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Fogelsong v. Commissioner, 691 F.2d 848 (7th Cir. 1982)

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Tax—*Foglesong* IV: THE SEVENTH CIRCUIT HOLDS THAT A PERSONAL SERVICE CORPORATION AND ITS SOLE SHAREHOLDER/EMPLOYEE DO NOT CONSTITUTE TWO SEPARATE ORGANIZATIONS, TRADES, OR BUSINESSES UNDER SECTION 482 OF THE INTERNAL REVENUE CODE. *Foglesong v. Commissioner* 691 F.2d 848 (7th Cir. 1982)

In *Foglesong v. Commissioner*[1] the Seventh Circuit Court of Appeals once again reversed the Tax Court, holding that the taxpayer and his personal service corporation did not constitute two separate organizations, trades, or businesses, as required to justify a reallocation of income under Internal Revenue Code section 482.[2]

Foglesong is the latest in a series of cases dealing with the proper allocation of income between a personal service corporation and its sole shareholder/employee. Its result constitutes a victory for taxpayers seeking to take advantage of tax benefits not available to sole proprietors.

The *Foglesong* case began in 1976 with a Tax Court Memorandum decision.[3] The taxpayer, a chemical engineer, was for fourteen years engaged in sales operations as an employee of Babcock & Wilcox Company. In 1962 the taxpayer left Babcock & Wilcox in order to enter into sales agreements with two tube supply companies: Pittsburgh Tube Company and Plymouth Tube.[4] Pursuant to this agreement, taxpayer's duties included "servicing existing customers, soliciting new business, responding to technical questions concerning steel tubing, negotiating orders for customers, and distributing the companies' promotional material."[5]

In 1966, on the advice of his accountant, the taxpayer organized Foglesong Company with an initial capitalization of $1,000 in common stock and $400 in preferred.[6] The common stock was distributed 98% to Foglesong, 1% to his wife, and 1% to his accountant.[7]

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1. 691 F.2d 848 (7th Cir. 1982).
2. I.R.C. § 482 (1982) provides:
   In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.
3. Foglesong v. Commissioner, 35 T.C.M. (CCH) 1309 (1976). [hereinafter cited as *Foglesong* I].
4. *Id.* at 1310.
5. *Id.*
6. *Id.*
7. *Id.* Neither the wife nor the accountant paid any consideration for these shares.

Foglesong's four minor children received the preferred stock.[8] The sums in payment of the stock were remitted directly by the taxpayer to Foglesong Company.[9]

Following incorporation, the taxpayer notified both Pittsburgh Tube and Plymouth Tube of the existence of Foglesong Company and requested that his sales agreement with each company be amended to reflect that Foglesong Company, rather than Foglesong himself, would render sales services to the tubing companies.[10] Both manufacturers agreed to this change, although it was not until several years later that contractual changes reflecting this agreement were actually effectuated.[11] During the interim, however, all commissions from both tubing companies were remitted directly to Foglesong Company.[12]

The Commissioner determined a deficiency.[13] At trial the taxpayer testified that he wanted to incorporate his business to obtain the limited liability protection of the corporate structure and to provide a better vehicle for his planned business expansion into new ventures.[14] It became clear, however, that the taxpayer did not in fact expand his sales business.[15] Significantly however, Foglesong Company did pay all of the taxpayer's business expenses, carry its own insurance coverage, maintain a corporate automobile, and comply with the formalities of New Jersey state corporation law.[16] Further, Foglesong Company "adopted bylaws, held an initial meeting of the board of directors at which officers were elected, and conducted periodic board of directors' and stockholders' meetings as required by its bylaws."[17] Although the taxpayer did not enter into any written employment contract or execute a non-competition agreement with Foglesong Company, he nevertheless worked exclusively for the corporation.[18]

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8. *Id.*

9. *Id.*

10. *Id.* at 1310-11. The taxpayer contacted the respective tubing companies by letter or in person during August and September of 1966.

11. *Id.* at 1311.

12. *Id.*

13. *Id.* at 1309. The Commissioner asserted deficiencies against both the Foglesongs and Foglesong Company.

14. *Id.* at 1311.

