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One-Man Personal Service Corporations: Singing a New *Foglesong*

Doing business in the corporate form offers the corporation's shareholders and employees many advantages, including limited liability, tax advantages, and employee fringe benefits.¹ Professionals have attempted to obtain these advantages by forming personal service corporations pursuant to state law.² The Commissioner of the Internal Revenue Service (Commissioner) has attacked the status of these corporations from their inception. Only after litigating the issue for almost a decade, did the Commissioner acquiesce³ and finally agree to recognize these professional corporations as true corporations.

Despite this acquiescence, the Commissioner has continued his attack on professional corporations using an indirect approach. The Commissioner has used three methods to bypass or ignore the corporation: the sham corporation theory,⁴ the assignment-of-income doctrine,⁵ and Internal Revenue Code (Code) section 482.⁶ By using these methods individually or collectively, the Commissioner has attempted to attribute the corporation's income to the individual.

This note examines the plight of one-man personal service corporations and explains how they may have won the battle against the Commissioner and found a refuge after *Foglesong IV*.⁷ Part I reviews the sham corporation and assignment-of-income theories and explains why their use to the Commissioner in attacking many one-man personal service corporations is limited. Part II examines Code section 482, the Commissioner's most powerful weapon yet, and dis-

1 H. HENN, HANDBOOK OF THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES § 68-76 (2d ed. 1970).

2 *Id.* at § 77.

3 Rev. Rul. 101, 1970-1 C.B. 278.

4 *See* notes 11-27 *infra* and accompanying text.

5 *See* notes 28-55 *infra* and accompanying text.

6 I.R.C. § 482 (1976). *See* notes 56-102 *infra* and accompanying text.

7 *Foglesong v. Commissioner*, 35 T.C.M. (CCH) 1309 (1976) (*Foglesong I*), *rev'd and remanded*, 621 F.2d 865 (7th Cir. 1980) (*Foglesong II*), *opinion on remand*, 77 T.C. 1102 (1981) (*Foglesong III*), *rev'd and remanded*, 691 F.2d 848 (7th Cir. 1982) (*Foglesong IV*). It is important to note that personal service corporations can be composed of one or many professionals. This note will deal primarily with one-man personal service corporations since these corporations have received most of the Commissioner's wrath. One-man personal service corporations truly test the corporation fiction to its limit.

cusses this section's debilitation by *Foglesong IV*. Part III examines Code section 269A and demonstrates how this new section will eliminate many personal service corporations. Part IV analyzes section 482's interpretation by the courts and shows that the *Foglesong IV* court reached the proper result.

I. Original IRS Approaches for Attacking Personal Service Corporations

Initially, the Commissioner used the common law doctrines of sham corporation and assignment-of-income to attack personal service corporations. The sham corporation doctrine disregards, for tax purposes, the corporation that nominally earned income and requires that income be taxed directly to the employee-owner.⁸ The assignment-of-income doctrine voids, for tax purposes, an anticipatory assignment of income to someone other than the person earning it; it thereby requires that the assignor be taxed on such income.⁹ Earlier, the Commissioner had used these judicially created doctrines in tandem.¹⁰ Recently, however, the Commissioner has practically abandoned the sham corporation argument and has instead concentrated on the assignment-of-income doctrine.

A. *The Sham Corporation Theory*

The Commissioner first attempted to use the sham corporation theory in *Fox v. Commissioner*¹¹ and *Laughton v. Commissioner*.¹² The Commissioner argued that the personal service corporations involved should have been disregarded for tax purposes because they were "mere dummies"¹³ or "alter egos"¹⁴ of the individual taxpayers. In both cases, however, the Board of Tax Appeals (Board) refused to disregard the corporate entity.

In *Fox*, the taxpayer contracted to work for his personal service corporation in exchange for a salary.¹⁵ The corporation's earnings

8 See D. KAHN, BASIC CORPORATE TAXATION § 1.6 (3d ed. 1981).

9 See *id.*

10 See *Fox v. Commissioner*, 37 B.T.A. 271 (1938). See also notes 15-19, 39-43 *infra* and accompanying text.

11 37 B.T.A. 271 (1938).

