



1-1-1982

Personal Service Corporations: Who Is the Income Earner?

J.E. Olson

Hamline University

Follow this and additional works at: <https://scholarlycommons.pacific.edu/mlr>



Part of the [Law Commons](#)

Recommended Citation

J.E. Olson, *Personal Service Corporations: Who Is the Income Earner?*, 13 PAC. L. J. 333 (1982).

Available at: <https://scholarlycommons.pacific.edu/mlr/vol13/iss2/6>

This Article is brought to you for free and open access by the Journals and Law Reviews at Scholarly Commons. It has been accepted for inclusion in McGeorge Law Review by an authorized editor of Scholarly Commons. For more information, please contact mgibney@pacific.edu.

Personal Service Corporations: Who is the Income Earner?

J.E. OLSON*

INTRODUCTION

In *Commissioner v. Culbertson*, the Supreme Court referred to the assignment of income doctrine as “the first principle of income taxation: that income must be taxed to him who earns it.”¹ The person earning the income—whether a corporation, partnership or an individual taxpayer—“cannot avoid taxation by entering into a contractual arrangement whereby that income is diverted to some other person or entity.”² The doctrine, whose boundaries are yet without precise delineation, arose in the 1930 case of *Lucas v. Earl*.³ In that case, an attorney and his wife entered into a contract which provided, in essence, that any income which either might acquire would be treated as “received, held, taken, and owned by us as joint tenants”⁴ The controversy arose over proper treatment of the salary and attorney’s fees received by Mr. Earl from his law practice. Although Mrs. Earl was not a party to the contracts under which those amounts were paid, the salary and fees, when received by Mr. Earl, were reported one-half by himself and one-half by her. The Supreme Court held that the Revenue Acts of 1918 and 1921 “tax[ed] salaries to those who earned them

* Associate Professor of Law, Hamline University; B.S., 1967, University of Notre Dame; J.D. *cum laude*, 1970, Duke University; LL.M. (Taxation), 1981, University of Florida. The author acknowledges the excellent critique and editing provided by his former research assistant, Ms. Cynthia L. Lehr, J.D. *cum laude*, 1981, Hamline University.

1. 337 U.S. 733, 739-40 (1940).

2. *United States v. Bayse*, 410 U.S. 441, 449 (1973).

3. 281 U.S. 111 (1930).

4. *Id.* at 114. The contract was valid under state law.

and the tax could not be avoided by anticipatory arrangements and contracts."⁵ The Court reasoned that the statute did not allow an "arrangement by which the fruits are attributed to a different tree from that on which they grew."⁶ No further rationale was given for the decision.

Since the decision in *Lucas v. Earl*, the courts have struggled with the application of the assignment of income doctrine in other contexts, including that of the personal service corporation.⁷ The tension between separate taxation of the two taxable persons and unitary taxation of the single economic unit is most acute where the corporation has a sole, or very few shareholders.⁸ Analysis of cases in this area is clouded by (1) the intensely factual nature of the inquiry and (2) the almost inevitable joining of the assignment of income doctrine with other theories in the Commissioner's attacks on these arrangements.

There are three lines of attack used by the Commissioner in personal service corporation cases. The corporation may be so lacking in operational characteristics that it is a mere "sham" to be disregarded for tax purposes.⁹ The corporation may lack sufficient direction and control over the earning of the income so that the shareholder is deemed to have attempted to assign his own income to the corporation.¹⁰ Finally, the Commissioner may exercise his discretion pursuant to Section 482¹¹ and allocate income from the corporation to its shareholder.¹²

Initially, the Commissioner's approach was to use the sham and assignment of income theories in tandem. This approach was eventually

5. *Id.* at 115.

6. *Id.*

7. See generally Battle, *The Use of Corporations by Persons Who Perform Services to Gain Tax Advantages*, 57 TAXES 797 (1979) [hereinafter cited as Battle]; Burdett, *Foglesong's Sec. 482 Approach May Threaten Closely-Held Personal Service Corporations*, 53 J. TAX. 330 (1980) [hereinafter cited as Burdett]; Kauder, *The Service Corporation as the Taxpayer's Alter Ego: Variations on the Borge Theme*, N.Y.U. 28TH INST. ON FED. TAX. 1109 (1970) [hereinafter cited as Kauder].

8. Kauder states that "the personal service corporation owned by a single shareholder would not exist but for the tax laws." *Supra*, note 7, at 1109. The Internal Revenue Service's efforts to reassign income to the shareholder presents a serious obstacle to use of the corporate form by physicians, accountants, attorneys, and other service providers. See Egerton, *Reallocation of Income: A New Threat to Professional Corporations?*, 58 A.B.A. J. 979 (1972).

9. See *Shaw Construction Company v. Commissioner*, 35 T.C. 1102 (1961). See generally Bittker, *Professional Association and Federal Income Tax*, 17 TAX L. REV. 1, 5 at n.8 (1961); Eustice, *Tax Problems Arising From Transactions Between Affiliated or Controlled Corporations*, 23 TAX L. REV. 451, 458-59 (1968); [hereinafter cited as Eustice]; Hobbet, *The Corporate Entity: When Will It Be Recognized for Federal Tax Purposes?*, 30 J. TAX. 74 (1969).

10. See *Jones v. Commissioner*, 64 T.C. 1066 (1975). The leading United States Supreme Court cases concerning the general doctrine of assignment of income are summarized in *Wood v. Harmon Corp. v. United States*, 311 F.2d 918, 921-922 (2d Cir. 1963).

11. I.R.C. §482.

12. See *Rubin v. Commissioner*, 56 T.C. 1155 (1971) (opinion on remand), *aff'd per curiam*, 460 F.2d 1216 (2d Cir. 1972) (Rubin III). See generally Battle, *supra* note 7, at 805-06; Burdett, *supra* note 7, at 332-36.

accepted by the Tax Court. If the corporation was a "sham," the inquiry ended. If not, the assignment of income doctrine was applied. In the 1970's,¹³ the Commissioner began to avoid the sham approach and to concentrate his attacks under the assignment of income doctrine with allocation pursuant to Section 482 as a backup theory. Neither the courts nor the Commissioner, however, were always clear with regard to the theory being used.¹⁴ In 1970, a panel of the Second Circuit, in *Rubin v. Commissioner*,¹⁵ (hereinafter referred to as *Rubin II*) held that use of the assignment of income doctrine under Section 61¹⁶ was error "where . . . there is a statutory provision [Section 482] adequate to deal with the problem presented."¹⁷ After *Rubin II* the Commissioner and the Tax Court continued to apply the assignment of income doctrine in these cases.¹⁸

On April 25, 1980, the Service issued a Technical Advice Memorandum¹⁹ in which it reaffirmed its assignment of income doctrine attack on certain personal service corporations. The stated rationale was as follows:

It has long been established that income must be taxed to the person who earned it, irrespective of whether he actually received it or rather assigned the rights to receive it to some person.

Where a small, closely-held corporation is involved, however, the issue may be complicated by the fact that the corporation can act only through agents who are likely to be its controlling shareholders. Nonetheless, so long as the corporation itself in fact earns the income, the corporation will be taxed But where the shareholder-employee, in fact, acts on his own behalf rather than for the

13. In a prior collateral approach to this general issue the Internal Revenue Service issued T.I.R. 1019, [1969] 7 *Stand. Fed. Tax Rep.* (CCH) § 6867 (Aug. 8, 1969), in which it conceded that professional corporations would, except where "special circumstances" were present, be considered to be within the definition of "corporations" for federal tax purposes under I.R.C. §7701(a)(3). See note 137 *infra*. The "sham" corporation is an example of such a "special circumstance." *Jones v. Commissioner*, 64 T.C. 1066 (1975).

14. See *Morrison v. Commissioner*, 54 T.C. 758 (1970).

15. 429 F.2d 650 (2d Cir. 1970) (*rem'g* 51 T.C. 251 (1968)) (*Rubin II*).

16. I.R.C. §61(a). In the earlier cases, the statutory basis for the assignment of income doctrine is Internal Revenue Code of 1939, C.I. §22a, 53 Stat. 9 and Revenue Act of 1913, §213(a), 38 Stat. 114. All of these provisions have the same meaning although their specific terms differ slightly. S. REP. NO. 1622, 83D CONG. 2D SESS. 168 (1954).

17. *Rubin v. Commissioner*, 429 F.2d 650 (2d Cir. 1970) (*Rubin II*). Judge Friendly clearly thought that Section 482 *did* apply in order for the assignment of income doctrine to be pre-empted. *Battle, supra* note 7, at 804. See *Rubin v. Commissioner*, 56 T.C. 1155 (*Rubin III*) applying Section 482 to cause the shareholder-employee to include in gross income the amounts received by the corporation for his services to a third party.

18. See *Shaw v. Commissioner*, 59 T.C. 375, 387 (1972) (concurring opinion); *American Savings Bank v. Commissioner*, 56 T.C. 828 (1971). Bittker and Eustice state in their treatise that "[t]hese assignment-of-income principles [from *Lucas v. Earl*, 281 U.S. 111 (1930)] apply with equal force to corporate transactions." B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS*, §1.05, at 1-19 (4th ed. 1979) [hereinafter cited as BITTKER & EUSTICE].

19. [1980] *Letter Rulings* (CCH) §6971K. (Apr. 25, 1980).

corporation, he and not the corporation must bear the burden of tax If the corporation involved is admittedly a separate taxable entity and not a mere sham, the issue has generally been narrowed to whether the corporation has been given sufficient corporate substance and sufficient control over the earning of the income so that it, and not the individual taxpayer, can be considered the true earner of the income²⁰

Four days later, on April 29, 1980, a panel of the Seventh Circuit issued an opinion which deemed the assignment of income doctrine "inappropriate" in personal service corporation situations where Section 482 could be applied.²¹ Thus, the two Courts of Appeal (Second and Seventh Circuits) to consider the issue have both determined that Section 482 should preempt the assignment of income doctrine whenever that section is applicable.

