompanying text.

39. *Supra* note 37.

butions, the court blessed this result because specific I.R.C. provisions allowed the deferral. Any change in this result would have to await amendment of the pension provisions, which arrived with TEFRA. There was no attempt to gratuitously assign income since Dr. Keller owned all the stock and substantially all of the earnings were redistributed to him. In applying the arm's length transaction test, the court concluded that no section 482 allocation of income was necessary since Dr. Keller's compensation approximated what he would have received absent incorporation.⁴⁰

The cases of *Achiro v. Commissioner*,⁴¹ *Pacella v. Commissioner*,⁴² and *Fatland v. Commissioner*,⁴³ reaffirmed the holding that the creation of a corporation for the purpose of securing better pension and other benefits does not amount to tax avoidance under section 482. When such benefits are included in the employee/owner's total compensation, the thrust of section 482 in this PSC context is lost: it becomes harder to show any reduction of income under the arm's length transaction test. As incorporating is otherwise made easier, the probability of discrimination increases. In *Achiro*, no tax savings were ultimately accomplished because the pension plans were discriminatory under the aggregation rules of section 414(b).⁴⁴

As discriminatory potential increases, more corporations are formed for frivolous reasons, or reasons not in keeping with recognized business purposes. The dissent in *Keller* distinguished between the incorporation of a professional business — "a physician or several physicians incorporating their practice, along with its assets, contracts, goodwill, books and records, accounts receivable and payable, medical facilities, equipment and supplies, physical facilities, and employees" — and the incorporation of only a portion of one — "having none of these features and no practical control over the earning of income by the business."⁴⁵ The dissent identified the result when "each professional becomes a paper corporation that in turn becomes a partner" as a "new creature", a "paper octopus", the tax consequences of which had never squarely been presented to the courts: "There is no reason to hold that

40. *Supra* note 20.

41. 77 T.C. 881 (1981).

42. *Supra* note 24.

43. *Supra* note 35.

44. Of the two original corporations, the pension plans did not cover any employees of one, and the contributions and benefits of the other were not commensurate with those of the PSC. 77 T.C. at 904.

45. 77 T.C. at 1041.

these new creatures are immune from the assignment of income doctrine."⁴⁶ While the majority felt that applying the assignment of income doctrine would have been renewing an attack on the one man PSC lost long ago, the dissent concluded that Dr. Keller was the *true earner* who simply assigned his income to a *corporate shell* he created.

F. Section 269A

The arrow most recently added to the Commissioner's quiver is section 269A. Section 269A provides:

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

(2) the principal purpose for forming, or availing of, such personal service corporation is the avoidance or evasion of Federal income tax by reducing the income of, or securing the benefit of any expense, deduction, credit, exclusion, or other allowance for, any employee-owner which would not otherwise be available, then the Secretary may allocate all income, deductions, credits, exclusions, and other allowances between such personal service corporation and its employee-owners, if such allocation is necessary to prevent avoidance or evasion of Federal income tax or clearly to reflect the income of the personal service corporation or any of its employee-owners.⁴⁷

Thus the triggering of section 269A requires two prerequisites: 1) that substantially all of the services of the PSC be performed for one client and 2) that the principle purpose for forming the PSC was to avoid or evade federal income taxes.

Given Committee Reports stating that the specific intent of section 269A is to overturn results achieved in cases like *Keller*,⁴⁸ and the prerequisite that substantially all of the services be for one client, the alarming characterization of the *new creature* created by allowing multiple *paper* corporations to operate together in partnerships and other associations, the so-called *paper octopus* set forth in the *Keller* dissent,⁴⁹ must have struck home. But sec-

46. *Id.*

47. I.R.C. § 269A (1982). Section 269A was added by section 250 of TEFRA.

48. See H.R. REP. No. 760, 97th Cong., 2d Sess. 633-34, reprinted in 1982 U.S. CODE CONG. & AD. NEWS 1190, 1405-06.

49. We would have MAL, Inc. at the center surrounded by the partnership and 11 corporate arms extending out in different directions, each a hollow prosthetic device without offices, a laboratory, equipment, facilities, . . . enabling each

tion 269A is not limited to addressing discrimination. For a limited group of corporations, it effectively gives the IRS perhaps unlimited power to disregard the corporate entity if the purpose of incorporating does not appear satisfactory. Therefore, it is important to define the contours of that limited group.

1. *Scope*

A PSC as defined by Proposed Regulation § 1.269A is "a corporation the principle activity of which is the performance of personal services that are substantially performed by employee/owners."⁵⁰ An *employee/owner* is defined as an owner of ten percent or more of the outstanding stock.⁵¹ The term *personal services* is not defined. Section 535(c)(2)(B)⁵² deals with certain service corporations in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, and consulting. By cross-reference, these might serve as examples of personal services. That section, however, does not cover real estate agents, professional athletes, or sales representatives such as Fred Foglesong. Considering the regulatory purpose of section 269A, it is likely that its use of the term *personal services* will be interpreted more broadly than that contained in section 535. Logically, the nature of the personal service is not intended to be dispositive so much as the functioning (or non-functioning) of the PSC for valid business reasons.

2. *One Client*

A more pressing question concerns the meaning of *substantially all* services of the PSC being performed *for or on behalf of one other . . . entity*. The situation in *Keller* is clearly provided for, (i.e., the PSC performs all services for the partnership). It is less clear whether a PSC which services one hospital, for example, but a variety of patients, is covered. On its face, section 269A does not cover multiple client cases but even the partnership in *Keller* serviced multiple clients so that the *on behalf of* language would appear to control there. Section 269A should not apply to multiple

physician to have a pension plan and fringe benefit package tailored to his own preferences without regard to the quite different preferences of each of his partners and whether or not the employees of the business were provided anything at all. . . . If Dr.Keller can do this, so can the technicians . . . and virtually any other employee.