15. *Id.* "Subsequent to the formation of Foglesong Co., petitioner interviewed a prospective salesman to help him in the New England area, but these negotiations were unsuccessful." *Id.* The corporation did hire a secretary. *Id.*

16. *Id.*

17. *Id.*

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

Between the tax years ending August 31, 1967 and August 31, 1970, Foglesong Company's annual gross receipts averaged approximately $138,000.[19] Out of this, the corporation paid compensation to the taxpayer averaging approximately $59,000 per annum.[20] Taxpayer, however, received no salary for the first four months of operation.[21] Foglesong Company also opened a stock brokerage account in 1967, maintaining stock investments of between approximately $35,000 and $92,000 between 1967 and 1970.[22] During these years, the corporation paid dividends on the preferred stock to the taxpayer's children in the amount of $38,000.[23] No dividends were paid on the common stock of Foglesong Company.[24] In *Foglesong* I, the Tax Court noted that "[i]n actual practice, as president of the corporation and chairman of the board of directors, all decisions regarding the payment of dividends were made solely by the [taxpayer]."[25]

History

In *Foglesong* I the Internal Revenue Service argued that the income reported by Foglesong Company was in reality income earned by Foglesong himself.[26] The Service contended that "under the broad scope of section 61[27] and the assignment of income doc-

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19. *Foglesong* I, 35 T.C.M. (CCH) at 1311.

20. *Id.*

21. *Id.* Although Foglesong Company had funds to compensate the taxpayer, the sole motive in drawing no salary from the corporation seems to have been to hold down tax liability for that year.

22. *Id.* at 1311.

23. *Id.* at 1312. These dividends apparently were paid from the income attributable to the stock investments. *Id.* at 1311.

24. *Id.* at 1311.

25. *Id.* at 1312.

26. *Id.*

27. I.R.C. § 61(a) (1982) provides:

> Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items: (1) Compensation for services, including fees, commissions and similar items; (2) Gross income derived from business; (3) Gains derived from dealings in property; (4) Interest; (5) Rents; (6) Royalties; (7) Dividends; (8) Alimony and separate maintenance payments; (9) Annuities; (10) Income from life insurance and endowment contracts; (11) Pensions; (12) Income from discharge of indebtedness; (13) Distributive share of partnership gross income; (14) Income in respect of a decedent; and (15) Income from an interest in an estate or trust.

For a discussion of the application of section 61 asssignment of income principles prior to the *Foglesong* IV decision, see Battle, *The Use of Corporations by Persons Who Perform Services to Gain Tax Advantages*, 57 TAXES 797, 803 (1979) [hereinafter cited as Battle]; Lyon and Eustice, *Assignment of Income: Fruit of the Tree as Irrigated by the P.G. Lake*

trine of *Lucas v. Earl*,[28] such income should properly be taxed to [Foglesong personally]".[29]

The court held that the taxpayer's primary motive in forming Foglesong Company was to avoid taxes and that control over the earning of income continued to remain with the taxpayer.[30] The Tax Court concluded that "on balance, tax avoidance considerations far outweighed any genuine business concerns petitioner may have had in setting up Foglesong Co."[31] Consequently, the Tax Court applied the principles of *Lucas v. Earl* and rejected Foglesong's contention that Foglesong Company, and not he, was the true party to the tubing sales agreements.[32]

In *Foglesong v. Commissioner*, the Seventh Circuit Court of Appeals reversed the Tax Court and remanded the case for further consideration.[33] In reaching this decision, the court placed great weight on the following factors:

> (1) the Corporation and not the taxpayer is the party to the contracts under which services are performed, (2) the Corporation is recognized to be a viable, taxable entity and not a mere sham, (3) non-tax business purposes are present even though tax avoidance is apparently a major concern, (4) the Corporation has not been formed for the purpose of taking advantage of losses incurred in a separate trade or business, (5) the corporate form (and the status of the Corporation as an actual operating enterprise) has been consistently honored by the taxpayer and other parties to the

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Case, 17 TAX L. REV. 393 (1962).

28. 281 U.S. 111 (1930) (husband's entire earnings were taxable to him despite an agreement with his wife that their incomes would be divided equally). *See also* Battle, *supra* note 27, at 803-05.