This article will trace the development of the Tax Court's sham and assignment of income approaches to the problem of income allocation in the context of the personal service corporation. It will discuss the Courts of Appeal cases favoring the use of Section 482 in this situation. The propriety of the assignment of income doctrine approach will be considered and contrasted with use of Section 482. Finally, a legislative solution will be suggested.

THE TAX COURT CASES

The Tax Court cases fall into two categories representing the earlier approaches to the "true earner" problem in the personal service corporation—the sham doctrine and the assignment of income doctrine.²² These cases are set forth in *Table I* in the Appendix. The Table provides an overview of the theoretical development from 1938 to 1976 by identifying the approaches used and the factors thought significant by the courts.

A. The Sham Doctrine

The sham doctrine traces its roots to *Moline Properties Inc. v. Commissioner*.²³ The corporation there involved was organized for use as a security device in connection with loans made by a third party to the taxpayer.²⁴ The Commissioner's attack was based solely on the conten-

20. *Id.*

21. *Foglesong v. Commissioner*, 621 F.2d 865 (7th Cir. 1980), *rem'g*, 35 T.C.M. (CCH) 1309 (1976) (Foglesong II).

22. The later Tax Court cases applying Section 482 are discussed *infra*.

23. 319 U.S. 436 (1943).

24. Certain real property was transferred to the corporation and the taxpayer's stock in the corporation (which constituted all outstanding shares) was placed in a voting trust controlled by the creditor. The corporation assumed certain obligations with respect to the property, defended

tion that the corporation was a mere agent which should be disregarded for tax purposes because of its limited purpose (to provide a means to secure a particular loan). After stating that the corporate form may generally be disregarded for tax purposes if it is "a sham or unreal," the court decided:

so long as that purpose [for creating the corporation] 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.²⁵

In that case, the corporation had performed an important business function required by third parties to the transaction.

Since *Moline Properties*, a functional test for corporate vitality has developed from the cases. As one commentator notes:

Neither the identity of economic interest between the corporation and its sole shareholder nor a tax motivation for the corporation's creation and use will defeat the corporate existence if the corporation actually engages in some business activity of a relatively continuous nature.²⁶

In *Bass v. Commissioner*,²⁷ the Tax Court looked to whether the purpose for creation of the corporation was "intended to be accomplished through a corporation carrying out substantive business functions."²⁸

In *Shaw Construction Company v. Commissioner*,²⁹ the construction company formed some 79 corporations to hold one or two lots which the construction company's shareholder had arranged to acquire and develop. The shareholder assigned VA loans to the construction company which built homes on the lots owned by the 79 companies. The homes were then sold and the proceeds received by the respective corporate "seller." The multiple companies had no separate offices, no employees, no payroll, no furniture or equipment and no real business function. Each company had separate books which were kept by an employee of the construction company. The court found the multiple corporations to be "shams" and not recognizable for tax purposes. Thus, all the income received by them was deemed income to the con-

its interests in a condemnation suit and instituted suit to remove restrictions imposed on the property by a prior owner.

25. 319 U.S. at 439.

26. Kauder, *supra* note 7, at 1122. See Note, 4 SUFFOLK U. L. REV. 958 (1970).

27. 50 T.C. 595 (1968). In *Bass*, the corporation not only looked like one, it also acted like one. See *Roubik v. Commissioner*, 53 T.C. 365, 381 (1969) (concurring opinion); Eustice, *supra* note 9, at 458; 39 U. CIN. L. REV. 396 (1970).

28. 50 T.C. at 601.

29. 35 T.C. 1102 (1961). *Accord* *Kimbrell v. Commissioner*, 371 F.2d 897 (5th Cir. 1967). See *Noonan v. Commissioner*, 52 T.C. 907, 910 (1969) wherein the Court stated "the bones of these corporations were without flesh . . . [t]hey were paper corporations that existed in form only for the purpose of obtaining tax benefits available by splitting the income" of the larger economic entity.

struction company.³⁰

The functional nature of the sham doctrine is illustrated by *Jones v. Commissioner*³¹ in which the Tax Court found that the corporation was not organized for a legitimate purpose (it was designed for tax avoidance) but that it was not a "sham" because it nevertheless engaged in substantial business activity. In *Estate of Cole v. Commissioner*,³² the court appeared to add a new element to the factual mix in sham cases when it looked at whether the corporation was bearing entrepreneurial risk. In all, the sham cases make it clear that more than *de jure* corporate status under state law and possession of a certificate of incorporation³³ are needed to achieve status as a separate taxable entity or "person"³⁴ for purposes of the federal income tax. The exact quantum of business functions required, however, is rather low, and the Commissioner increasingly appears to be conceding this issue to the taxpayer.³⁵

B. The Assignment of Income Doctrine

Although frequently joined with the sham theory in the Commissioner's contentions, the assignment of income doctrine is inconsistent with the sham doctrine. For there to be an assignment of income, there must first be at least two taxable persons. In *Lucas v. Earl*, the separate taxable persons were Mr. Earl and his wife. In the personal service corporation cases, the separate taxable persons are the corporation and its sole shareholder. The assignment of income doctrine, if applied, merely results in a determination that the corporation did not "earn" the income in question in the taxable year under examination. Application of the doctrine does not affect the corporation's status as a separate taxable entity. In *Jones v. Commissioner*,³⁶ the court noted:

Recognition of a corporation as a viable tax entity does not completely bridge petitioners' journey over the pitfalls of section 61(a) because petitioners' scheme was no more than an assignment of income earned by Mr. Jones.³⁷

30. The court also found that the construction company which took all of the major steps necessary to create the income and which controlled its disposition was the "true earner" under the assignment of income doctrine.

31. 64 T.C. 1066 (1975).

32. 32 T.C.M. (CCH) 313 (1973).

33. Issuance of such a certificate by the Secretary of State (or other appropriate official) is generally conclusive evidence of corporate existence against all but the State. See MINN. STAT. §302A.155.

34. I.R.C. §7701(a)(1) includes both individuals and corporations as "persons" for purposes of tax law.

35. See Battle, *supra* note 7, at 803. See generally Schwartz, *Meeting Attacks on the Professional Corporation*, N.Y.U. 32ND INST. ON FED. TAX. 859 (1974).

36. 64 T.C. 1066 (1975).

37. *Id.* at 1076.

The first personal service corporation case to reach the Tax Court was *Fox v. Commissioner*,³⁸ decided a mere eight years after the birth of the assignment of income doctrine in *Lucas v. Earl*. In *Fox*, the taxpayer had been a successful cartoonist for a number of years. He formed a corporation to market the cartoons which he would subsequently create as an employee of the corporation. He agreed to render his exclusive services as an artist and author to the corporation. In addition, he agreed to approve contracts which the corporation was later to make for syndication of his work in newspapers. The shareholder, as president of the corporation, entered into contracts for newspaper syndication of the cartoons. Under these contracts, the corporation received three (3) times the amount which it was required to pay over to the shareholder-employee under his employment contract. The royalties from the syndication contracts were paid directly to the corporation. The corporation employed clerical employees to assist the shareholder-employee in preparing the cartoons.

The Commissioner attempted to charge the income to the shareholder-employee arguing first, the sham theory and second, the assignment of income theory. The Board of Tax Appeals, after noting that the separate identity of the corporation had been generally respected by the cartoonist and by those who had dealings with it, such as the newspaper syndicates, found that there was no factual basis for application of the sham doctrine to disregard the corporation as a separate taxable entity. With respect to the assignment of income attack, the Board felt that the facts before it did not come within the purview of the decision in *Lucas v. Earl*.³⁹ The Board was impressed by the lack of contractual relationship between the shareholder-employee and the newspaper syndicates as well as by a concession by the Commissioner that no assignment of future earnings was involved in any of the contracts. It is difficult to understand the Commissioner's concession with respect to assignment of future earnings in view of his basic contention that an assignment of income *had* occurred. The failure of the Board to deal with this apparent inconsistency weakens the resulting opinion. In *Fox*, there was no attempt to explore in detail the activities of the corporation *qua* corporation with regard to generation of the income from the syndication contracts. The Tax Court faced another personal service corporation problem in *Laughton v. Commissioner*⁴⁰ when the taxpayer, a successful actor, formed a corporation for the purpose of engaging in the motion picture and theatrical business. The actor was

38. 37 B.T.A. 271 (1938).

39. *Id.* at 277.

40. 40 B.T.A. 101 (1939), *rem'd*, 113 F.2d 103 (9th Cir. 1940).

not a member of the Board of Directors nor was he an officer of the company, although he owned all of the shares. He entered into a contract to provide exclusive services to the corporation for a period of five years in return for compensation of \$750 per week. The corporation subsequently entered into contracts with various motion picture studios whereby it "loaned" its employee to the studio for the purposes of acting in pictures.⁴¹ For this use of its employee's services, the corporation received compensation substantially in excess of the amounts which it was required to pay the shareholder-employee. This "loan-out" arrangement was in accordance with the general practice in the industry where one studio or producer had a long-term contract for the services of an actor.

The Commissioner sought to tax the shareholder-employee directly on the income generated under the "loan-out" contract. The Commissioner argued that the Board should disregard the corporate form and determine that the corporation was organized merely as a tax avoidance scheme.⁴²

The Board viewed the Commissioner's attack as a melange of sham doctrine, agency concepts, tax avoidance objections, and perhaps an assignment of income doctrine attack.⁴³ The Board determined, primarily by looking at the activities of the corporation in taxable years subsequent to those in question, that the corporation was a functioning business entity and not a sham. Comparing the case with *Fox*, the Board noted that the amounts sought to be taxed to the shareholder-employee had been received directly by the corporation under contracts between the corporation and the studios. Thus, the Board felt there was no occasion to apply the assignment of income doctrine.⁴⁴

In *Wilgus v. Commissioner*,⁴⁵ the personal service corporation had operated for a number of years as an independent poultry processor, owning its own processing facility and employing a substantial number

41. During the taxable years in question, the corporation apparently engaged in nominal activities other than the loan-out of the services of its shareholder-employee. The corporation, however, had been formed as a production company, and in later years, after the corporation had acquired sufficient capital, it actively engaged in film production.