77 T.C. at 1039.

50. Treas. Reg. § 1.269A(b)(1) (1983) (proposed).

51. Treas. Reg. § 1.269A(b)(2) (1983) (proposed).

52. I.R.C. § 535(c)(2)(B) (1982).

client situations which present a legitimate need for the PSC to coordinate the provision of services and which do not present the same inherent discriminatory potential found in *Keller*, where the self-incorporator is one employee merely seeking isolation from fellow employees or associates. At what percentage does *substantially all* draw the line? And should measurement proceed against total time spent with each client or gross revenue or some other basis? Nothing in the section or proposed regulation addresses these questions. Presumably the courts will apply a substance over form approach.

3. Principle Purpose

The principle purpose language contained in the new law is similar to old section 269;⁵³ thus it would appear that the same test of principle purpose should apply. The inquiry under section 269 is whether avoiding income tax by acquiring a corporation was *the* principle purpose which exceeded all others in importance. Proposed Regulation § 1.269A-1(a)(2), however, sets out objective standards which radically alter that test, essentially by turning it on its head. According to the regulation, so long as *any* tax benefit(s) not otherwise available is secured by an employee/owner, or so long as the PSC reduces the income of *any* employee/owner, principle purpose has been evidenced.⁵⁴

The test for principle purpose is apparently tied to a comparison of income and tax benefits before and after incorporation. Such comparison is similar to the object of the arm's length transaction test under section 482, and curiously, the language in section 269A granting the power to allocate "all income, deductions, credits, . . . if . . . necessary to prevent (tax) avoidance . . . or clearly to reflect . . . income" closely parallels the language in section 482. Yet in *Keller*, *Achiro*, *Pacella*, and *Fatland*, section 482 turned out to be ineffective pursuant to the arm's length transaction test. Why would Congress repeat language after receiving an adverse judicial reaction to it? What will distinguish the test for reduction of income under section 269A from the arm's length transaction test under section 482?⁵⁵

53. I.R.C. § 269 (1982).

54. "Such purpose is evidenced when use of the corporation either reduces the income of any employee/owner, or secures for any employee/owner one or more tax benefits which would not otherwise be available." Treas. Reg. § 1.269A(a)(2) (1983) (proposed). *Tax benefits* is broadly defined in Treas. Reg. § 1.269A(b)(6) (1983) (proposed).

55. "The moral of *Achiro*, *Keller*, *Foglesong*, and *Pacella* is that arm's length eco-

One major difference between the respective sections will stem from the different concerns each is intended to correct. Corporate status is in no way threatened under section 482; only the proportionate earnings of each admittedly separate trade or business is involved. Far from recognizing the tendency of the PSC toward abuse as a separate trade or business, the object of section 269A is to undermine the corporate status for tax purposes. Not only are proportionate earnings involved, but any tax consequences which the PSC may claim by virtue of being a corporation may be lost once section 269A is found to apply. Any tax benefits secured by the PSC which would "not otherwise be available" had the services been rendered by an individual are no longer seen as valid.⁵⁶ Since some disparities in tax treatment between corporate and self-employed retirement plans remain, (despite TEFRA's effort to equalize tax treatment),⁵⁷ and since other differences exist, the proposed regulation appears unduly restrictive. Moreover, the legislative history suggests a different interpretation.⁵⁸

4. Allocation

Section 269A differs from section 482 in that once the two pre-

nomic terms in service corporation arrangements will provide a defense to IRS adjustments under §§ 482 and 61. But new § 269A . . . provides § 482-type powers to IRS to reallocate income in *Keller* situations." BITTKER AND EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* § 1.05 (stud. ed. Supp. 1984). See generally Gombinski & Kaplan, *Demise of the Tax Motivated Personal Service Corporation*, 1 J. COPYRIGHT, ENTERTAINMENT & SPORTS L. 73 (1982); and Wood, *supra* note 3.

56. "The term 'not otherwise available' refers to any tax benefit that would not be available to an employee/owner had such employee/owner performed the personal services in an individual capacity." Treas. Reg. § 1.269A(b)(4) (1983) (proposed). Treas. Reg. § 1.269A(c) (1983) (proposed) provides a safe harbor to the objective standards of the principal purpose test: A PSC will not be deemed to have been formed for the principal purpose of avoiding or evading federal income taxes if the federal income tax liability of any employee/owner is reduced in a 12 month period by no more than the lesser of (1) \$2,500 or (2) 10% of the federal income tax liability that would have resulted in that 12 month period absent incorporation.

57. *Infra* notes 87-102 and accompanying text.

58. For example, if a personal service corporation were formed or availed of for the principal purpose of utilizing the corporate surtax exemption or a fiscal year that would defer the payment of income tax or both, then the Secretary could allocate income, etc., between the corporation and the employee/owners. On the other hand, no such allocation would be made if under the facts and circumstances, the taxpayer can show that the principal purpose was not the avoidance or evasion of income tax.