12 40 B.T.A. 101 (1939), *remanded*, 113 F.2d 103 (9th Cir. 1940).

13 37 B.T.A. at 276.

14 40 B.T.A. at 105.

15 In *Fox*, a newspaper cartoonist formed a personal service corporation and contracted to work exclusively for this corporation. Fox also assigned other contracts for his cartoons to the corporation and received a weekly salary. The corporation then contracted with a syndicate to distribute Fox's cartoons. 37 B.T.A. at 272-76.

were significantly larger than Fox's salary. The Commissioner argued that the corporation was a "mere dummy" and should thus be ignored for tax purposes.¹⁶ He therefore contended that the corporation's reported income should be allocated to Fox.

The Board of Tax Appeals rejected the Commissioner's contention, citing *New Colonial Ice Co. v. Helvering*.¹⁷ In *New Colonial Ice*, the Supreme Court of the United States held that a corporation and a shareholder are separate entities that should be disregarded only in exceptional circumstances.¹⁸ The Board in *Fox* was impressed by the corporate formalities observed, the separateness of Fox and the corporation, and the corporation's recognition by third parties.¹⁹

In *Laughton*,²⁰ a motion picture actor contracted to work exclusively for the personal service corporation he had formed to act as his manager and personal representative. The corporation's earned income far exceeded the taxpayer's weekly salary.²¹

The Commissioner, contending that the corporation was only the taxpayer's "agent and alter ego,"²² argued that the Board should look through the corporate form and allocate the corporation's income to Laughton.²³ However, the Board of Tax Appeals again recognized the corporation and the individual as separate entities and refused to disregard the corporate entity.

The United States Supreme Court severely limited the Commissioner's sham corporation argument in *Moline Properties, Inc. v. Commissioner*.²⁴ The Court stated that "the doctrine of corporate entity fills

16 *Id.* at 276. The Commissioner also relied on the assignment-of-income doctrine. See notes 39-43 *infra* and accompanying text.

17 292 U.S. 435 (1934). In *New Colonial Ice*, a new corporation took over all of an older business's assets. The new corporation then attempted to deduct the losses that the old corporation had incurred. The Court disallowed the attempted deduction because the two corporations were separate and distinct. The Court added that the substantial identity between the two corporations' shareholders did not destroy that distinctness. *Id.* at 441-42.

18 For an example of a case presenting "exceptional circumstances," see *Roubik v. Commissioner*, 53 T.C. 365 (1969). *Roubik* is discussed at note 31 *infra*.

19 The Board stated that the personal service corporation's separate identity had been generally respected by Fox and had been recognized by all who had dealt with it. 37 B.T.A. at 277.

20 40 B.T.A. 101 (1939), *remanded*, 113 F.2d 103 (9th Cir. 1940).

21 *Id.* at 102-05.

22 *Id.* at 105.

23 *Id.*

24 319 U.S. 436 (1943). In *Moline Properties*, an individual taxpayer transferred some properties to a corporation organized for this purpose. The corporation assumed and agreed to pay the mortgages on these properties. A few years later, the corporation sold the properties at a gain. The Commissioner challenged the taxpayer's attempt to include the gain on his

a useful purpose in business life."²⁵ Consequently, courts must recognize a corporate entity if either a substantial business purpose exists in forming a corporation or the corporation carries on a business after its formation.²⁶

Thus, the sham corporation argument has been severely curtailed and will apply only in extreme situations. Generally, one-man personal service corporations have avoided the sham corporation argument quite easily by strictly following corporate formalities. Nevertheless, the Commissioner continues to use the sham argument.²⁷

B. *The Assignment-of-Income Doctrine*

Under the assignment-of-income doctrine, income is allocated to the person who truly earned it.²⁸ Determining the "true" earner, however, is often difficult.²⁹ Because this determination can be especially difficult³⁰ when the assignment-of-income doctrine is applied to one-man personal service corporations, courts have often blurred the sham corporation and assignment-of-income theories together.³¹

income tax return. The Supreme Court agreed with the Commissioner and held that the corporation was not a sham. Thus, the corporation had to report the gain.