42. In this regard, the Commissioner asserted that the corporation was merely the agent and *alter ego* of its shareholder serving as a conduit for his Hollywood earnings to his London bank account. Therefore, the agreements between the corporation and the studios should be characterized as anticipatory arrangements for the deflection of income.

43. A significant indicator of the Board's view of the case is presented by the comment that "the answer to the respondent's contentions turns upon whether the corporation should be recognized or disregarded as an entity separate and apart from the petitioner." 40 B.T.A. at 105. Thus, it appears the Board is viewing the case solely as a "sham" theory case and not as a true assignment of income doctrine case. Under assignment of income principles, the separate existence of the corporation would be a prerequisite to application of the doctrine.

44. The court of appeals disagreed with this conclusion. See note 82 and accompanying text *infra*.

45. 20 T.C.M. (CCH) 752 (1961).

of persons. As part of an economy move, five poultry processors formed a new corporation and transferred the physical assets of the independent corporations to the new entity. All non-executive employees of the old corporations were fired and then rehired by the new corporation. The new corporation acquired its management by entering into oral service contracts with the former corporations for the services of various executives. In the case of Wilgus' corporation, both of the principal shareholders were "loaned out" under this arrangement.⁴⁶

The court focused on the payment by the new corporation directly to the old corporation without deduction for FICA, withholding tax, or other amounts normally deducted with respect to an employee. The Commissioner cited *Lucas v. Earl*, arguing that the income should be taxed directly to the individual shareholder and not to the old corporation. The court, however, found that the principal shareholders continued to be the employees of the old corporation and that the payments were income to that corporation. There was no discussion of the factual predicate for this determination. Specifically, the court did not indicate concern for the change in the nature of the old corporation as it went from an active poultry processor to a passive provider of the services of its principal shareholders.

In *Rubin v. Commissioner*,⁴⁷ (hereinafter referred to as *Rubin I*) the taxpayer, as part of an effort to purchase Dorman Mills, entered into a contract to provide management of Dorman Mills for a four-year period. The parties to the contract were Dorman Mills and the predecessor to Park International, Inc. (Park) because at the time that this contract was executed Park was not in existence. Subsequent to the execution of the contract, the taxpayer caused Park to be incorporated with 70% of its stock being issued to himself. The other shareholders of Park were the taxpayer's brothers. The taxpayer, as the controlling shareholder-employee, did not enter into any kind of employment contract with Park, and during the period of time covered by the management services contract, he also worked for other corporations. At various times, Dorman Mills held the taxpayer out as part of its management by listing him as general manager, and, on at least one occasion, treated a loan between Park and itself as if the taxpayer, not Park, had advanced the money. Third parties dealing with Dorman Mills during the period of the management contract viewed the taxpayer as the key employee of Dorman Mills. These third parties did not know

46. The employees continued to receive their regular salary from the old corporation, and the new corporation paid a specified sum to the old corporation for executive services.

47. 51 T.C. 251 (1968), *rem'd*, 429 F.2d 650 (2d Cir. 1970) (*Rubin I*).

of the existence of Park. Between themselves, however, Park and Dorman Mills generally respected the existence of the corporation and the status of the taxpayer as an employee of Park. All of the management fees received by Park were attributable to services performed for Dorman Mills by the taxpayer. Park had no employees other than the taxpayer who were involved in the provision of management services.

The Commissioner did not argue the sham doctrine in *Rubin I*, conceding that Park was a valid corporation during the years in question. The Commissioner's approach was to argue that the taxpayer, not the corporation, in substance earned the income and thus was taxable on the net income pursuant to Section 61.

The Tax Court divided the legal theories asserted by the Commissioner into two parts. First, it considered whether, in substance, the taxpayer worked directly for Dorman Mills but occasionally contributed part of his compensation to Park as capital for use in its other business. The court determined that there was no business purpose for the interposition of Park between the taxpayer and his real employer, Dorman Mills.⁴⁸ Thus, in substance, the taxpayer worked directly for Dorman Mills and should be taxed on the net management service income which Park received from Dorman Mills. The court distinguished *Fox*⁴⁹ and *Laughton*.⁵⁰ The substance-over-form issue as presented in those cases dealt with the validity of the corporation, whereas in the present case, the inquiry was into the validity of the specific transaction entered into by the corporation. In *Fox* and *Laughton*, each shareholder-employee was contractually bound to render services exclusively to his corporation. In *Rubin I* the taxpayer was not so bound, and thus had the freedom to work for Park under its management contract with Dorman Mills or not do so. Therefore, he could control the earning of income by Park. Furthermore, in the earlier cases, the corporations had transacted business with independent third parties, whereas in the present case, the taxpayer not only controlled the corporation for whom he was purportedly an employee but also the corporation which had contracted to "borrow" his services. Based on these differences, the court felt that it was not bound by the prior decisions.⁵¹

Second, the court applied the assignment of income doctrine, noting that in this instance it was only semantically different from the sub-

48. With respect to this issue, the taxpayer had the burden of proving there was substance or an economic purpose for casting his transaction in the form he chose, and he failed to do so.

49. 37 B.T.A. 271 (1938).

50. 40 B.T.A. 101 (1939).

51. See 51 T.C. at 267.

stance-over-form argument presented earlier. This issue turns upon the question of who has the ultimate direction and control over the earning of the compensation. If this control lies with the shareholder-employee who actually performs the services, then he remains taxable on the earnings from the personal services, whether or not he chooses to divert the receipt of that compensation to his corporation. The court determined that the taxpayer had directed and controlled the earning of income. He had negotiated the management services contract before the entity was incorporated, had continued to work for other organizations during the period of time covered by the management services contract, and when it served his interest, had the contract between the corporation and Dorman Mills terminated without consideration. These facts demonstrated that the corporation did not control the earning of the income in question but rather that the individual did. Thus, he must include these amounts in his gross income.

In *Roubik v. Commissioner*,⁵³ four physicians formed a corporation and entered into separate employment agreements with it.⁵⁴ Notwithstanding the incorporation and the execution of the employment agreements, the four physicians continued to engage in the practice of medicine substantially as they had before the corporation was formed.⁵⁵

The Commissioner challenged these arrangements on the basis that the physicians had actually been engaged in the practice of radiology as partners. The Commissioner did not attack the arrangement on the sham doctrine but rather based his attack entirely on the assignment of income doctrine.

The Tax Court defined the issue as "whether petitioners' business was actually carried on by the incorporated organization or whether it was carried on outside that organization" citing to the Ninth Circuit

52. *Id.* at 265-266 citing *Lyon & Eustice, Assignment of Income: Fruit and the Tree as Irrigated by the P. G. Lake Case*, 17 TAX L. REV. 293, 393 (1962).

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

54. Under the agreements, the physicians purported to agree that the corporation would assign the employee to specific job locations and to specific duties at those locations, that the employee would devote his entire time and attention exclusively to the medical practice of the employer, and that the employee would not compete with the employer after termination of employment.

55. The books of the corporation were kept in such fashion that the income and expenses of each physician were separated from those of the others and the net income from his "practice" inured to the benefit of that physician only. The corporation did not enter into any contracts to provide the service of its "employees" to any of the hospitals, other physicians or patients to whom its physician-shareholders provided actual service during the period in question and was unknown to most of these third parties. The corporation did not own any equipment, incur any debts for rent, office or medical supplies, or services, or pay any salaries, except for those of its physician-shareholders.

opinion in *Commissioner v. Laughton*.⁵⁶ The court framed the test as follows:

[i]n the case of a corporation which provides personal services for a fee, income is 'earned' by the corporation or by the person who actually performs the services, whoever has the ultimate direction and control over the earning of ***[the] compensation.⁵⁷

The court determined that the physicians had surrendered control over their services to the corporation in form only. In substance, each doctor continued his own separate practice with the corporation being used solely to provide bookkeeping services. Thus, during taxable years in question, the doctors were not bona fide employees of the corporation. The court determined that the corporation did not assign any of its employees to a job location, nor to specific duties, nor did it direct any of its employees in their professional activities, nor did it control the quality of its employees' work. Thus, the court held that the corporation had nothing to do with the earning of the income reported by it during the years in question. The income, therefore, could not be assigned by the physicians to their corporation, and that income was includable in the gross income of the respective physicians.⁵⁸

*American Savings Bank v. Commissioner*⁵⁹ involved a challenge by the Commissioner to two arrangements made by the individual taxpayers involved. The two taxpayers controlled American Savings Bank and had large stockholdings in several other banks. They had also previously formed a partnership for the purpose of selling insurance to customers of their banks. The agency contracts with the insurance companies ran to the partnership and were not assignable without written assent of the particular insurance company involved. In 1959, the two individuals formed a corporation and transferred the insurance business to it.⁶⁰ The operation of the insurance business after the transfer remained substantially the same as it had been before.⁶¹ The corporation never made any distributions to its shareholders, but rather utilized its net income to retire obligations of its own under notes secured by its bank stock.

The second arrangement challenged by the Commissioner involved a

56. 113 F.2d 103 (9th Cir. 1940) (*rem'g* 40 B.T.A. 101 (1939)).

57. 53 T.C. at 379. This is the *Rubin I* test. See text accompanying note 51 *supra*.