STAFF OF JOINT COMMITTEE ON TAXATION, 97TH CONG., 2d SESS. 326-27, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982, H.R. 4961 (Joint Comm. Print 1982), reprinted in WESTS INTERNAL REVENUE ACTS OF 1982, at 1275-76 (1983) (hereinafter cited as *Joint Comm. Print*).

requisites have been met, it gives the Commissioner power to reallocate *all* income, deductions, etc. The Committee Reports disparaging the result in *Keller* and the insertion of the word *all* suggest that once section 269A is found to apply, the Commissioner may *totally* ignore the corporate entity. This result is unacceptable from a policy standpoint because it overkills in situations where limited reallocation would serve assignment of income principles behind the statute's intent and where the corporation is not a sham. Fortunately, the *if necessary to clearly reflect income* language may be interpreted as limiting by the courts, and will subject the Commissioner's power to allocate according to the same arbitrary and capricious standard that now governs allocations under section 482.

G. Summary and Guidelines

In summary, so long as the PSC serves legitimate business purposes and respects corporate formalities, the law will protect it from the most blatant attack upon its integrity — the sham theory. While the assignment of income doctrine remains a potent weapon in the arsenal of the IRS, presently it is ineffective due to recent confusion in its application. Section 482 gives the Service broad power to reallocate income, but only among commonly controlled *organizations, trades or businesses* and only following an *arm's length* transaction test. Although section 269A has yet to be applied, by its terms and history its main targets are: (1) the professional whose PSC acts as no more than an incorporated pocket-book servicing only one client, and (2) the partnership of such PSC's, the so-called *paper octopus*. Assignment of income concerns with control over the earning process will probably play a role in the application of section 269A.

While the formation of a PSC to secure corporate retirement benefits did not amount to tax avoidance or evasion under section 482, the same may not be said of section 269A. TEFRA has eliminated much of the disparity between corporate and self-employed individual retirement plans, but Proposed Regulation § 1.269A suggests that the securing of *any* corporate tax consequence which is in some way preferable and which is *not otherwise available* may trigger application of the section. Once the threshold tests have been met, it appears (just as under the sham theory) the Commissioner may attribute all of the PSC's income to the individual. The key is to prevent the threshold test from being met.

For those who chose to go the corporate route after careful

consideration of the changes in the pension rules (discussed in Part II of this article) and the various tax and non-tax advantages left after TEFRA (discussed in Part III), some guidelines should prove helpful.⁵⁹

(1) The PSC should negotiate and contract directly with any client(s), and should receive income directly from any client(s) for providing the personal services of its employee/owner; any contracts previously executed by the employee/owner personally should be terminated and replaced with contracts executed by the PSC;

(2) The employee/owner should respect the PSC's commitments to clients and ideally should contract exclusively with the PSC to ensure that the employee status is recognized;

(3) The PSC should maintain offices, equipment, books, records and other incidents to carrying on a business;

(4) The PSC should maintain all of the incidents to carrying on a business in its own name;

(5) The affairs of the PSC and the employee/owner should be kept separate; there should be no commingling of funds or unreasonable loans made so that the PSC is not seen as a financing device; and

(6) Especially if the PSC contracts with only one entity, or with one entity which in turn services many clients, or if the PSC serves more than one client but only one at a time for extended periods, the books, records, billings, communications and business activities of the PSC should clearly show that it is a practicing business with control over the earning process.

II. TOWARD PARITY IN RETIREMENT PLANS IN LIGHT OF TEFRA AND TRA '84

Until TEFRA was passed, the vast number of self-incorporations were due mainly to the dramatic differences between corporate and non-corporate retirement plans. Tax qualified retirement plans covering self-employed individuals, also known as *Keogh* or *H.R. 10* plans, were subject to many unfavorable restrictions that did not apply to plans covering only corporate employees.⁶⁰ The

59. See also Dicker, *Tax Oriented Options for the Professional Athlete*, 8 REV. TAX. OF IND. 195 (1984).

60. (A) pension or profit-sharing plan is not a qualified plan unless it is established by an employer for the exclusive benefit of employees or their beneficiaries. For these purposes, a sole proprietor is considered both an employee and an employer, and a partnership is considered the employer of each partner . . . (Keogh plans) were subject to special rules which were in addition to the other qualification requirements. . . . (which) also applied to qualified plans of sub-

self-incorporated individual also gained additional tax savings from lower rates, deferral of income through choice of year end, and improved fringe benefit deductability. Through TEFRA, Congress sought to subject both kinds of retirement plans to one set of rules.⁶¹ As outlined below, TEFRA has succeeded in eliminating many, but not all, of the increased benefits realized by self-incorporation.⁶²

After the Economic Recovery Tax Act (ERTA) was adopted self-employed taxpayers covered under defined contribution⁶³ self-employed taxpayers covered under defined contribution Keogh plans were permitted to contribute and deduct the lesser of \$15,000 or 15% of their net earnings from self-employment for the taxable year.⁶⁴ TEFRA increased these limits to \$30,000 and 25% respectively for taxable years beginning after 1983.⁶⁵ For defined benefit⁶⁶ Keogh plans, TEFRA increased the level of accruals permitted annually to \$90,000. TEFRA simultaneously reduced the defined contribution limit to \$30,000 and the defined benefit limit to \$90,000 for corporate plans. These contribution and benefit parity rules eliminated one major reason for self-incorporating.

Many of the other restrictions repealed by TEFRA particularly affect the role of the PSC because they applied only to Keogh

chapter S corporations . . . and to simplified employee pensions.

Joint Comm. Print, supra note 57, at 301. See I.R.C. § 401(a).

61. Congress believed that the level of tax incentives made available to encourage an employer to provide retirement benefits to employees should generally not depend upon whether the employer is an incorporated or unincorporated enterprise. Similarly, Congress believed that the rules needed to assure that the tax incentives available under qualified plans are not abused should generally apply without regard to whether the employer maintaining the plan is incorporated or unincorporated.

Joint Comm. Print, supra note 57, at 308.