29. *Foglesong* I, 35 T.C.M. (CCH) at 1312 (citations omitted). The Tax Court noted that "[w]here, as here, the corporation involved is admittedly a separate taxable entity and not a mere sham, the issue has generally 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 income." *Id.* *See generally* FED. TAX CO-ORDINATOR 2D, ¶ G-4009-4011 (RIA 1982).

30. *Foglesong* I, 35 T.C.M. (CCH) at 1313. Several factors were pointed to by the court as affecting its decision: (1) no dividends were paid on the common stock of Foglesong Company, although such dividends were paid on the preferred stock held by the taxpayer's children; (2) Foglesong himself could decide, in his sole discretion, when and in what amount dividends would be paid; (3) the taxpayer failed to receive a salary from Foglesong Company for the first four months of operation, although he continued to perform under the contracts with the tubing companies and (4) earnings generated by the taxpayer prior to the creation of Foglesong Company were nevertheless paid directly to Foglesong Company, rather than to the taxpayer.

31. *Id.*

32. *Id.* at 1315.

33. 621 F.2d 865 (7th Cir. 1980) [hereinafter cited as *Foglesong* II].

> transaction giving rise to the income, (6) the taxpayer does not render services as an employee to any entity other than the Corporation, (7) the Corporation is not disqualified from performing the Services required of it by contract because the law requires these services to be performed by an individual, (8) the entities paying or providing the income are not controlled or dominated by the taxpayer, and (9) . . . other and more appropriate legal bases exist for attacking apparent tax avoidance than broadscale disregard of the corporate form through application of assignment of income theory.[34]

Viewing these factors, the court determined that it is "inappropriate to attempt to weigh 'business purposes' against 'tax avoidance motives' in determining whether the assignment of income doctrine of *Lucas v. Earl* should apply, in effect, to substantially disregard the corporate form."[35]

Although the Seventh Circuit found it unnecessary to "crack walnuts with a sledgehammer", the court did suggest an alternative method of attack for the Service:

> In the instant case, Section 482 of the Internal Revenue Code appears available to allocate among controlled taxpayers 'gross income, deductions, credits, or allowances' to prevent evasion of taxes or to clearly reflect the income of the controlled taxpayers. . . . We, therefore, remand to the Tax Court for consideration of the issues surrounding the Commissioner's claim under Section 482 and other claims available.[36]

On remand, the Tax Court considered the application of section 482 in *Foglesong v. Commissioner*.[37] The taxpayer maintained that section 482 was inapplicable to him because he was a corporate *employee,* and not an "organization, trade, or business" as required for the application of that section.[38] The Tax Court disagreed, noting that "[b]ecause the petitioner as an employee and the corporation are separate taxable entities and separate trades or

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34. *Id.* at 868-69 (footnotes omitted).

35. *Id.* at 869. The court also noted that with respect to the sales agreement, there had not only been an assignment, but a novation. *Id.* at 870. Consequently, the court concluded that "[h]ere not only the fruit but the tree itself was transferred to the Corporation" and so declined to apply *Lucas v. Earl.* The court also found that the absence of a written employment contract or a covenant not to compete was less meaningful than the fact that the taxpayer *did in fact* work exclusively for the corporation. *Id.* at 872.

36. *Id.* at 872-73.

37. 77 T.C. 1102 (1981) [hereinafter cited as *Foglesong* III].

38. *Id.* at 1104.

businesses, we hold that under the facts presented herein, the threshold requirement of section 482, that there be at least two organizations, trades, or businesses, is met."[39]

The taxpayer argued further that even if section 482 was applicable, it could be applied only to reallocate income earned by him prior to incorporation but paid to Foglesong Company, and to dividends paid to his children.[40] The Tax Court found that "[t]he standard against which we must test arbitrariness of the [Commissioner's] determination is whether and to what extent actual dealings between the petitioner and the corporation reflect arm's-length dealings between two uncontrolled parties."[41]

In holding section 482 applicable, the Tax Court noted that the taxpayer's primary motive for incorporating was the avoidance of federal income taxes by splitting sales commission income between himself and Foglesong Company.[42] Although observing that there were bona fide reasons, other than tax avoidance, for incorporating, the court found that "just because the petitioner and the corporation are separate taxable entities does not mean the manner by which Petitioner, as controlling shareholder, chooses to allocate income between them should be given tax effect. Before we will accept petitioner's allocation, it must reflect arm's-length dealing."[43]

Looking to the facts of the case, the Tax Court determined that the taxpayer's dealings with the corporation were not at arm's length. "Had petitioner been dealing at arm's length with the corporation, his salary and benefits would not have so substantially deviated from his worth to the corporation."[44]

Foglesong IV

On appeal, the Seventh Circuit[45] once again reversed the deci-

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39. *Id.* (citing Keller v. Commissioner, 77 T.C. 1014 (1981)).