58. The concurring opinion classified *Roubik* as a "sham" case notwithstanding the failure of the Commissioner to raise that contention. *Id.* at 381. See, Note, 4 SUFFOLK U. L. REV. 958 (1970).

59. 53 T.C. 365 (1969).

60. No consent, however, was received from the insurance companies relating to this transfer, and the insurance companies were not notified of it until shortly before trial.

61. The actual sales were made primarily by three unrelated individuals who were officers of the various banks. These banks' officers were aware of the transfer of the business to the corporation, and after the transfer, they considered themselves to be agents of the corporation.

contract between American Savings Bank and the corporation whereby the corporation agreed to render management services to the bank. The management services were actually rendered by the two shareholders of the corporation and consisted of the duties which they had previously carried out as controlling shareholders of the bank. The corporation did not pay either of its shareholder-employees for providing the services nor were there any contracts or other employment agreements between the corporation and its purported employees.

The grounds of the Commissioner's challenge to these transactions are unclear at best. He appears to have confused the sham doctrine with the assignment of income doctrine.⁶² The Tax Court, however, saw two separate issues. The court first determined that the corporation was not a "sham" but rather a valid taxable entity separate from its shareholders. The court then dealt with the assignment of income question with regard to each of the arrangements under examination.

With regard to the insurance commissions, the court noted that nearly all of the income earned by the corporation was generated by policy sales carried out by the three non-shareholder agents of the corporation. The agency contracts, issued by the insurance companies, authorized the sale of insurance by the corporation and not by its shareholders as individuals. Thus, the court felt that the corporation had the power to permit or prohibit the agents from selling insurance. That being so, the court felt the corporation had earned, through its agents, the income in question. It was significant that the personal services which generated the income, i.e., the selling efforts of the bank officers, were performed by persons who were *not* the controlling shareholders of the corporation.⁶³ Such "ordinary" employees would not be in a position to gain economically from an assignment of income to the corporation.

With respect to the contract for providing management services to

62. Application of Section 482 was not argued.

63. *Cf. Gettler v. Commissioner*, 34 T.C.M. (CCH) 442 (1975). The court therein rejected the Commissioner's assignment of income doctrine challenge to use of a personal service corporation. As in *American Savings Bank*, the corporation in *Gettler* had other professional-level employees who generated substantial receipts in addition to those generated by the services of its two shareholder-employees. Although the Commissioner did not base his challenge to the arrangement on the sham doctrine, the petitioners apparently chose to fight on that ground. Thus, the issue in the case was confused in the opinion because the court seemed to believe that a finding that the corporation carried on an active business leads inevitably to a finding that the corporation earned the particular income in question. The court's citation to *Roubik* and its failure to cite *Rubin I*, *American Savings Bank* or *Ronan State Bank* supports this view of the opinion. The court also appears to place weight on the Commissioner's failure to show how the assignment of income resulted in a significant tax advantage to the petitioners. The quantum of tax advantage resulting from an assignment of income is, of course, completely irrelevant to the question of whether or not there has been an assignment of income. The holding in *Gettler* is weakened by the court's failure to deal effectively with these issues.

the bank, the Court looked to its decision in *Rubin I* for guidance. The Tax Court again distinguished the traditional "loaned" employee cases⁶⁴ on the basis that the individuals involved in those cases had been contractually bound to render exclusive services to their employer-corporations, and because the control of both the "loan-out" and the "borrowing" corporations by the same shareholder was lacking in those cases. The *American Savings Bank* court also identified a third distinguishing factor: the lack of any showing that the controlling shareholders were either in the employ of the corporation or acting as its agents in rendering the management services.⁶⁵ Since the shareholders are the individuals who actually performed the services and generated the income, they are (in the absence of any overriding employment obligations) the true earners of the income. The shareholders could have ceased at any time providing the management services to the corporation. This ability to control, without legal impediment, the income flow to the corporation results in taxation of that income to the shareholder.

In *Ronan State Bank v. Commissioner*,⁶⁶ the banking corporation participated through the state bankers association in a group credit-life and health insurance program. The policy designated the various financial institutions as "participating creditors" or policy holders under the policy. The policy terms were such that the participating creditor (the Bank) performed the duties of, and received remuneration similar to that which would normally be received by, an insurance agent selling a policy. In that capacity, the bank paid the premiums on the policy, solicited enrollment of the bank's debtors under the group policy, charged the debtors the appropriate fee and collected those amounts and issued certificates of insurance under the group policy. The two controlling shareholders of the bank, believing that local law prohibited the bank from engaging in the insurance business, caused the corporation to "assign the insurance business to them."⁶⁷ The shareholders, who were licensed insurance agents, individually re-

64. See *Fox v. Commissioner*, 37 B.T.A. 271 (1938); *Laughton v. Commissioner*, 40 B.T.A. 101 (1939).

65. That is, not only was there no employment contract, but there was, in fact, no employment relationship. The controlling shareholders were acting on their own in furnishing the management services to the bank, and thus they should be taxed on the income received by the corporation for those services.

66. 62 T.C. 27 (1974).

67. The insurance companies never appointed either of the individuals as an agent, and the terms of the group policy did not allow payment to be made to anyone other than the corporate policyholder. The income distributed to the shareholders was generated through the bank's participation in the group policy as a participating creditor and did not represent agents' commissions earned by them on the sale of insurance.

ported their respective shares of the income generated by the corporation's participation in the group policy.

The Commissioner determined that the individual shareholders had earned the income in question under the assignment of income doctrine.⁶⁸ There was no challenge made under the sham doctrine nor was Section 482 utilized.

The Tax Court determined that the purported assignment of the insurance business to the shareholders was "wholly lacking substance" because the corporation was never relieved of its liabilities under the policy as participating creditor, its activities were never assumed by the individuals, and all essential services with respect to the policies continued to be performed by employees of the bank after the purported assignment. Thus, since the corporation retained all of its rights and liabilities under the group policy and continued to perform the activities required of a participating creditor under the policies, the corporation was clearly in control of the enterprise or the capacity to produce the income, and thus it was the "true earner" of the income in question.⁶⁹

In *Jones v. Commissioner*,⁷⁰ the individual was an official court reporter for the United States District Court.⁷¹ In 1967, the taxpayer was assigned as court reporter for a major anti-trust case. As a result of the demands of that case, his income rose dramatically. Thus, in 1968 he formed a corporation to engage in the court reporting business. The corporation operated the business in exactly the same fashion as it had

68. 62 T.C. 27 (1974).

69. *Cf. Shaw v. Commissioner*, 59 T.C. 375 (1972). *Shaw* involved a challenge based on the assignment of income doctrine alone. The taxpayer was the sole or controlling shareholder of the three automobile dealerships. He was also a licensed insurance agent in the jurisdiction. He entered into contracts with several insurance companies authorizing the sale of personal life insurance, credit-life insurance and other insurance policies to the clients of the automobile agencies. The policies were sold at each of the automobile dealerships through unlicensed "closers" at the time the automobiles were purchased. The shareholder's name, however, was entered on the policy forms as the selling agent. All of the work with respect to processing the individual policies was handled by employees of the respective automobile agencies and all costs related to the sale of the insurance was born by the agency. These costs were not separately accounted for on the books of the corporation. The Commission checks were received from the insurance companies directly by the individual shareholder. He, however, endorsed them over to the account of, and they were reported as income by, the corporation through which the particular policy had been generated. The court found that the shareholder was himself in the insurance business and used the corporations as his agents in carrying out his business of selling insurance. Notwithstanding the substantial quantum of effort expended in servicing the policies by employees of the corporations, the court determined the commission income in question was includable in the gross income of the shareholder. With respect to the amount of income so includable, the court determined that only 25% of the income derived by the corporations from the insurance enterprise (after deducting expenses properly related thereto) should be allocated to the shareholder. The dissenting judge felt that the corporations had in fact carried on the insurance activities, and that they, not the controlling shareholder, should be taxed on the income in question.

70. 64 T.C. 1066 (1975).

71. The statute authorizing court reporters requires that the appointee be an individual, and that only that person may supply the certifications necessary to make trial transcripts official.

been operated prior to incorporation.⁷² The corporation paid no salary to its shareholder-employee, however, it paid him bonuses in two years and lent him a substantial sum in the third. There was no employment contract between the shareholder-employee and his corporation.

The Commissioner attacked this arrangement, seeking to have a portion of the net income of the corporation reported as gross income by its sole shareholder. The Commissioner based his contention on Section 61, arguing both the sham doctrine and the assignment of income doctrine. In the alternative, he argued that an allocation was required under Section 482.

The Tax Court determined that although the corporation was organized solely for tax purposes, it did engage in substantial business functions and thus was not a sham. The court also determined that, because the statute required the shareholder personally to prepare and sell transcripts and that without his certification they were not official, the shareholder was the "true earner" of the income. The court noted that the lack of an employment contract gave the shareholder freedom to funnel income either through the corporation or elsewhere at his whim. Since the individual shareholder was the court reporter, only he could earn the income from those services. Thus, the courts sustained the Commissioner's determination under Section 61(a).⁷³

In *Foglesong v. Commissioner*,⁷⁴ (hereinafter referred to as *Foglesong I*) the taxpayer was an independent manufacturer's representative selling steel tubing. After operating as a sole proprietor for a number of years, he formed a corporation in which he held 98 out of 100 shares. After forming the corporation, the shareholder-employer contacted the two steel fabricating companies for whom he was a representative and asked them to change his sales agreement to reflect the existence of the corporation. The tubing companies agreed to this change orally, and at a later date, both entered into contracts with the corporation. It was clear that the tubing companies wanted the benefit of Foglesong's salesmanship and *not* the contractual obligations of the newly-formed corporation. During two of the four years in question, the shareholder was the sole employee of the corporation, and in the other two years, the corporation employed a secretary. However, at all times, 98% of

72. There was no expansion by turning to new areas of endeavor, and the corporation confined itself to providing the support services required by the sole shareholder's duties. The shareholder-employee did not execute any written assignment of any of his rights as the court reporter to the corporation nor did the corporation assume the responsibility for performing any of his functions as a court reporter. The 1000 shares of outstanding common stock were held by the taxpayer and his spouse as joint tenants.