62. Hira, *supra* note 4, gives a very detailed and thorough treatment of the changes TEFRA made in retirement plans that exceed the scope of this article. For a detailed discussion of the changes wrought by the Tax Reform Act of 1984, see Stein and Schier, *How the New Tax Law Affects Pension Plans*, 10 J. PENS. PLAN. & COMP. 245 (1984).

63. "A defined contribution plan is one under which each participant's benefit is based solely on the balance of the participant's account consisting of contributions, income, gain, expenses, losses, and forfeitures allocated from the accounts of other participants." *Joint Comm. Print, supra* note 57, at 284. Annual contributions are based on a percentage of salary.

64. Economic Recovery Tax Act of 1981 (ERTA), Pub. L. No. 97-34, § 312(a); I.R.C. § 404(e) (1981).

65. I.R.C. §§ 404(a), 415(b)(1), and 415(c)(1).

66. A defined benefit pension plan specifies a participant's benefit independently of an account for contributions, etc. Annual contributions are based on the amount of funds desired for retirement, determined actuarially.

plans which covered employee/owners.⁶⁷ For the purposes of these restrictive provisions, employee/owners were defined as individuals who owned all of an *unincorporated* business, or more than 10% of a partnership. Although employee/owners stood to gain the most by incorporating, many of the restrictions relating to coverage and antidiscrimination applied only where there also existed a number of other common law employees. For example, pursuant to ERTA, when annual compensation in excess of \$100,000 was taken into account for a defined contribution Keogh plan, the rate of employer contributions for any plan participant was not permitted to fall below 7 ½ % of that participant's compensation.⁶⁸ Regarding defined benefit Keogh plans, the antidiscrimination rule mandated that benefits for full-time employees be equated to a percentage rate no lower than one-half of that used for the self-employed owner.⁶⁹

For taxable years beginning after 1983, TEFRA has done away with these antidiscrimination rules, as well as other restrictive rules required by adoption of a Keogh plan, such as the coverage requirement that where a Keogh plan covered an employee/owner, it also had to cover all employees with at least three years of service. TEFRA also brought about the following changes:

Repealed the 6% excise tax on excess contributions on behalf of non-corporate owner/employee and provided the same carry-over (to succeeding tax years) privilege for excess contributions to Keogh plans as to corporate plans;⁷⁰

Repealed the restrictive rules on mandatory or voluntary nondeductible contributions so that Keogh plan participants could also make excess contributions which, although non-deductible,

67. [P]rior law required that if an H.R. 10 plan benefitted an owner-employee, then the plan was also required to meet special standards providing employees additional security. The special standards included rules relating to (1) coverage, (2) vesting, (3) distributions, (4) integration with social security, (5) employee contributions, (6) plan trustees, and (7) employers under common control. They also imposed limitations with respect to an owner-employee which did not apply to a shareholder-employee under a subchapter S plan or to partner under an H.R. 10 plan whose partnership interest does not exceed 10%.

Joint Comm. Print, supra note 57 at 302.

68. I.R.C. §§ 408(k)(3)(C)(ii); 401(a)(17)(B).

69. E.R.T.A. § 312(b); I.R.C. § 401(a)(17)(B)(ii).

70. I.R.C. § 4972 (repealed) and § 401(a)(1)(D). For years after 1983, there are no special limits applicable to self-employed plans as such. That is, the general limitations on deductions under qualified employee plans apply also to self-employed plans. If the plan covers both types of employees, the limits on contributions are applied separately to each group.

are allowed to accumulate tax-free until distribution;⁷¹

Subjected loans made from Keogh plans to participants to the same rules governing loans from corporate plans;⁷² as not automatic distributions unless by their terms they do not require repayment within five years, or exceed the lesser of a set maximum;⁷³

Subjected the determination of whether a plan is "top heavy" to the same standards determining whether a corporate plan is top heavy;⁷⁴

Subjected Keogh plans covering owner/employee to the same vesting schedules as corporate plans;⁷⁵

71. Under prior law, an H.R. 10 plan which benefitted employee/owners could not provide for mandatory employee contributions. . . . If an H.R. 10 plan benefitted only employee/owners, nondeductible voluntary employee contributions were also precluded (sec. 4972). If an H.R. 10 plan which benefitted employee/owners also benefitted other employees, voluntary nondeductible contributions by an employee/owner were limited.

Joint Comm. Print, supra note 57, at 307.

72. See *id.* at 298. Notice that TEFRA did not change prior law prohibiting loans to employee/owners and requiring fiduciary standards, i.e., a plan loan must bear a reasonable rate of interest, be adequately secured, provide a reasonable repayment schedule, and be made available on a basis which does not discriminate in favor of employees who are officers, shareholders, or highly compensated. *Id.* See I.R.C. § 4975(d).

73. A distribution results to the extent that the amount of the loan, when added to the outstanding loan balance (principal plus interest) with respect to the employee under all plans of the employer exceeds the lesser of (1) \$50,000, or (2) one-half of the present value of the employee's non-forfeitable accrued benefit under such plans. However, no loan is treated as a distribution under this provision to the extent that the amount of the loan, when added to the outstanding loan balance with respect to the employee, totals \$10,000 or less.

Id. at 296.

74. [A] defined benefit pension plan is a top-heavy plan for a plan year if, as of the determination date, the present value of the cumulative accrued benefits for participants who are key employees for the plan year exceeds 60% of the present value of the cumulative accrued benefits for all employees under the plan. A defined contribution plan is a top-heavy plan for a plan year if, as of the determination date, the sum of the account balances of participants who are key employees for the plan year exceeds 60% of the sum of the account balances of all employees under the plan.