40. *Id.*

41. *Id.* at 1105.

42. *Id.*

43. *Id.*

44. *Id.* at 1106. Specifically, the court found that had the taxpayer not incorporated, he would have realized additional total compensation of $212,000 for the period 1966 through 1969. *Id.* For a discussion of *Foglesong* II and its perceived impact under section 482 upon personal service corporations see Burdett, *Foglesong's Sec. 482 Approach May Threaten Closely-Held Personal Service Corporations*, 53 J. TAX. 330 (1980); McFadden, *Section 482 and the Professional Corporation: The Foglesong Case*, 8 J. CORP. TAX. 35 (1981).

45. Foglesong v. Commissioner, 691 F.2d 848 (7th Cir. 1982) [hereinafter cited as *Foglesong* IV].

sion of the Tax Court and remanded the case for further consideration. At the outset, the court stated that "*[t]he crux of the case is whether the taxpayer and his personal service corporation constitute two 'organizations, trades, or businesses'*" as required for a reallocation under section 482.[46]

In determining that the provisions of section 482 should be broadly applied,[47] the court noted that section 482 has been applied when a taxpayer seeks to offset the profits of one business with the losses of another,[48] and "when an individual engages in a business that is distinct from or in addition to the business in which [his] personal service corporation is engaged."[49] The Seventh Circuit observed that "[i]n recent decisions, however, the Tax Court has gone beyond this to hold that section 482 is designed 'to cover any type of entity or enterprise which has independent tax significance,' when evasion of taxes is perceived."[50] The result of such decisions was that under the Tax Court approach a corporation and its sole shareholder/employee could constitute two separate trades or businesses under section 482, even when the shareholder/employee devoted no time or effort to other businesses.[51]

The Seventh Circuit disagreed with the Tax Court's interpretation of section 482.[52]

> The Tax Court in large part seems to have based its broad reading [of section 482] on the statement in a Congressional committee report that the provision was designed to encompass "all kinds of business activity." The Tax Court did not consider the statement in context, however. The committee made the remark in explaining why it was adding "organizations" to "trade or businesses": "While it is believed that the language of the present law is broad enough to include 'organizations,' this word is added to remove any doubt as to the application of this section to all kinds of business activity."[53]

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46. *Id.* at 850. (emphasis added).

47. *Id.*

48. *Id.* (citing Ach v. Commissioner, 42 T.C. 114 (1964), *aff'd*, 358 F.2d 342 (6th Cir.), *cert. denied*, 385 U.S. 899 (1966)).

49. *Id.* (citing Borge v. Commissioner, 405 F.2d 673 (2d Cir. 1968), *cert. denied*, 395 U.S. 933, *reh. denied*, 396 U.S. 869 (1969)).

50. *Foglesong* IV at 850-51 (quoting Keller v. Commissioner, 77 T.C. 1014, 1022 (1981)).

51. *Id.* For a discussion of several Tax Court cases relating to the application of section 482 to personal service corporations see Comment, *Reallocation of Personal Service Corporation Income: A Trilogy of Tax Court Cases*, 14 CONN. L. REV. 819 (1982).

52. *Id.* at 851.

53. *Id.* (quoting H.R. Rep. No. 704, 73d Cong., 2d Sess. 24 (1934) (citation omitted)).