73. The court also sustained the Commissioner's allocation to the sole shareholder, on the basis of Section 482, of all the income received by the corporation. See note 114, *infra*.

74. 35 T.C.M. (CCH) 1309 (1976), *rem'd*, 621 F.2d 865 (7th Cir. 1980) (*Foglesong I*).

the income received by the corporation was allocated to the sales activity of its shareholder-employee.⁷⁵ The corporation followed the usual corporate formalities and paid all the expenses incurred in connection with the sales activities, carried insurance coverage and maintained a company automobile. The duties and responsibilities of the shareholder-employee with respect to sales of steel tubing were identical both prior to and after creation of the corporation. The corporation and shareholder did not enter into any contract of employment, nor was there a covenant not to compete with the corporation. During one of the years in question, the corporation paid no salary to its shareholder-employee for the last four months of the year apparently in an effort to stabilize his taxable income for that year. Additionally, the corporation never paid dividends on its common stock, although it paid dividends totalling \$38,000 on the preferred stock held by the children of the shareholder-employee.⁷⁶

The Commissioner contended that there had been an assignment of income from the shareholder-employee to the corporation so that the income ought to be taxable to the shareholder-employee under Section 61. In the alternative, the Commissioner sought to allocate the income to the shareholder-employee pursuant to Section 482. There was no contention that the corporation was a "sham."

After stating the basic prerequisites of the assignment of income doctrine, the Tax Court turned to an extensive discussion of the shareholder-employee's motive in forming the corporation,⁷⁷ concluding that tax avoidance considerations far outweighed any genuine business concerns the taxpayer may have had in forming the corporation. The significance of this discussion of tax avoidance is its complete lack of relevance as there was no sham issue involved in *Foglesong I*. The question under the assignment of income doctrine is not "why the taxpayer chose to assign the income," but rather, "whether he did so."

Turning to the assignment of income issue, the court determined that control of the income had remained with the shareholder-employee, so that the income was taxable to him. The court noted that virtually all of the corporation's income was generated by the sales activities of its shareholder-employee and went on to conclude:

75. The corporation's sole source of income was sales commissions, however, the court allocated 2% of the income to the exclusive territorial rights held by the corporation.

76. The preferred stock for which the taxpayer had paid only \$400 was given to him by his minor children shortly after the formation of the corporation.

77. The taxpayer testified that he wanted to incorporate his business in order to obtain limited liability protection afforded by a corporation, and also to prove a better vehicle for his planned expansion into several new business ventures. There was no business expansion conducted during the years in question, and apparently no efforts were expended in this direction. The Tax Court did not believe the testimony with regard to the purpose for incorporation.

There was never a written employment contract or a covenant not to compete between petitioner and Foglesong Co., and, thus, he had complete control over the corporation's financial fate and could have set up a separate business and ceased working for Foglesong Co. altogether without any recourse or repercussions from his corporation.⁷⁸

THE COURT OF APPEALS CASES

The *Laughton* case⁷⁹ is frequently cited for the proposition that "loan-out" arrangements will result in taxable income only to the corporation because there is no assignment of income involved.⁸⁰ In fact, the Court of Appeals did not affirm on that point! The opinion only supported the Board's determination that the corporation *qua* corporation was not a sham. The case was remanded for a finding on the assignment of income issue. The Board had seen "no occasion to apply the doctrine,"⁸¹ but the Court of Appeals saw the issue differently. The Court of Appeals questioned whether the corporation was being used to effect "a transfer of assets (here Laughton's services), with a retention of their control, solely to reduce tax liability."⁸² The issue was stated as whether the shareholder-employee's employment by the corporation at a salary substantially less than the corporation received for the "loan-out" of his services constituted, in effect, a single transaction by the shareholder-employee in which he received indirectly the larger sum paid by the third parties to the corporation?⁸³ Since the Board had not considered this issue, the case was remanded for further findings. There is no further report of the case—it was apparently settled by stipulation after the remand.⁸⁴

Thirty years passed before another Court of Appeals examined the application of the assignment of income doctrine to the situation of the "one-man" personal service corporation. In *Rubin II*,⁸⁵ a panel of the

78. 35 T.C.M. at 1314. This is the same conclusion reached in *Rubin I*. In view of its finding on the assignment of income issue, the Tax Court did not make any allocation based on Section 482.

79. 113 F.2d 103 (9th Cir. 1940).

80. See e.g., *Rubin v. Commissioner*, 51 T.C. 257, 266-67; *American Savings Bank v. Commissioner*, 56 T.C. 828, 841 (which treated both *Fox* and *Laughton* as supporting this statement); *Battle*, *supra* note 7, at 804; *Burdett*, *supra* note 7, at 331-32.

81. 40 B.T.A. 101, 107 (1939).

82. 113 F.2d at 104. This statement is very close to an exposition of the income-generating property branch of the assignment of income doctrine. See note 111 *infra*. However, the court's statement of the issue on remand frames an inquiry consistent with the personal service income branch of the doctrine.

83. *Id.* See *Roubik v. Commissioner*, 53 T.C. 365, 1378 (1969); *Rubin v. Commissioner*, 51 T.C. 257, 264 (1968) (*Rubin I*); *Kauder*, *supra* note 7, at 1125.

84. *Bittker, Professional Associations and Federal Income Tax*, 17 TAX. L. REV. 1 (1962).

85. 429 F.2d 650 (2d Cir. 1970).

Second Circuit, in an opinion by Judge Friendly, held that “. . . ‘common law’ doctrines of taxation [e.g., the assignment of income doctrine] and the broad sweep of Section 61 . . . have no place where, as here, there is a statutory provision [Section 482] adequate to deal with the problem presented.”⁸⁶ The court characterized the assignment of income doctrine as a “blunt tool” which did not require analysis of the facts in terms of the competing policies of the graduated income tax on one hand and the separate tax existence of corporations on the other hand. The court, referring to the tension between these policies in the context of the personal service corporation, deemed the “practical effect” of application of the assignment of income doctrine to be disregard of the existence of the corporation,⁸⁷ that is, treatment of the corporation as a “sham.” That position, of course, completely ignores the valid theoretical distinctions between the “sham” doctrine and the assignment of income doctrine. The “practical effect” analysis proves too much for, under it, no income splitting between these two taxable persons (corporation and shareholder-employee) will ever result in a prohibited assignment of income. In this regard, the court was further disturbed by what it deemed the inflexible all-or-nothing result under the assignment of income doctrine. The Tax Court, however, does allocate income in accordance with the actual earning thereof.⁸⁸

The Court of Appeals disagreed with the Tax Court’s grounds for distinguishing *Fox* on the basis of (1) the exclusive employment contract there present and (2) the control over both the “lending” and the “borrowing” corporations present in *Rubin I*. The court felt that, even though the first distinction was factually incorrect,⁸⁹ neither distinction was relevant to the assignment of income doctrine. The court’s opinion is weakened by its virtual ignorance of the Ninth Circuit’s decision in *Laughton*⁹⁰ and by its total lack of rationale for the preemption of the assignment of income doctrine by Section 482. The court failed to recognize the acceptance of the assignment of income approach by the *Laughton* court, and thus it did not attempt to render its opinion consistent with that earlier decision.

In *Foglesong v. Commissioner*⁹¹ (hereinafter referred to as *Foglesong*

86. *Id.* at 653.

87. *Id.* at 652 n.3.

88. *Shaw v. Commissioner*, 59 T.C. 375, 386-87, (1972); *Foglesong v. Commissioner*, 35 T.C.M. (CCH) 1309 (1976) (*Foglesong I*); Blend, *Problems Arising From Imputation of Income*, N.Y.U. 35TH INST. ON FED. TAX. 637, (1977).

89. Review of the facts found by the Tax Court in *Rubin I* indicates that the distinction is correct as there was no such contract in *Rubin*.

90. 113 F.2d 103 (9th Cir. 1980). The court of appeal in *Rubin II* cites the *Laughton* opinion only for the point that there may be complete disregard of the corporation where it is a “sham.”

91. 621 F.2d 865 (7th Cir. 1980) (*Foglesong II*).

II) a split panel of the Seventh Circuit followed the Second Circuit's lead in holding that it was "inappropriate" to apply the assignment of income doctrine where Section 482 was applicable. In so holding, the court stated ". . . there is no need to crack walnuts with a sledgehammer."⁹² Once again, the taxpayer succeeded in having the issue determined in the guise of the sham doctrine. The court noted "to apply *Lucas v. Earl* [to question the validity of a transaction purportedly entered into by the corporation] under the circumstances present here is effectively (and more realistically) to nullify the determination that the corporation is a viable, taxable entity . . ."⁹³ Whenever the issue is framed in terms of the sham doctrine, the policy of the law favoring recognition of a corporation as a separate taxable person appears to control over all other policies. However, to decide the corporation is a separate taxable person is to open (not foreclose) the issue of assignment of income.⁹⁴ The Ninth Circuit recognized this distinction in *Laughton*.⁹⁵ The *Foglesong II* opinion⁹⁶ cites to this portion of the *Laughton* opinion apparently without comprehension of the meaning of the Ninth Circuit's action. In this regard, the insidious effect of the Tax Court's irrelevant digression into the tax avoidance motives of the shareholder-employee is clear because the Seventh Circuit apparently felt that the assignment of income issue was to be determined on the basis of a weighing of "business purposes" against "tax purposes." The court notes three times the inappropriateness of such an exercise.⁹⁷ The assignment of income doctrine, properly applied, disregards motive and looks only to effects. The Tax Court, in fact, found the forbidden effect.