Id. at 314. I.R.C. § 416(g) (1983). Note: TRA '84 now defines a *key employee* as one who earns more than 15% of the dollar limit on annual additions to defined contribution plans under I.R.C. § 415(c)(1)(A) (\$45,000 for years 1984 to 1987).

75. I.R.C. § 411. The purpose of mandatory vesting schedules is to insure that employees with substantial periods of service with the employer do not lose plan benefits upon separation from employment before retirement. TEFRA recognized that more rapid vesting might be necessary to prevent discriminatory forfeitures by the rank-and-file in favor of officers, etc. For top heavy plans, defined *supra* note 74, TEFRA provides two alternative accelerated schedules. The first mimics the old Keogh rule, i.e., three-year full vesting. The second dictates a six-year graded vesting beginning with 20% after two years, 40% after three years, 60% after four years, etc. I.R.C. § 416(b). See also *Joint Comm. Print* at 1252, 1267. Notice that a corporate plan as well as a Keogh plan is subject to being top heavy. For discussion of the newest provisions making certain plan qualification requirements even

Extended the \$5,000 death benefit exclusion to beneficiaries of self-employed individuals provided distribution is in one taxable year;⁷⁶

Repealed prior law rules which restricted integration with social security under Keogh defined contribution plans and extended to all qualified plans the rule under which the tax rate and wage base applicable to employers for old age, survivors, and disability insurance (OASDI) under social security are the maximum rate and base for employers figuring reductions for integration contributions;⁷⁷ and

Subjected defined benefit Keogh plans to an integration rule for social security payments so that plans can be integrated with social security so long as no discrimination results.⁷⁸

Many of TEFRA's changes have put Keogh plans in a more competitive position with their corporate counterparts by repealing certain restrictive rules. The law now also tends to equalize the two kinds of plans by extending certain restrictions previously applicable only to self-employed plans to cover corporate plans as well.

Many of the restrictions to Keogh plans which were extended apply only to plans covering the employee/owner, or greater than 10% owners. They particularly affect the PSC, whose employee/owner by definition under section 269A owns 10% or more of the corporation. As a result, concerns with possible abuse and discrimi-

more stringent to protect employees, see Campbell, *The Retirement Equity Act of 1984*, 32 C.L.U. 40 (1985). See also Stein and Schier, *supra* note 62.

76. The exclusion is available to the estate or beneficiary of the deceased person who dies after December 31, 1983, with \$5,000 total allowed regardless of number of beneficiaries. See Treas. Reg. § 1.101-2(a)(3) (1983).

77. I.R.C. § 401(1) (1983). "Under an integrated plan, an employee's plan benefits may be reduced by taking into account social security benefits deemed to be provided by the employers." *Joint Comm. Print*, *supra* note 57, at 305. Before TEFRA, defined contribution Keogh plans which benefitted an employee/owner were not allowed any reductions unless (1) the employee/owner took into account the self-employment taxes he paid for himself and (2) not more than 1/3 of deductible contributions to the plan for the year were made on behalf of employee/owners. *Id.* at 306.

For 1982, the employer's tax rate with respect to OASDI benefits under social security is 5.4%, and the taxable wage base is the first \$32,400 of an employee's pay. Thus, if the provisions were applicable for 1982, a profit-sharing plan could provide contributions of 5.4% of 1982 pay in excess of \$32,400 and no contributions for 1982 with respect to the first \$32,400.

Id. at 313.

78. An individual is a key employee of an employer if the individual is (1) an officer (in the case of a corporate employer), (2) is one of the 10 employees owning the largest interests in the employer, (3) owns more than a 5% interest in the employer, or (4) owns more than a 1% interest in the employer and has compensation from the employer in excess of \$150,000.

I.R.C. § 416(i)(1).

nation by self-employed employee/owners are now directed toward both corporate and non-corporate top heavy plans alike. For example, two stringent vesting schedules are to be employed when a plan is determined to be top heavy. Since most retirement plans for PSC's by definition tend to be top heavy, the special rules become almost always applicable to the PSC.

Similarly, the section 269A definition of employee/owner of the PSC always qualifies as a *key employee* (as defined in TEFRA '78 and TRA '84).⁷⁹ The additional requirements that have been extended to corporate top heavy plans target possible abuses or discrimination favoring these key employees. These additional qualification requirements: (1) limit the amount of a participant's compensation which may be taken into account, (2) provide minimum non-integrated contributions or benefits for plan participants who are non-key employees, (3) reduce the aggregate limit on contributions and benefits for certain key employees, and (4) limit distributions to key employees.⁸⁰

Before TEFRA, a 10% penalty applied to employee/owners for distributions from Keogh plans made before age 59 ½. TEFRA repealed this penalty but subjected distributions made to an individual who is (or was) a key employee before age 59 ½ to a similar one. This new tax applies whether or not the plan is top heavy at the time of distribution, in the amount of 10% on the distributed portion attributable to accumulations or accruals made when the individual was a key employee in a top heavy plan.⁸¹ TRA '84 makes the 10% tax apply to the extent the distribution was attributable to years in which the participant maintained a 5% or more ownership. Again, the PSC would be affected every time.

Despite TEFRA's attempt to eliminate distinctions between corporate and non-corporate retirement plans, several remain. Though a technical corrections bill may be forthcoming which would eliminate some of the remaining disparities, proper planning dictates that they be kept in mind when considering self-incorporation after TEFRA. They are as follows:

—A self-employed person may not receive a qualifying lump sum distribution prior to age 59 ½ and thus may not roll such

79. The Tax Reform Act of 1984 amends the definition to exclude officers who earn less than 1 ½ times the dollar limit on contributions under a defined benefit plan (or \$45,000). H. R. REP. NO. 98-861, § 524 amending I.R.C. § 416(i)(1)(A).