25 *Id.* at 438.

26 *Id.* at 438-39.

27 *See, e.g., Oginoy v. Commissioner*, 617 F.2d 14 (2d Cir. 1980), *cert. denied*, 449 U.S. 900 (1980).

28 *Lucas v. Earl*, 281 U.S. 111, 114-15 (1930).

29 When income is split between a corporation and an individual taxpayer, our graduated income tax system is undermined. *See* note 32 *infra*.

30 *See, e.g., American Sav. Bank v. Commissioner*, 56 T.C. 828, 839 (1978). Two taxpayers owned a corporation that sold insurance policies (through outside agents) and provided management services (through the taxpayers). The Commissioner, relying on the assignment-of-income doctrine, attempted to allocate the income from both the insurance sales and the management services to the taxpayers. The court noted that, under the assignment-of-income doctrine, it is often difficult to determine the "true" earner of income, especially when [the] tax laws . . . 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 corporation wholly owned by that individual, is said to have been earned by the corporation.

Id. at 839. The Tax Court held that the Commissioner could allocate only the management services income to the individual taxpayers. *Id.* at 842-43.

31 *Roubik v. Commissioner*, 53 T.C. 365 (1969), illustrates how the assignment-of-income and sham corporation doctrines have been used loosely and sometimes incorrectly. Four radiologists who had previously engaged in individual practices formed a personal service corporation. Despite entering into an employment agreement with the corporation, each continued his separate practice. The corporation entered no contracts; owned no equipment, office, or medical supplies; and paid no rent or salaries, except to the taxpayers. The corporation merely maintained a set of records in which corporate income and deduction items were entered. *Id.* at 379.

The Tax Court held that the corporation's reported income should be allocated to the

In addition, courts have found that this application raises a conflict between two important tax policies: (1) the graduated income tax system³² and (2) the concept of a corporation as a separate taxable entity.³³

The Supreme Court established the assignment-of-income doctrine in its landmark decision, *Lucas v. Earl*.³⁴ There, an attorney contracted with his wife that any property or earnings either spouse acquired during their marriage would be joint property.³⁵ Consequently, the husband reported only half of his earnings on his tax return. The Commissioner sought to tax the husband on all the income he earned.³⁶ The Supreme Court did not challenge the contract's validity, but it nonetheless agreed with the Commissioner's treatment.³⁷ Justice Holmes, writing for the Court, stated that the income should be taxed to the individual who "earned" it, emphasizing that "the fruits [should not be] . . . attributed to a different tree from that on which they grew."³⁸ In other words, the "true" earner must recognize all the income that he earns.

The Commissioner first wielded the assignment-of-income doctrine against a personal service corporation in *Fox v. Commissioner*.³⁹ The Board of Tax Appeals, however, rejected the Commissioner's contention. In *Fox*, the taxpayer had assigned contracts to the corporation and the Board treated this assignment like the assignment of

taxpayers, based on the assignment-of-income doctrine. *Id.* at 381. Judge Tannenwald, concurring, pointed out that a "sham" corporation was involved. He emphasized that a corporation must be given substance and that "the petitioners here did not put flesh on the bones of the corporate skeleton." *Id.* at 382 (Tannenwald, J., concurring).