The Court of Appeals considered the shareholder-employee's lack of outside employment during the period in question to be the equivalent of an exclusive employment contract. Thus, it distinguished such Tax Court cases as *Rubin I*⁹⁸ and *American Savings Bank*.⁹⁹ In so doing, the court characterized the Tax Court's requirement of an employment contract to avoid assignment of income treatment as an "elevation of form over substance."¹⁰⁰ The court felt that it was not possible to es-

92. *Id.* at 872.

93. *Id.* at 869.

94. *Jones v. Commissioner*, 64 T.C. 1066, 1076 (1975).

95. 113 F.2d 103 (9th Cir. 1940).

96. 621 F.2d at 870, n.12.

97. *Id.* at 869, 872-73.

98. 51 T.C. 251 (1968) (*Rubin I*).

99. 56 T.C. 828 (1971). The dissenting judge on the Seventh Circuit panel characterized the *Foglesong* case succinctly: "[t]his corporation is nothing more than a few incorporating papers lying in a desk drawer of no significance except when a tax return is due." *Foglesong v. Commissioner*, 621 F.2d 865, 873 (7th Cir. 1980) (*Foglesong II*).

100. 621 F.2d at 872.

establish an enforceable legal obligation between a sole shareholder-employee and his personal service corporation which would require him to work exclusively for that corporation. The "deal" made with himself could be undone at will.

The Court of Appeals also distinguished prior Tax Court cases on the issue of control by the shareholder-employee over both the loan-out corporation and the borrowers of his services.¹⁰¹ It was correct to do so. Control over ultimate recipient of the services is not relevant under any approach used. For example, under the assignment of income doctrine, the relevant control is over the *earning* of the income, and the parties compared are the shareholder-employee and the corporation which "lends" his services and receives compensation therefore. The borrowing corporation which actually receives the services and pays the loan-out corporation for them is, simply, outside of the analysis.

THE RATIONALE FOR THE ASSIGNMENT OF INCOME DOCTRINE

The assignment of income doctrine is the "cornerstone of our graduated income tax system."¹⁰² This is because, for example, one taxpayer with taxable income of \$50,000 pays over 50% more total tax than two taxpayers who each have \$25,000 of taxable income.¹⁰³ A "black-letter" statement of the doctrine is simple: the party whose efforts or assets generate the income in question is taxable on it regardless of its actual receipt by another in accordance with a contract or otherwise, i.e., income is taxed to him who earns it.¹⁰⁴ The problem lies in determining *who* is providing the assets or efforts. In the case of a closely-held personal service corporation, the issue is complicated by the fact that the corporation can act only through agents and those agents are also its controlling shareholders. The identity is absolute in the sole shareholder situation. In *American Savings Bank*, the court stated:

The more difficult question, often shrouded in confusion, is the determination of who, in fact, is the real earner of the income. This determination is made no easier by tax laws that permit the conceptually difficult arrangement where an individual performs services thereby earning the income that is received, and the next day performs the same services and the compensation, when paid to a corpo-

101. *Id.* at 870.

102. *United States v. Bayse*, 410 U.S. 441, 450 (1973).

103. Compare the various rates contained in the Tax Rate Schedules of I.R.C. §§1, 11. In addition to the lower total tax because of rate-splitting between individuals at many income levels, the corporate rate is lower than the individual rate, so diversion of income to a corporation results in an even lower tax bill.

104. *McIver v. Commissioner*, 36 T.C.M. (CCH) 719, 722 (1977).

ration wholly owned by that individual, is said to have been earned by the corporation. The patent artificiality of such a situation leads this Court to carefully scrutinize any such arrangement to assure that an individual is not merely siphoning off income to another entity at the expense of the public fisc.¹⁰⁵

In determining who is the "true earner," the Tax Court looks beyond who has apparent control over the proceeds to see who has control over the earning of the income. To do so, the court seeks to identify who had control of the source of the income, more precisely, who was in control of the enterprise or the capacity to produce income.¹⁰⁶ The form of the Tax Court's assignment of income doctrine is greatly influenced by the conclusions of Lyon and Eustice. In an article, those scholars state:

The distinction in these [personal service assignment of income] cases is grounded on the question of who has the ultimate direction and control over the earning of this compensation. If such control lies with the taxpayer who actually performs the services, then he remains taxable on the earnings from his personal services, whether or not he chooses to divert the receipt of that compensation to a third party. However, if the direction and control of the performer's activities resides in a superior authority, and the consideration paid for the performance of those services is made to the person having such ultimate direction and control, then the mere fact that the taxpayer has performed the services does not render him taxable on the amount paid for these services.¹⁰⁷

Exploration of the Tax Court cases reveals that control over the earning of the income is reduced, in practice, to the question of whether there is a written exclusive employment contract and perhaps, a covenant not to compete.¹⁰⁸ The analysis of cases contained in *Table I* illustrates this conclusion with respect to the cases which find assignment of income to be present. Without an employment contract, the shareholder-employee is free to provide his services to third parties either directly or through the corporation, thus retaining the ability to choose the alternative which minimizes his total tax burden. Since the one-man personal service corporation has no independent earning capacity (such as other employees or assets), the shareholder-employee is in a position to control its income flow.¹⁰⁹ However, as the Court of Ap-

105. *American Savings Bank v. Commissioner*, 56 T.C. 828, 839 (1971).

106. *Ronan State Bank v. Commissioner*, 62 T.C. 27 (1974).

107. Lyon & Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case*, 17 TAX L. REV. 293, 393 (1962) (author's footnotes omitted).

108. *Foglesong v. Commissioner*, 35 T.C.M. (CCH) 1309, 1314 (1976) (Foglesong I); *Jones v. Commissioner*, 64 T.C. 1066, 1074 (1975); *Battle*, *supra* note 7, at 805; *Rubin v. Commissioner*, 51 T.C. 251, 267 (1968) (Rubin I).

109. *Foglesong v. Commissioner*, 35 T.C.M. (CCH) 1309 (1976) (Foglesong I). In *Realty Set-*

peals pointed out in *Foglesong II*, an employment contract between a shareholder-employee and his controlled corporation is unlikely to reflect a real, enforceable bargain.¹¹⁰ Thus, the assignment of income question, in practice, turns on a trivial, formalistic requirement.¹¹¹ The Tax Courts' search for form over substance has resulted in nothing more than a trap for the unwary. Many commentators thus regard slavish adherence to form as the ultimate defense to the assignment of income doctrine attack on the personal service corporation.¹¹²

With this analysis of the dichotomy between the Tax Court's verbal rubric and its actual practice, the frustration with the assignment of income doctrine so clearly present in the Courts of Appeal opinions in *Rubin II* and *Foglesong II* becomes more understandable.¹¹³ The assignment of income doctrine is a valuable and important tool for the Commissioner and the courts in safeguarding the integrity of the progressive tax rate structure. However, the incongruity between theory and application, in this instance, is simply too great to ignore. The failure of the Tax Court to develop a factual rationale based on substantial economic effects for the application of the assignment of income doctrine makes rational prediction of its application impossible. The courts are reduced to deciding important financial questions on the basis of trivial formalities. Therefore, the appellate courts have abandoned the assignment of income doctrine as "inappropriate" in the personal service corporation cases and sought refuge from the "sledgehammer" by requiring the application of Section 482.

tlement Corp. v. Commissioner, 40 T.C.M. (CCH) 569, 573 (1980), the court stated that a "taxpayer may not avoid his tax liability by the simple expedient of drawing up legal papers assigning income which he has earned to another." See Burdett, *supra* note 7, at 334; Katz, *Can Section 482 Be Used to Negate the Tax Effect of a Bona Fide Corporation?*, 28 J. TAX 2, 3 (1968).

110. *Foglesong v. Commissioner*, 621 F.2d 865, 872 (7th Cir. 1980) (*Foglesong II*).

111. Even if the assignment of income issue is viewed through the medium of the income-producing property line of cases, with the employment contract seen as the property owned by the corporation, the determination would still turn on a formality (as there can be no arm's length bargaining) and not on any substantial economic effect. See generally *Helvering v. Horst*, 311 U.S. 112 (1940); Lyon & Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case*, 17 TAX. L. REV. 293, 327-45 (1962). In the context of the "family partnership," an income-producing property approach has proven effective to combat assignments of income among partners where the partners own "a capital interest" in a partnership "in which capital is a material income-producing factor." I.R.C. §704(e). See Blount, *Family Partnerships: Who Must Recognize the Taxable Income*, 44 MO. L. REV. 217 (1979). In the personal service corporation, however, capital is not a material factor in the production of income.

112. See Battle, *supra* note 7, at 805; Blend, *Problems Arising From Imputation of Income*, N.Y.U. 35TH INST. ON FED. TAX, 637, 650 (1980); Burdett, *supra* note 7, at 336; 19 KAN. L. REV. 348 (1971).

113. The Courts of Appeal have been hindered in their review by the almost universal presence of the sham theory in these cases. In some instances, that issue has been interjected by the taxpayer's counsel where the Commissioner has not argued it. Except in the most egregious cases, the presence of the sham theory serves merely to obscure the assignment of the income issue. The temptation is strong once a valid, separate taxable person has been found to resist all efforts to examine the operations of that entity. The same obscuring effect results from gratuitous tirades concerning tax avoidance motives such as that present in *Foglesong I* at 313.