80. A plan will not be tax-qualified under § 401 unless it includes provisions meeting the additional requirements which will automatically become effective if the plan becomes top heavy. I.R.C. § 401(10)(B).

81. I.R.C. §§ 72(m)(5), 402(e).

distribution tax free into an IRA unless it was received because of a plan termination due to disability. In contrast, a corporate participant qualifies for a lump sum distribution merely by separation from employment. As a result, favorable tax treatment such a *ten-year averaging* is unavailable to self-employed individuals.⁸² TRA '84 allows tax free rollovers to employees of, but not directly to, self-employed owners.

—Contributions to Keogh plans are not deductible to the extent they would be used to purchase life, accident, health, or other insurance for the self-employed taxpayer. They are deductible for corporate plans.⁸³

—Plan loans to employee/owners, although not taxable as distributions if made within the limits described in § 72(P) are still considered prohibited transactions for ERISA purposes and are subject to a 5% excise tax and a possible 100% penalty tax.⁸⁴

—A Keogh contribution may not create or enlarge net operating loss. Corporate contributions may increase net operating loss.⁸⁵

A minor area of disparity, one which is outside of Congress's reach, is the deductibility of plan contributions under various state income tax laws. Each state's laws would have to be examined. Some allow deductions for contributions made to corporate plans and those made by self-employed taxpayers for their employees, but deny a deduction for contributions made on behalf of the self-employed individual.

These parity have dealt a large disincentive to incorporating today by making the unincorporated status and self-employed status viable alternatives. The presently operating PSC should take note of the changes subjecting corporate retirement plans to new distribution and antidiscrimination rules for top heavy plans. In addition, the threat to allocation of income under section 269A and the uncertainty of being able to prove a legitimate principal purpose led Congress to provide some tax relief to those who should decide to liquidate.⁸⁶ Before considering liquidation, it is advisable to weigh the remaining advantages to self-incorporating apart from

82. I.R.C. § 402(e).

83. I.R.C. § 404(e).

84. I.R.C. § 4975(c)(1)(B); § 4975(e) defines "disqualified persons" as including self-employed taxpayers while corporate employees fall under the exemption granted by § 4975(d)(1)(B).

85. I.R.C. § 172(d)(4)(D).

86. I.R.C. § 333 and TEFRA § 247; however this benefit was only available for 1983 and 1984 with regard to the special exception which stated that the corporation would not recognize any gain or loss upon the distribution of unrealized receivables. Thus, there was no chance E & P would be increased, with resulting increase in dividend income to the distributee/shareholders.

retirement plans.

III. THE CONTINUING ROLE OF THE PSC AS A PLANNING TOOL

Many tax and non-tax advantages to self-incorporating remain after TEFRA and after TRA '84, including limited liability, medical reimbursement plans, group term life insurance, more favorable tax rates, availability of additional entities to share the tax burden, the dividends received deduction, capital gain treatment in certain cases, availability of fiscal years, and ease of transferability. The above advantages, as well as certain disadvantages, are introduced below and then incorporated into a planning summary.

Most of the tax benefits discussed below are deductible by the PSC and not included in the employee/owner's income, but would *not* be deductible if the individual remained self-employed (or also if the PSC elected S Corporation status).⁸⁷ Hence, they are tax benefits *not otherwise available* within the meaning of section 269A. Should section 269A apply, the effect would be to deny the deduction to the service corporation and create additional income for the recipient of those benefits.⁸⁸ This might be especially important for the professional athlete who provides all of his services to one team through his corporation. However, for the non-team sports athlete who services many clients, the prospects of the IRS successfully invoking section 269A, as presently written, appear slim.

A. Medical Expense Reimbursement Plans

This feature alone makes incorporation most attractive and TEFRA, inadvertently, may have made it more so. TEFRA raised

87. 26 U.S.C. § 1 subchapter S (1982).

88. The term "tax benefits" means any expense, deduction, credit, exclusion or other allowance which would not otherwise be available. The term includes, but is not limited to: multiple surtax exemptions being claimed by the owners of a single integrated business operation conducted through multiple corporate entities, accumulation of income by the corporation, the corporate dividends received deduction under § 243, deferral of income of an employee/owner through the use of a corporation with a fiscal year or accounting method differing from that of such employee/owner, the use of multiple classes of stock to deflect income to taxpayers in lower tax brackets, group-term life insurance (§ 79), certain accident and health plans (§§ 105 and 106), certain employee death benefits (§ 101), meals and lodging furnished for the convenience of the employer (§ 119), and qualified transportation expenses (§ 124). Except as otherwise provided in paragraph (d)(2)(ii) of this section, the term *tax benefits* does not include contributions in a qualified employer plan.

Treas. Reg. § 1.269A (1982) (proposed).

the minimum amount of deductible medical expenses to those which exceed 5% of a self-employed individual's adjusted gross income.⁸⁹ Conversely, a corporation may adopt a medical reimbursement plan to provide for all employees and their dependents. This would be especially attractive where the corporation is closely held and the family group constitutes the majority of shareholders, as in *Foglesong*. The corporation may then deduct the reimbursed medical expenses in full and without any stipulated limitations,⁹⁰ while employee/owners may exclude them from gross income.⁹¹ Otherwise non-deductible medical expenses of a self-employed individual, (allowable deductions only up to 5% of his adjusted gross income), would be fully deductible by a corporation. More importantly, while the self-employed individual must pay his medical expenses with *after-tax* dollars, his corporate counterpart has his reimbursed with *tax-free* dollars.