32 Under our graduated income tax system, tax rates increase progressively as taxable income increases. If a person is allowed to "split" his income, the graduated tax system is undermined. For example, the tax liability of a single taxpayer with \$100,000 taxable income (\$41,318 for the 1982 taxable year) will be much greater than the combined tax liabilities of five single taxpayers, each of whom has \$20,000 taxable income (\$18,800 for the 1982 taxable year). Thus, the Commissioner prefers to tax the employee-owner on all of the income involved rather than "split" the income between the corporation and the individual. The Second Circuit, in *Rubin v. Commissioner*, 429 F.2d 650 (2d Cir. 1970) (*Rubin II*) recognized these conflicting policies. See notes 49-53 *infra* and accompanying text.

33 Corporations can be formed only pursuant to state statutes, and should thus receive the protections of the state laws. These protections include recognition as separate and legal entities. See, e.g., ILL. REV. STAT. ch. 32, § 415-1 to -18 (Professional Service Corporation Act, P.A. 76-1283)(1979 & Supp. 1980).

34 281 U.S. 111 (1930).

35 *Id.* at 113-14.

36 *Id.* at 113.

37 *Id.* at 114.

38 *Id.* at 115.

39 37 B.T.A. 271 (1938). See notes 11, 13, 15-19 *supra* and accompanying text.

any other income-producing property.⁴⁰ The Board explained that, once the taxpayer transferred the income-producing property, the Commissioner could no longer tax the assignor on the income that the property subsequently produced.⁴¹ In *Fox*, the contracts represented income-producing property; therefore, the corporation was the "true" earner of any income arising from these contracts after it acquired them.⁴² Thus, the Board concluded that there was no assignment of future earnings as was present in *Lucas v. Earl*.⁴³

In *Rubin v. Commissioner (Rubin I)*,⁴⁴ the Commissioner again used the assignment-of-income doctrine against a personal service corporation; this time, the United States Tax Court held for the Commissioner. In *Rubin*, the taxpayer formed a personal service corporation to do business with another corporation. The taxpayer held interests in both corporations⁴⁵ and did not work exclusively for his personal service corporation.⁴⁶ The Tax Court stated that the decision in an assignment-of-income case turns upon who controls the earning of the income.⁴⁷ According to the court, the taxpayer controlled the income because he controlled both the personal service corporation and the "serviced" corporation.⁴⁸

On appeal, however, the United States Court of Appeals for the Second Circuit reversed the Tax Court's decision and remanded the case for consideration of the issue, using section 482 (*Rubin II*).⁴⁹ Judge Friendly, writing for the court, stated that common law doctrines of taxation may occasionally be useful in considering tax avoidance transactions which cannot be satisfactorily handled in other ways. However, he reasoned these doctrines should not be used when a statutory provision can adequately deal with the problem.⁵⁰

40 37 B.T.A. at 278.

41 *Id.*

42 *Id.*

43 281 U.S. 111 (1930). See notes 34-38 *supra* and accompanying text.

44 51 T.C. 251 (1968) (*Rubin I*), *rev'd and remanded*, 429 F.2d 650 (2d Cir. 1970) (*Rubin II*), *opinion on remand*, 56 T.C. 1155 (1971) (*Rubin III*), *aff'd per curiam*, 460 F.2d 1216 (2d Cir. 1972) (*Rubin IV*).

45 The taxpayer owned 70% of the personal service corporation's stock and had voting control of the "serviced" corporation. 51 T.C. at 255. The "serviced" corporation is the corporation for which the personal service corporation performed services. In *Rubin*, there was only one "serviced" corporation. See notes 109-10 *infra* and accompanying text.

46 Apparently, the taxpayer had no employment agreement with the personal service corporation. The taxpayer was also vice-president of a corporation formed by his father. The "serviced" corporation was a customer of this latter corporation. 51 T.C. at 252-53.

47 *Id.* at 264-65.

48 *Id.* at 266.

49 429 F.2d at 654. Section 482 is discussed at Part II *infra*.

50 429 F.2d at 653.