Thus, the Seventh Circuit found that the addition of the word "organizations" was not intended to include the case of a personal service corporation and its sole shareholder/employee.[54] "[W]e believe that it is appropriate to hold that an individual who does not work exclusively for his personal service corporation may have the income earned by it allocated to him under section 482. The section should not apply, however, to one who *does* work exclusively for his corporation."[55]

The court went on to distinguish several other prominent cases in the area of reallocation of income between personal service corporations and employee/shareholders. In *Borge v. Commissioner*,[56] a well-known entertainer transferred the assets of his unsuccessful poultry business to a corporation. The taxpayer then entered into an agreement with that corporation wherein he agreed to work for his corporation as an entertainer. The Second Circuit Court of Appeals held that the dual business requirement was met because "Borge was in the business of entertaining. He was not devoting his time and energies to the corporation; he was carrying on his career as an entertainer, and merely channeling a part of his entertainment income through the corporation."[57]

The Seventh Circuit distinguished *Foglesong* from *Borge* in several ways. In *Foglesong:* both the taxpayer and his corporation were engaged in the same business; the taxpayer was engaged in no outside business; the corporation, rather than the taxpayer himself, was paid for the services; and there was no attempt to offset the gains of one business with the losses of another.[58]

The Seventh Circuit also distinguished *Ach v. Commissioner*[59] from *Foglesong*. In *Ach*, the taxpayer (Pauline) ran a successful dress business while her husband and son jointly operated a losing dairy business. In 1952 the father and son ceased operations of the dairy business, sold the dairy equipment and leased the business land and improvements.[60] The following year, the "dairy" corporation changed its name to the Ach Corporation and its business to

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54. *Id.*

55. *Id.*

56. 405 F.2d 673.

57. *Id.* at 676. The court also noted that Borge received $50,000 per year from the corporation for his services. *Id.* at 675. The court concluded that "Borge obviously would not have entered into such a contract with an unrelated party." *Id.*

58. *Foglesong* IV, at 852.

59. 42 T.C. 114. For a more thorough analysis of *Ach* and *Borge* and the relation of these cases to section 482, see Battle, *supra* note 27, at 805-06.

60. 42 T.C. at 117.

"general business," as permitted under state law.[61] Pursuant to his parents' suggestion, the son transferred 149 of the 300 shares of Ach Corporation common stock then outstanding (of which the son owned all) to his brother, Laurence.[62] Subsequently, Pauline, then 60 years of age, became president, treasurer, and chairman of the board of directors of Ach Corporation although she then held none of the corporate stock.[63] On that same date Pauline sold her dress business to the corporation, although she continued to manage the business.[64] There was no name change and no payments were made to Pauline by the corporation.[65] Neither of the taxpayer's sons actually participated in the day-to-day activities of the dress business, but maintained their own separate enterprises.[66]

In 1956 the taxpayer's husband died.[67] At that time, the corporation was indebted to him in the amount of $232,390 for notes previously executed to cover dairy losses.[68] Payments were made on these notes out of the profits of the dress business and were designated by the corporation as "payment of indebtedness" and used to offset income from the dress business.[69]

The Tax Court held that the transaction between the taxpayer and Ach Corporation was not at arm's length.[70] Further, the Tax Court stated that "it is all too clear to us on this record that Pauline was acquiring control of this moribund corporation for the purpose of attempting to utilize the net operating loss carryover of the dairy business, to offset the resulting deductions against earnings of her successful dress business, and to obtain the actual benefits of those tax-free earnings by having the corporation pay off, first, her $30,705.57 note (in payment for the dress business), and then the notes of some $280,000 held by her husband which were

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61. *Id.*

62. *Id.* Laurence paid no consideration for the transfer of these shares. *Id.*

63. *Id.* at 118.

64. *Id.* at 118-19.

65. *Id.* Ach Corp. issued a note in the amount of $30,705.57 to Pauline in payment for the dress business. *Id.* at 119.

66. *Id.* at 119.

67. *Id.*

68. *Id.* "During the latter part of 1952, Roger [taxpayer's son] went to his father and told him that it was time to give up the dairy and creamery business; Roger felt his father was too old to have to worry about continued losses and the *continued backing of a losing cause.*" *Id.* at 117. (emphasis added).

69. *Id.* at 119-21.