B. Other Insurance Plans

The cost of up to \$50,000 of group term life insurance may be deducted by the corporation and excluded from the income of the corporate employee. As with most of these benefits, TEFRA will deny the exclusion if the plan discriminates against a certain segment of employees. This should not pose an obstacle where the service corporation is closely held. Even with a few *outside-the-family* employees, the insurance rates versus the benefits provided should not cause this to be offered on a discriminatory basis. The costs of health and disability insurance may also be deducted by a corporation and would be excluded from an employee's gross income.

C. Rates

Corporate rates, especially at lower levels, are more favorable than those accorded individuals. The total tax on the first \$100,000 of corporate taxable income is \$25,750 (an effective rate of less than 26%) for taxable years beginning after 1982. The corporate rate over this amount is a maximum of 46%, while an individual's levels out at 50% (or approximately twice the 26% rate cited above). After 1982, the tax on the first \$25,000 of taxable income within the PSC is only \$3,750 compared to a maximum of \$12,500

89. I.R.C. § 213(a).

90. I.R.C. § 162; Treas. Reg. § 1.162-10(a) (1985).

91. I.R.C. § 105(b).

for a highly compensated self-employed individual who has substantial income from other sources (a marginal rate of 15% versus 50%). In effect, you are taking income off the top individual brackets and placing it at the bottom of the lower corporate rates.

Subject to certain restrictions, the corporate employee who controls his PSC may also direct his compensation level so as to maximize his tax benefits better than his self-employed counterpart.⁹² The self-employed individual is *stuck* with whatever his services earn directly from clients; no accumulations of earnings within another taxable entity, such as a corporation, can occur. Likewise, the self-employed individual bears the full burden of his total taxes, whereas the fellow investors (and these could well be family members to whom the divided income tax burden is shifted) in the PSC share the tax levy at the corporate level.

D. *Penalty Taxes*

A common ploy used by self-incorporated taxpayers is to draw a small salary and leave the balance in the PSC to be taxed at lower rates. Not only have the courts attacked this strategy in numerous cases involving compensation in closely held corporations, but there are also substantial penalty taxes for unreasonable accumulations of earnings and for the use of the PSC as a mere vehicle for investments, or as a personal holding company. Therefore it is necessary to maintain perspective when taking advantage of the lower rates.

If there is found to be an *unreasonable accumulation* of corporate earnings — beyond the reasonable needs of the business, or for *forbidden purpose* — the accumulated earnings tax may be applied under section 531 of the Code. Where one individual's services provide nearly all of the earnings for the corporation, it is especially difficult to defend a substantially lesser sum being paid as compensation. On the other hand, the PSC may acquire other businesses, and saving for expansion generally is an acceptable purpose for accumulating earnings if the facts substantiate that asserted purpose. The rates are relatively high on such excess accu-

92. There is no universal rule as to what a reasonable level of compensation should be. It must be decided on the facts in each particular case. One may look to the type and extent of services rendered; the scarcity of qualified employees for the position; the prior earning capacity of the employee; peculiar characteristics of the taxpayer's business; and the general economic conditions of the period. *E.g.*, *Charles McCandles Tile Service v. United States*, 422 F.2d 1336 (Ct. Cl. 1970); *Edwin's, Inc. v. United States*, 501 F.2d 675 (7th Cir. 1974).

mulations, and the penalty tax is imposed in addition to any other taxes due on the amount.⁹³ The Code provides for a *safe harbor* in the form of a credit of \$150,000 for certain PSC's listed under § 535(c)(2)(B), and a credit of \$250,000 for other corporations.⁹⁴ There is some question as to whether sales representatives (such as in *Foglesong*) or real estate agents are limited to the lower credit amount.

Another trap for the unwary professional is the personal holding company tax. To be labeled a personal holding company, (1) passive receipts or *personal holding company income* must equal at least 60% of a corporation's adjusted ordinary gross income and (2) more than 50% of the value of the stock must be owned by no more than five individuals within the last half of the taxable year. *Personal holding company income* includes receipts from a variety of sources, encompassing dividends, interest, certain rents and royalties, and certain personal service contracts.⁹⁵ The penalty is 50% of the amount found to be personal holding company income and is in addition to other taxes, except that personal holding companies are exempt from the accumulated earnings tax.

Most PSC's meet the stock ownership test for being considered a personal holding company, but it is a numerical limit easily circumvented.⁹⁶ The income test will have to be applied case by case. Amounts received under personal service contracts will be excluded from personal holding company income only if the corporation furnishing the services retains the right to designate the individual who will perform. This is true even where no doubt exists as to who will actually perform, like in a PSC with only one primary shareholder and employee. The mere expectation that this individual will in fact perform is not enough to transform the income into personal holding company income. In contrast, where the performing individual is designated in the contract, by name or description, income generated from the contract is personal holding com-

93. I.R.C. § 531. The rates are 27.5% on the first \$100,000 and 38.5% on accumulations in excess of \$100,000.

94. I.R.C. § 535(c); the accumulated earnings credit permits the corporation to exempt from the penalty surtax the greater of the unused portion of a \$150,000 or \$250,000 exemption, or the addition that is made to the amount of the corporation's "reasonably accumulated earnings."