The court stated that section 482 was "clearly superior to the blunt tools used by the Tax Court."⁵¹ According to the Second Circuit, section 482 was superior for two reasons. First, section 482 addressed the issues more clearly, avoiding the conflict between the two major policies—graduated taxation and the corporation as a separate entity—raised by the assignment-of-income.⁵² Second, section 482 provided relief not found in the assignment-of-income doctrine's all-or-nothing approach.⁵³

Other courts have refused to use the common law assignment-of-income doctrine in situations where section 482 more readily applies.⁵⁴ Even though the courts have stripped the assignment-of-income doctrine of some of its effectiveness, the Commissioner still uses the doctrine in certain situations.⁵⁵

II. Reallocation Under Internal Revenue Code Section 482

A. *Statutory Requirements*

The Commissioner's most powerful weapon to attack personal service corporations is section 482.⁵⁶ Three basic requirements must

⁵¹ *Id.*

⁵² *Id.* According to the court, § 482 analyzed the facts in light of the competing policies of graduating the income tax system and recognizing the corporation as a separate entity. Because § 482 takes these competing policies into account, the Second Circuit noted that the section was superior to the assignment-of-income doctrine in the situation presented. *See* notes 32-33 *supra* and accompanying text.

⁵³ 429 F.2d at 653-54. Under § 482, if the Commissioner allocates income from the personal service corporation to the taxpayer, the taxpayer receives this income from the corporation without incurring further personal tax liability. This remedy is unavailable under the assignment-of-income doctrine; thus, double taxation results (assuming that the personal service corporation has not elected Subchapter "S" treatment).

⁵⁴ In *Foglesong v. Commissioner*, 621 F.2d 865 (7th Cir. 1980) (*Foglesong II*), the United States Court of Appeals for the Seventh Circuit reversed the Tax Court's holding, which was based on the assignment-of-income doctrine, and remanded the case for redetermination using § 482. *See* notes 88-96 *infra* and accompanying text.

⁵⁵ In *Foglesong IV*, the Seventh Circuit remanded the case to the Tax Court to determine if

assignment-of-income principles may be employed to allocate the dividends and preferred stock received by Foglesong's children to Foglesong as well as commission income earned by Foglesong before incorporation but paid to the company after incorporation.

691 F.2d at 853. Both these items will undoubtedly be allocated to Foglesong. The preferred stock dividends amounted to approximately \$38,000. It appears that Foglesong, rather than his children, paid the \$400 preferred stock purchase price. In addition, any commissions earned prior to incorporation should properly be allocated to Foglesong. *See* notes 99-101 *infra* and accompanying text.

⁵⁶ I.R.C. § 482 (1976) provides:

In any case of two or more organizations, trades, or businesses (whether or not

be met before section 482 applies: (1) two or more organizations, trades, or businesses must be involved; (2) these organizations, trades, or businesses must be commonly controlled; and (3) the Commissioner's allocation of income or deductions must be necessary to prevent tax evasion or to clearly reflect income.⁵⁷

If these three requirements are met, the Commissioner can allocate income and deductions among the taxpayers to clearly reflect income. The Commissioner's allocation, however, is subject to a "substantially equivalent" or "arm's-length" test,⁵⁸ which attempts to compare the employee-owner's compensation from the corporation with his probable compensation had the corporation not existed. If this test is met, a court will disallow the Commissioner's allocation, even if section 482's first three requirements were met.⁵⁹

While section 482's second and third requirements generally present no definitional problems, the approach for evaluating the first requirement remains unsettled. Courts differ over whether the Commissioner can treat the employee-owner and his service corporation as two distinct organizations or businesses.

The dual business requirement is met when the employee-owner fails to work exclusively for his personal service corporation. In *Rubin*,⁶⁰ the taxpayer fit this requirement by working for both his personal service corporation and a corporation that his father had founded.⁶¹ After the Second Circuit rejected the Commissioner's use of the common law doctrines, the Tax Court reheard the case using section 482 (*Rubin III*)⁶² and concluded that section 482 applied. The

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.