70. *Id.* at 123. "The corporation was hopelessly insolvent, and it is utterly beyond belief that any unrelated third party would have sold a prosperous business for a non-interest-bearing $30,705.57 note of such an insolvent maker" *Id.*

otherwise uncollectable - all of which would be received free of tax!"[71]

With regard to the application of section 482, the Tax Court found that "sufficient aspects of the business remained with Pauline so as not to deprive her of the status of a separate 'organization,' 'trade,' or 'business,' within the meaning of section 482."[72] Further, the court found that "[t]he conclusion is irresistible that the corporation in fact belonged to her, and that she was actually the beneficial owner of the stock even prior to the formal transfer (to her) in 1959. In any event, it is not record ownership, but actual control, which counts in the application of the statute."[73]

In distinguishing *Foglesong* from *Ach*, the Seventh Circuit noted that:

> By contrast, Foglesong transferred all of his business to the corporation and retained nothing. The corporation treated him as an employee, not a sole proprietor, by paying him a salary. Although he had no employment contract with the corporation, we find his actual performance - exclusive work for the company - far more significant than any paper obligation. Finally, unlike *Ach*, there was no shifting of profits from one business to another; thus one of the evils that section 482 was designed to prohibit is not present.[74]

The court also discussed the case of *Rubin v. Commissioner*.[75] In *Rubin*, the taxpayer organized one corporation to do business with another corporation which he also controlled.[76] The taxpayer caused one corporation to pay the other corporation "management fees" for services rendered to it by the controlling shareholder/employee (Rubin).[77] In its first opinion,[78] the Tax Court held for the Service, basing its decision on reallocation principles under *Lucas v. Earl*. However, the Second Circuit Court of Appeals reversed and remanded for a determination of whether section 482 should be applied.[79] On remand, the Tax Court, although taking into con-

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71. *Id.* (parenthetical material added).
72. *Id.* at 125.
73. *Id.*
74. *Foglesong* IV at 852 (citing *Foglesong* II, 621 F.2d at 872).
75. 51 T.C. 251 (1968), *rev'd & remanded*, 429 F.2d 650 (2d Cir. 1970). The case was reheard at 56 T.C. 1155 (1971), *aff'd per curiam*, 460 F.2d 1216 (2d Cir. 1972).
76. 56 T.C. at 1156.
77. *Id.*
78. 51 T.C. 251 (1968).
79. 429 F.2d 650 (2d Cir. 1970). For a brief discussion of *Rubin*, see Battle, *supra* note

sideration the taxpayer's argument that the Commissioner was seeking "to increase the salary of a corporate employee" by allocating corporate income to the shareholder/employee,[80] nevertheless stated that:

> [W]e do not today hold that employment status constitutes, in and of itself, a trade or business within the meaning of section 482. Nor have we ruled that section 482 empowers the Commissioner at will to readjust the salaries of corporate employees. We merely hold, as is the clear import of both the *Ach* and *Borge* decisions, that *where the particular facts of a case are such as to justify a finding that a shareholder operated an independent business and merely assigned to the corporation a portion of the income therefrom, the business activity of the taxpayer may constitute a trade or business to which allocation of all or part of the income attributable to his efforts is authorized under section 482.*[81]

The Seventh Circuit, in discussing *Rubin*, merely stated that "[t]he court in an earlier ruling in that case noted that taxpayer performed more than $25,000 worth of other work unrelated to the work for his controlled corporation."[82]

Conclusion

In *Foglesong* IV, the Court of Appeals held that "the Tax Court erred in its decision that [section 482] should be applied to allocate income received by Foglesong's personal service corporation to Foglesong,"[83] and concluded that "[b]ecause the taxpayer did work exclusively for the corporation and because there was no shifting of profits," the judgment of the Tax Court should be reversed.[84]

On the strength of *Foglesong* IV, and at least in the Seventh Circuit, so long as: (1) the personal service corporation pays its sole shareholder/employee a salary and benefits commensurate with an arm's length transaction; (2) the corporate form is ob-

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27, at 807.

80. 56 T.C. at 1160.

81. *Id.* at 1161 (emphasis added). *See generally* Warren and Dunkle, *Professional Corporations—Organization and Operation*, TAX MGMT. No. 334, § VII, at A-32 (BNA 1976).

82. *Foglesong* IV at 853. Although not attempting to distinguish *Rubin* from *Foglesong*, the Seventh Circuit did seem to find this level of other, outside work to be significant. *Id.* at 852.