95. See I.R.C. § 543(a).

96. The easiest way to avoid the PHC provisions is to transfer existing or newly issued shares to a sufficient number of persons so as to fail the *five or fewer individual shareholder* requirement. With a PSC these shareholders need to be unrelated so that the constructive ownership rules in § 544(a) do not apply. Therefore, one in a PSC setting may be better advised to fail the *income test* instead.

pany income.⁹⁷

E. Capital Gains Treatment

Income retained by the PSC can ultimately be converted into capital gain which would be taxed at no more than 20% (the maximum tax on an individual of 50% applied to the 40% remaining capital gain after the 60% deduction), should the shareholder sell its stock, have it redeemed, or effect a corporate liquidation. Net capital gain is also excluded from the accumulated earnings tax due to the exemption granted under § 535(b)(6). Thus mutual funds which provide for this type of return are an excellent investment vehicle (as long as the personal holding company income limitations noted above are respected). Also, tax exempt interest from investments in municipal bonds is also not subject to this penalty tax and thus should be considered for accumulation purposes. Upon death, stock bequeathed to beneficiaries receives a step-up in basis to fair market value at death, so that many capital gains go unrecognized.⁹⁸

F. Other Tax Consequences

A corporation receives a *dividends received deduction* of 85% of all domestic dividends.⁹⁹ As a result, if a taxpayer can successfully accumulate some funds in his corporation, the maximum corporate tax exposure (not including possible personal holding company or accumulated earnings penalties) would be 6.9% on the earnings derived from various stock investments made by the corporation.¹⁰⁰

A self-employed individual could defer up to one year's tax by judiciously selecting a year-end after incorporating the business. For instance, the taxpayer who chooses a year-end of January 31 would have the corporation pay only a small salary from February 1 to December 31 and then have a large bonus paid out during January. The latter would not be reported until the return for the second year was due. In essence, the taxpayer is receiving an inter-

97. Thus, failure of the *income test* may be easily accomplished by the PSC holding numerous personal services contracts with outside third parties. This provides another reason for making sure that the PSC signs any contracts with clients, in addition to those discussed in light of the *Charles Johnson* case, *supra* note 36; and the assignment of income doctrine, *supra* notes 15-22 and accompanying text.

98. I.R.C. §§ 1202, 1014, 1222(11), and 535(b)(6).

99. I.R.C. § 243.

100. $6.9\% = (15\%) \times (46\%)$.

est free loan from the government.

Although liberal estate and gift tax exclusions exist,¹⁰¹ it might be possible to avoid any such tax imposed on large amounts transferred via stock ownership in the PSC. This conclusion depends on the IRS and the courts neglecting to assert either an estate or gift tax due to their preoccupation with imposing an income tax on the right party. Although no gift tax was asserted or imposed in *Foglesong*, the case has no authority to recommend that no tax should have been imposed. The risk of litigating the assignment of income issue, as well as the possible estate and/or gift tax avoidance, needs to be considered when projecting expected tax savings.

A large disadvantage of doing business in a corporate form is the *double taxation* of income. Nevertheless, if most income was to be distributed in the form of salaries and bonuses, there would be little remaining for taxable dividend distributions. However, there is the continuing and unresolved question of what constitutes *unreasonable compensation*.¹⁰² As mentioned earlier, this pitfall can also be escaped where stock is sold or bequeathed after being held for a period of time.

If an existing partnership incorporates, there may be an unwanted *bunching* of income if the prior entity used a fiscal year. This would also hold true of the professional proprietor who decided to incorporate using a fiscal year.

G. Non-Tax Advantages/Disadvantages

1. Transferability

A corporation offers easy transfer of ownership, thus facilitating sales or gifts of stock, unlike a proprietorship or partnership. Also, a corporation can choose to have a perpetual life, unlike a proprietorship which dissolves every time a partner is added or withdraws. This might be a moot point where the corporation consists of only the professional whose efforts resulted in most of its income. However, the existence of stock, with its ease of transferability, is still the best means of carrying out various tax savings and planning opportunities, especially in the closely-held family corporation.

101. A taxable estate of up to \$600,000 passes tax free (after 1986). I.R.C. § 2010. And the first \$10,000 gift per donee is excluded from taxable gifts each year. I.R.C. § 2503.

102. *Supra* note 91.

2. *Limited Liability*

While all of the assets of the corporation or PSC may be subject to liability, those assets do not include the personal assets of the shareholders and employee/owners. In certain licensed fields, there are insurance restrictions and other capitalization requirements so as not to subject the public to hazardous and uninsured services. Thus, the ability to incorporate may be somewhat restricted, for instance, where it is required that all members of the proposed corporation have the same professional background.

The largest, single disadvantage of doing business in corporate form involves the expense of maintaining separate books, records, facilities, and of complying with other corporate formalities like keeping minutes, ledgers, etc. As we have seen from the case law, courts ascribe great importance to the observance of such formalities. There is also the risk of the *many are filed, few are chosen* lottery, given today's attitude toward what the IRS perceives as potential abusive tax shelters. Although Fred Foglesong drastically reduced a large deficiency in an out-of-court settlement, the legal costs and other burdens of fighting with the IRS in court for over ten years can not be taken lightly.

The professional might just as well feel this added cost and complexity is not worth the enumerated advantages outlined above. This might be especially so with the corporate retirement parity rules passed with TEFRA. Also, TRA '84 further provided technical corrections to eliminate discrepancies in the treatment of the self-employed individual versus his corporate counterpart.

IV. CONCLUSION

The main concern for the professional athlete playing for one team is to avoid being hit by new section 269A. However, for the individual sports player, and possibly for the team athlete involved in multiple business activities such as endorsements and outside investments, operating in a corporate format appears a safe and prosperous route to travel. Despite near parity in the retirement area, and for the reasons discussed above, the Personal Service Corporation remains an attractive planning tool still generally recommended by many tax professionals.