57 *Id.*

58 Under the "substantially equivalent" or "arm's-length" test, a court will uphold the Commissioner's allocation if the employee-owner's compensation package from the corporation is less than what he would have received absent incorporation. Conversely, the Commissioner's allocation will be invalid if the employee-owner's compensation package from the corporation is substantially equivalent to what he would have received absent incorporation. The employee-owner's salary and employment benefits such as pension plan contributions will be combined to determine the amount of the compensation package. See *Pacella v. Commissioner*, 78 T.C. 604 (1982).

59 See I.R.C. § 482 (1976); note 58 *supra* and accompanying text.

60 See notes 44-53 *supra* and accompanying text.

61 See note 46 *supra* and accompanying text.

62 56 T.C. at 1162.

Tax Court thus held against the taxpayer.

The Tax Court in *Rubin III* relied principally on *Ach v. Commissioner*⁶³ and *Borge v. Commissioner*⁶⁴ when it analyzed the dual business requirement. In *Ach*, the taxpayer sold her dress business to her son's corporation.⁶⁵ Although she became the corporation's president and chairman of the board, the taxpayer worked voluntarily and received no compensation.⁶⁶ The Tax Court, finding that section 482's three requirements had been met, held that section 482 applied. The crucial issue was whether the taxpayer and the corporation fell within the dual business requirement. The court explained that the taxpayer had continued to be a "separate" business, despite having sold the dress business assets to the corporation.⁶⁷ The court likewise found that the other two requirements had been met.

The court in *Rubin III* also relied on *Borge v. Commissioner*.⁶⁸ In *Borge*, the taxpayer channeled income he earned as an entertainer into the personal service corporation he had established with the assets of his unprofitable poultry business.⁶⁹ The Second Circuit decided that section 482 applied. The court found that the dual business requirement had been met because Borge was involved in the entertainment business and his corporation was involved in the poultry business.⁷⁰

After *Ach*, *Borge* and *Rubin III*, it appeared that the Tax Court was expanding its interpretation of the dual business requirement. This trend continued in *Keller v. Commissioner*.⁷¹ There, a pathologist formed a personal service corporation and contracted to work exclu-

63 42 T.C. 114 (1964), *aff'd*, 358 F.2d 342 (6th Cir.), *cert. denied*, 385 U.S. 899 (1966).

64 405 F.2d 673 (2d Cir. 1968), *cert. denied*, 395 U.S. 933 (1969).

65 42 T.C. at 118-19.

66 *Id.* 115-19. The taxpayer had conducted a highly profitable dress business for several years, while her son owned a controlling interest in a consistently unprofitable dairy business. The son changed the name of his corporation and made the taxpayer the president, treasurer, and chairman of the board. Simultaneously, the taxpayer sold all of the dress business assets to the son's corporation. The taxpayer did not contract to work exclusively for this corporation, but voluntarily rendered her services, receiving no compensation.

67 *Id.* at 124. The court noted that sufficient aspects of the dress business had remained with the taxpayer; thus, she remained a "separate" business or organization for § 482 purposes. *Id.* at 125.

68 405 F.2d 673 (1968).

69 According to the court, Borge did not devote his time and energies to the corporation; he conducted his career as an entertainer and merely channeled a part of his income through the corporation. *Id.* at 676.

70 *Id.*

71 77 T.C. 1014 (1981). In *Keller*, the partnership involved was comprised of several personal service corporations. This is a very popular business arrangement that § 269A will foreclose. *See* note 109 *infra* and accompanying text.

sively for it. The personal service corporation then contracted to provide pathological services to a partnership. The Commissioner attacked this arrangement, again using section 482.⁷²

Although the Tax Court decided that section 482 applied, the court disallowed the Commissioner's allocation because the substantially equivalent test had also been met.⁷³ The Tax Court noted that section 482 applied to one-man personal service corporations, even when the taxpayer worked exclusively for his corporation.⁷⁴ The court added that the dual business requirement should be interpreted broadly.⁷⁵ The court therefore believed this situation met the dual business requirement simply because the personal service corporation was in the business of providing services and the taxpayer was in the business of providing his exclusive services to the personal service corporation.⁷⁶ However, since Keller had received compensation that was substantially equivalent to what he would have received had he not incorporated,⁷⁷ the Tax Court ultimately found in the taxpayer's favor.