83. *Id.* at 853.

84. *Id.*

served; and (3) there is no shifting of losses or profits, neither section 61's assignment of income principles, nor section 482's reallocation provisions, may be utilized to reallocate or assign income between a corporation and its sole shareholder/employee. Further, no written agreement with the corporation seems necessary, at least so long as the taxpayer works exclusively for the corporation, although good practice would seem to suggest that such a written agreement is desirable.

Developments in TEFRA[85]

The Seventh Circuit also observed that in 1982 Congress sought to legislatively reverse the result in *Keller v. Commissioner*[86] by amending section 269 of the Code.[87] In *Keller* the Tax Court held that although the provisions of section 482 are applicable to sole shareholder personal service corporations, no allocation is required when the "employee's" compensation reflects an arm's-length transaction. However, the *Foglesong* IV court found that the new provision was not applicable to the tax years in question.[88]

The amendment, incorporated into the Tax Equity & Fiscal Responsibility Act of 1982, provides that if substantially all of the services of a personal service corporation are performed for (or on behalf of) one other corporation, partnership, or other entity, and the principal purpose of forming the personal service corporation is the avoidance or evasion of federal income tax by taking advantage of tax incentives not otherwise available, "then the Secretary may allocate all income, deductions, credits, exclusions, and other allowances between such personal service corporation and its employee-owners" to prevent the avoidance or evasion of income tax,

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85. Tax Equity and Fiscal Responsibility Tax Act of 1982, Pub. L. No. 97-248, § 250, 96 Stat. 324 [hereinafter cited as TEFRA].

86. 77 T.C. 1014 (1981).

87. I.R.C. § 269(a) (West Supp. 1982). Section 269(a) provides that if:

> (1) substantially all of the services of a personal service corporation are performed for (or on behalf of) 1 other corporation, partnership, or other entity, and (2) the principal purpose for forming, or availing of, such personal service corporation is the avoidance or evasion of Federal income tax by reducing the income of, or securing the benefit of any expense, deduction, credit, exclusion, or other allowance for, any employee-owner which would not otherwise be available, then the Secretary may allocate all income, deductions, credits, exclusions, and other allowances between such personal service corporation and its employee-owners, if such allocation is necessary to prevent avoidance or evasion of Federal income tax or clearly to reflect the income of the personal service corporation or any of its employee-owners.

88. *Foglesong* IV at 851, n. 3.

or to clearly reflect income.[89] Although the Seventh Circuit declined to address the matter, it appears that this provision will not be applicable to a factual situation such as that present in *Foglesong* because Foglesong Company performed substantially all of its services for *two* other corporations, rather than *one* as provided for by statute.[90].

Consequently, the amendment appears to be limited to the *Keller* situation in which, perhaps, the taxpayer was a little too clever. Sole shareholder/employees of a personal service corporation in the *Keller* position (i.e. substantially all of the services of a personal service corporation being performed for, or on behalf of, one other corporation, partnership or other entity) will have a strong incentive to dissolve, or at least to alter the structure of their operation. The alternative is to risk a finding that the "principal purpose" of the taxpayer in using the corporate form was the avoidance or evasion of federal income tax. Just how easy [or difficult] it will be for the Service to establish this "principal purpose" attack remains to be seen. However, when organizing personal service corporations, practitioners should pay particular attention to developments under the amendment.

Although the new provision affecting personal service corporations contained in TEFRA presents another hurdle to taxpayers, it is only applicable to tax years beginning after January 1, 1983. Consequently, the *Foglesong* decisions will be important in tax litigation for many years to come.

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89. I.R.C. § 269(a) (West Supp. 1982).

90. The business of Keller, Inc. was that of providing pathology services as a corporate partner of MAL (a partnership of pathologists). Keller, Inc. employed Keller to render his services as a pathologist, with laboratory and technical support provided by MAL, Inc. (which was controlled by the partners of MAL). Consequently, Keller, Inc. performed substantially all of its services for *one other partnership:* MAL. This would seemingly bring the *Keller* situation within the ambit of I.R.C. §269(a), while excluding situations such as the one in *Foglesong* (because *two* other entities are involved), as well as the situation in which the sole shareholder of a personal service corporation renders corporate services to the general public.