THE SECTION 482 APPROACH

Section 482¹¹⁴ broadly authorizes the Commissioner to allocate income among commonly controlled organizations, trades or businesses whenever necessary to clearly reflect the income of any of the entities. It has been described as an amalgam of several important themes and policies of the tax law: "tax avoidance principles, assignment of income notions, . . . and clear reflection of income under the parties' accounting methods."¹¹⁵ Use of Section 482 provides the Commissioner with formidable tactical advantages. In addition to the usual presumption of correctness accompanying the Commissioner's determination,¹¹⁶ the Commissioner's exercise of administrative discretion will be sustained unless arbitrary, capricious or unreasonable.¹¹⁷ In the personal service corporation area, the application of Section 482 raises significant issues in two areas: whether there are two or more organizations, trades or businesses and what criteria should be applied to determine the proper allocation of income between the two organizations.

With respect to the separate trade or business requirement, the analysis of the courts concerning what circumstances distinguish the taxpayer's trade or business from his mere shareholder status, has been described as "fuzzy [and] conclusionary"¹¹⁸ [*sic*], "imaginative"¹¹⁹ and the product of "some rather circuitous reasoning."¹²⁰ This question, relating to a prerequisite for the application of Section 482, is discussed in this article only because of the courts' use of the assignment of income doctrine "to the limited extent of supporting the existence of a trade or business on the part of the shareholder who purportedly acts as a corporate employee in conducting his business affairs."¹²¹

114. I.R.C. §482 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 such organizations, trades, or businesses.

The legislative history of Section 482 is set forth in *B. Forman Co., Inc. v. Commissioner*, 453 F.2d 1144, 1150-151 (2d Cir. 1972) (*rev'g* 54 T.C. 912 (1970)).

115. Eustice, *supra* note 9, at 483.

116. U.S. TAX CT. R. PRAC. & P. 142 (1979).

117. Eustice, *supra* note 9, at 494.

118. Burdett, *supra* note 7, at 333.

119. Battle, *supra* note 7, at 805-06.

120. Egerton, *Reallocation of Income: A New Threat to Professional Service Corporations?*, 58 A.B.A. J. 979, 981 (1972).

121. *Rubin v. Commissioner*, 56 T.C. 1155 (1971) (*Rubin III*). *Accord* *Borge v. Commissioner*, 405 F.2d 673 (2d Cir. 1968) (*aff'g* 26 T.C.M. 816 (1967)).

In *Arch v. Commissioner*, the factors which the court cited to support its finding of a separate business were the familiar ones:

the corporation did not receive the taxpayer's right to services; there was no contract of employment between them; and she in fact rendered her services to the corporation voluntarily without compensation. Nor did the corporation receive a covenant not to compete from [her]. For aught that appears, in the absence of a covenant not to compete, she could readily have established a competing business that might well have rendered [the corporation] worthless¹²²

This approach was adopted by the Tax Court in *Rubin III* where the court noted that "the effect of the transactions is to channel income generated¹²³ by petitioner through his performance of management services for Dorman Mills to a controlled corporation."¹²⁴ Thus it held that:

where the particular facts of a case are such as to justify a finding that a shareholder operated an independent business and merely assigned to the corporation a portion of the income therefrom, the business activity of the taxpayer may constitute a trade or business to which allocation of all or part of the income attributable to his efforts is authorized under section 482.¹²⁵

The parallel to the assignment of income doctrine used, but disapproved, in *Rubin I* is striking. In its affirming opinion,¹²⁶ the Second Circuit stated: "[i]t was the shareholder-employee's special ability that Dorman Mills wanted, and it wanted nothing else from [the corporation] This is enough to constitute his rendition of services . . . a trade or business."¹²⁷ A consideration of the assignment of income doctrine, thus, is essential in determining the applicability of Section 482.

The assignment of income doctrine, the cases reveal, is the basis for the allocation of income authorized by Section 482. The Regulations mandate that the allocation shall place the controlled entity on a tax parity with uncontrolled entities by determining the "true taxable in-

122. *Ach v. Commissioner*, 42 T.C. 114, 124-125 (1964), *aff'd*, 358 F.2d 342 (6th Cir. 1966).

123. When the Court uses the term "generated," it is apparent that the meaning is the same as "earned" (the term generally used in the assignment of income cases).

124. *Rubin v. Commissioner*, 56 T.C. 1155, 1159 (1971) (*Rubin III*).

125. *Id.* at 1161.

126. 460 F.2d 1216 (2d Cir. 1972) (*aff'g per curiam* 56 T.C. 1155 (1971) (*Rubin IV*)).

127. *Id.* at 1218. Burdett, *supra* note 7, at 334, analyzes this statement in the following passage: "Perhaps Judge Friendly was saying that *Rubin*, like *Arch*, did not transfer all of the business assets, i.e., 100% of his personal services through an exclusive employment agreement to his PSC [See *Cooper v. Commissioner*, 64 T.C. 576 (1975)], and, therefore, was in a position to deal directly with the borrower who wanted his 'special ability.' In that context, Judge Friendly may have been saying that the borrower wanted *Rubin's* 'special ability,' and it was *Rubin's*, not the PSC's, right to provide it. If so, the opinion is understandable. A nonexclusive agreement would permit the individual to control the production of the income from his services so that he could direct income both to the PSC and to himself." *Id.* (annotation added).

come"¹²⁸ from the property and business of the controlled taxpayer (i.e., the personal service corporation). The standard is that of an uncontrolled taxable person dealing at arm's length with another uncontrolled taxable person.¹²⁹ Uncontrolled taxpayers do not include in their gross income amounts which have been "earned" by another taxpayer. The "true taxable income" test is inconsistent with the artificial channeling of income from one taxable person to another. As Eustice states:

[t]he reallocation rules of section 482 seem to be strongly infused with assignment of income notions: while not identical in scope or outlook, these two approaches nevertheless often involve parallel considerations. Thus, a major issue in many section 482 cases is whether a particular taxpayer has in substance earned the income in question. This in turn often depends on whether such taxpayer is a viable business entity; . . .¹³⁰

In *Jordan v. Commissioner*,¹³¹ the Tax Court upheld the Commissioner's allocation of all income received by the corporation to its shareholder-employee. The income arose from a contract to provide management services to an insurance company. The shareholder-employee was the corporation's only employee, and he provided all the services. There was no employment contract between the shareholder-employee and his controlled corporation. Thus, the court found the effect of the transaction to be a mere channeling of "income earned by petitioner to a corporation under his control."¹³² The corporation never had control over the activities of the shareholder in the performance of the services generating the income received by it.

The Courts of Appeal in *Rubin II* and *Foglesong II* held that Section 482 preempted the common law doctrines under Section 61. Those courts were seeking a "more precise" device¹³³ for dealing with the issue of the proper taxpayer in the personal service corporation context. The end result, however, is that while the statutory basis has changed, the courts have ended up asking *the same question*: "who earned the income?"¹³⁴ And the answer has been found by *the same analysis*: the

128. Treas. Reg. §1.482-1(a)(6) (1968).

129. Treas. Reg. §1.482-1(b)(1) (1968). *Specific rules* are provided for allocations of income in the family partnership and the Subchapter S corporation contexts to prevent assignment of income among the two or more partners or shareholders. See I.R.C. §§704(e)(1), 1375(c). These rules, however, operate only to allocate income among the partners or shareholders; not to allocate it between the entity and the individuals whose efforts have generated that income. See Comment, *Income Shifting through a Subchapter S Corporation*, 37 MD. L. REV. 809 (1978).

130. Eustice, *supra* note 9, at 460. See also 492.

131. 60 T.C. 872 (1973).

132. *Id.* at 883.

133. *Foglesong v. Commissioner*, 621 F.2d 865, 872 (*Foglesong II*).

134. See Burdett, *supra* note 7, at 335.

assignment of income doctrine. The courts, therefore, have not escaped the formalism to which the assignment of income doctrine leads in the personal service corporation cases.

CONCLUSION

The Internal Revenue Service challenges to the use of the personal service corporation have continued for over forty years under many approaches.¹³⁵ The Service is appropriately concerned with what may be viewed as discretionary rate-splitting and conversion of ordinary income to capital gains.¹³⁶ If the taxpayer can freely direct the flow of income either to himself or through a second taxable person so as to reduce his total tax burden, the Congressional policy supporting a graduated income tax is severely undercut.

The courts have responded to these challenges by applying legal concepts which seem to fall into a hierarchy of analytical sophistication—sham doctrine, assignment of income doctrine, Section 482. Review of the cases, however, reveals that the analytical sophistication is illusory. The sham doctrine has such a low threshold for compliance that it is useful only in the most outrageous situations. Application of the assignment of income doctrine is dependent on the presence or absence

135. In addition to the sham and assignment of income doctrines and the allocation power provided by Section 482, the professional service corporation may be subject to challenge on other grounds. See generally Eaton, *Professional Corporations and Associations in Prospective*, 23 TAX L. REV. 1, 24-25 (1967).

1. Whether the required employment relationship exists between the corporation and the service provider for purposes of deferred compensation arrangements. See Burdett, *supra* note 7, at 335.
2. Whether the corporation will be subject to the personal holding company penalty tax of I.R.C. §541. See text accompanying note 143, *infra*. Lee, *Personal Holding Company Status: Hidden Dangers for Service Corporations and Corporations in Transition*, N.Y.U. 38TH INST. ON FED. TAX. 8-1 (1980). In *Rubin I*, the Tax Court held that the existence of Section 543(a)(7) did not preclude attack on other grounds such as the assignment of income doctrine or Section 482. *Rubin v. Commissioner*, 51 T.C. 251, 268 (1968) (*Rubin I*) (the later Court of Appeal decision supports this holding as to Section 482). *Accord* Borge v. Commissioner, 405 F.2d 673, 666-667 (2d Cir. 1968).
3. Whether deductions or credits taken by the corporation may be disallowed pursuant to I.R.C. §269(a). This section was applied in tandem with Section 482 in *Borge v. Commissioner*, 405 F.2d 673 (2d Cir. 1968) and *Arch v. Commissioner*, 42 T.C. 114 (1964). See generally Watts, *Acquisitions Made to Avoid Taxes*, 34 TAX L. REV. 539 (1979).
4. Whether the corporation is formed or availed of to accumulate excess earnings at lower corporate tax rates so as to be subject to the penalty tax of I.R.C. §531. See generally Cunningham, *More Than You Ever Wanted to Know About the Accumulated Earnings Tax*, 6 J. CORP. TAX 187 (1979).

136. Earnings may be left in the corporation at a tax rate as low as 16%, I.R.C. §11(b)(1), up to a total accumulation of \$250,000 with no business justification at all, I.R.C. §535(c)(2). Since the maximum tax rate on individuals is 50%, I.R.C. §1(c)(1), 33% of the corporation's taxable income can be sheltered from immediate taxation (subject to the penalty tax of Section 531) and converted, by subsequent corporate liquidation or sale of stock, into capital gains income taxable to the shareholder at an effective rate of 20%. See I.R.C. §1202. The minimum accumulation for personal service corporations in such fields as health, law and performing arts is limited to \$150,000. This reflects the tax law changes effective for taxable years beginning in 1982.

of an employment contract. That document, in this context, is a mere formality. The application of Section 482 in the personal service corporation context also reduces to reliance on that same formality because the key concept of "true taxable income" is dependent on the application of assignment of income principles.

The Commissioner's attempt to deal with *professional* personal service corporations by denying them status as corporations under section 7701(a)(3) was defeated in 1969.¹³⁷ A series of Court of Appeals decisions established that incorporation under state corporation statutes was sufficient to comply with the Internal Revenue Code definition of "corporation."¹³⁸

So long as there is recognition of the corporate status of the personal service corporation, especially in the one-man situation, any attempt to control the taxpayer's allocation of income between the corporation and its shareholder-employee is foredoomed to rest ultimately on mere formalities. Such a corporation does not possess the *economic* attributes of a corporation—packaging of efforts, pooling of investment and sharing of risk.¹³⁹ Thus, there cannot be a substantial economic basis for determining the income *earned* by the corporation. There being no economic substance, form must triumph.

The conclusion which must be reached is that the problem of free-choice rate-splitting presented by the personal service corporation cannot be effectively resolved either by treasury regulations or by judicial doctrines. As the Court of Appeals noted in *Foglesong II*:

137. In 1965, the Commissioner issued an amendment to Treasury Regulation Section 301.7701-2(h) designed to prevent achievement of corporate status for federal tax purposes by *professional* personal service corporations by characterizing such organizations as outside the statutory definition which provides: CORPORATION. The term "corporation" includes associations, joint-stock companies and insurance companies. I.R.C. §7701(a)(3). After an unbroken series of losses, the Commissioner conceded the issue of status as a "corporation" in T.I.R. 1019, [1969] 7 STAND. FED. TAX REP. (CCH) §6867 (Aug. 8, 1969), and the 1965 Amendments to the Regulations were withdrawn in 1977 by T.D. 7515, 1977-2 C.B. 482.

138. While none of the cases dealt with a one-man personal service corporation, sound dicta in those cases appears to foreclose the Commissioner's use of a status argument in this situation as well. See *United States v. Empey*, 406 F.2d 157 (10th Cir. 1969), *O'Neill v. United States*, 410 F.2d 888 (6th Cir. 1966); *Kurzner v. United States*, 413 F.2d 97 (5th Cir. 1969). After noting that Section 7701(a) does not specifically provide a category for an *incorporated* business organization and that the legislative history provides no in-depth examination of the term "corporation," the cases state in various ways the conclusion set forth in *O'Neill*: "It appears clear that the corporate entity created by state law is the *corporation* taxed under the Internal Revenue Code" [emphasis added]. 410 F.2d at 896.

Thus possession of a Certificate of Incorporation issued by state authorities, see note 34 and accompanying text *supra*, sufficient to meet the definition of "corporation" provided in Section 7701(a)(3). See generally *Eaton*, *supra*, note 135, at 30; Scallen, *Federal Income Taxation of Professional Associations and Corporations*, 49 MINN. L. REV. 603, 622-623 (1965). The state law "label" of corporations may have imported incidents of real economic significance, when the predecessor of Section 7701(a)(3) was adopted in the Revenue Act of 1918, ch. 18, §1, 40 Stat. 1057, but modern state corporation laws no longer perform that function.

139. See generally R. POSNER, *ECONOMIC ANALYSIS OF LAW*, (2d ed. 1977).

We think that our approach in this case of recognizing some vitality in personal service corporations accords with congressional intent. 'A history of legislation targeted at personal service corporations from corporate taxation and the personal holding company tax provisions indicate that to some extent Congress has sanctioned the incorporation of service businesses for tax purposes.'¹⁴⁰

The solution, then, lies in new legislation designed to curb the abuse of corporate *tax* status by organizations, such as the one-man personal service corporation, which do not perform the economic functions which justify the special treatment accorded to corporations under the Internal Revenue Code.

The existing personal holding company provisions¹⁴¹ are designed, in part, to prevent tax avoidance by the one-man personal service corporation. One commentator describes the problem the Congress sought to cure as follows:

(2) 'Incorporated Talent.' A highly paid person providing personal service skills (e.g., an actor) would organize a corporation and contract to work for it at a relatively small salary. The corporation would then contract out its employee's services at the market value. The difference between the amount received by the corporation for the services of its 'employee' and the salary paid to him would be taxed at the relatively lower corporate rates.¹⁴²

That is essentially the *same* problem with which the courts and the Service have been struggling in the cases reviewed in this article. The continued need for new approaches is the result of the overly-restrictive definition of personal services. Such income includes *only* amounts received under a contract by which the corporation is to furnish personal services if some person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services as designated (by name or by description) in the contract.¹⁴³ Thus, physicians,¹⁴⁴ certified public accountants¹⁴⁵ and consultants¹⁴⁶

140. *Foglesong v. Commissioner*, 621 F.2d 865, 873 (7th Cir. 1980), *citing* *Battle, The Use of Corporations by Persons Who Perform Services to Gain Tax Advantage*, 57 TAXES 797, 802 (1979). The Revenue Act of 1918, ch. 18, §200, 40 Stat. 1059 (1919), contained a special classification for personal service corporations:

The term 'personal service corporation' means a corporation whose income is to be ascribed primarily to the activities of the principal owner or stockholders in the active conduct of the affairs of the corporation and in which capital (whether invested or borrowed) is not a material income-producing factor

Id. Such organizations were treated as partnerships by the Act, *Id.*, ch. 18, §218(e), 40 Stat. 1070 (1919). This special definition was repealed in the Revenue Act of 1921, ch. 136, §218(d), 42 Stat. 245 (1921). The only remaining reference to it is in I.R.C. §1016(a)(4).

141. I.R.C. §§541-547.

142. D. KAHN, *BASIC CORPORATE TAXATION* 199 (3d ed. 1981). *See generally* BITKER AND EUSTICE, *supra* note 18, §8.20.

143. I.R.C. §543(a)(7).

144. Rev. Rule 75-67, 1975-1 C.B. 169.

have been able to avoid receipt of personal holding company income while operating one-man corporations.¹⁴⁷ The overly-restrictive nature of these provisions appears to be an unfortunate result of congressional attention on specific instances of abuse.¹⁴⁸ Section 543(a)(7) could be amended to read (deletions indicated by strike-throughs):

(7) PERSONAL SERVICE CONTRACTS.—

(A) Amounts received under a contract under which the corporation is to furnish personal services; ~~if some person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or if the individual who is to perform the service is designated (by name or by description) in the contract;~~ and

(B) Amounts received from the sale or other disposition of such a contract.

This paragraph shall apply with respect to amounts received for services under a particular contract only if at some time during the taxable year 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for the individual who has performed, -[or] is to perform, ~~or may be designated (by name or by description) as the one to perform,~~ such services.

The extension of the personal holding company provisions would resolve the problem caused by the lack of economic criteria for allocating income in the cases discussed in this article in a straight forward manner without resort to form over substance. It would give legislative direction for the proper treatment of these personal service corporations.

145. Rev. Rule 75-250, 1975-1 C.B. 172.

146. Private Ruling 7733052 (May 19, 1977) reprinted in Lee, *supra* note 135, at 8-12.

147. Where one person performs the crucial income-generating services for the corporation, specific designation is never needed by the parties. In Rev. Rule 77-336, 1977-2 C.B. 202, the taxpayer avoided personal holding company income but the Service ruled he was taxable on the corporation's net income on assignment of income grounds citing *Shaw v. Commissioner* 59 T.C. 375 (1972). *Accord*, *Foglesong v. Commissioner*, 35 T.C.M. (CCH) 1309 (1976) (*Foglesong I*).

148. BITTKER & EUSTICE, *supra* note 18, §8.20 n.104.

APPENDIX

Assignment of Income found	Earl (1930)	Fox (1938)	Laughton (1939)	Wilgus (1961)	Shaw Cont. (1961)	Kimbrell (1965)	Rubin I (1968)	Roubik (1969)	Am. Sav. B (ins.) 1971	Am. Sav. B. (Mgtk) 1971	Shaw (1972)	Ronan Stat. Bk. (1974)	Gettler (1975)	Jones (1975)	Foglesong (1976)
"Sham" status found	*				*	*	*	*				*		*	*
§ 482 applied														*	
Employment contract		*	*					1							
Covenant not to compete								1							
Contracts w/3d parties		*	*	*			*		*	*			*		*
Notice to 3d parties		*	*	*					*				*	*	*
Other significant employees									*		*		*		
Tax avoidance motive found					*									*	*
Other consistent acts		*		*			*		*		*		*		*
"Sham" theory advanced		*	*		*	*	*		*	*				*	
Legal impediments to receipt by cor- poration															
Ignored by the parties															