These broad interpretations of section 482's dual business requirement appeared to foreshadow the personal service corporation's extinction. If the courts continued to interpret section 482 broadly, then many advantages of the corporate form would be extinguished.⁷⁸ But, on October 29, 1982, the United States Court of Appeals for the Seventh Circuit decided *Foglesong IV*.⁷⁹ This important decision may provide a refuge for many personal service corporations.

B. *The Foglesong Cases: Are One-Man Personal Service Corporations Safe at Last?*

The *Foglesong* cases⁸⁰ parallel the Commissioner's attempts to tax

72 *Id.* at 1021.

73 *Id.* at 1027-28.

74 *Id.* at 1022.

75 *Id.*

76 *Id.* at 1023-24.

77 *Id.* at 1028. In computing Keller's total compensation, the Tax Court added the salary that the personal service corporation paid, the pension plan contributions it made, and medical expense reimbursements it paid.

78 See note 115 *infra* and accompanying text.

79 *Foglesong v. Commissioner*, 691 F.2d 848 (7th Cir. 1982).

80 *Foglesong v. Commissioner*, 35 T.C.M. (CCH) 1309 (1976) (*Foglesong I*), *rev'd and remanded*, 621 F.2d 865 (7th Cir. 1980) (*Foglesong II*), *opinion on remand*, 77 T.C. 1102 (1981) (*Foglesong III*), *rev'd and remanded*, 691 F.2d 848 (7th Cir. 1982) (*Foglesong IV*).

individuals maintaining personal service corporations.⁸¹ In *Foglesong*, the taxpayer was a sales representative for two corporations.⁸² To obtain corporate advantages, Foglesong formed a personal service corporation.⁸³ Foglesong worked exclusively for this personal service corporation, although no employment contract obligated him to do so.⁸⁴ When Foglesong refused to pay tax deficiency notices, the Commissioner brought the case before the Tax Court (*Foglesong I*).⁸⁵ Citing the assignment-of-income doctrine, the Commissioner contended that he should be permitted to allocate the personal service corporation's income to Foglesong.⁸⁶ The Tax Court agreed with the Commissioner.⁸⁷

On appeal, the Seventh Circuit rejected the Tax Court's reasoning (*Foglesong II*).⁸⁸ The court in *Foglesong II* noted that the assignment-of-income result was essentially equivalent to the sham corporation result.⁸⁹ Neither doctrine applied to the *Foglesong* case, however, since the personal service corporation involved was a viable, taxable entity.⁹⁰ The Seventh Circuit distinguished *Lucas v. Earl*,⁹¹ and concluded that no assignment of income took place since Foglesong had assigned no future earnings.⁹² The court held that *Fox v. Commissioner*⁹³ was indistinguishable—because the assignment-of-

81 The *Foglesong* cases exemplify the Commissioner's attempts to use the sham corporation argument, the assignment-of-income doctrine, and § 482 against personal service corporations. In *Foglesong I*, the Commissioner, conceding this was not a sham corporation, used the assignment-of-income doctrine. The *Foglesong II* court rejected this doctrine. In *Foglesong III*, the Commissioner attempted to use § 482, but the *Foglesong IV* court rejected this argument.

82 See text accompanying note 111 *infra*.

83 Foglesong incorporated for limited liability and business diversification reasons. See 621 F.2d at 866-67.

84 Foglesong executed no formal employment contract with his personal service corporation, but he worked exclusively for his corporation. *Id.* at 867. However, the courts will focus on what actually occurred; therefore, an employment contract requiring the employee-owner's exclusive services will be disregarded if the individual does not actually work for his corporation.

85 35 T.C.M. (CCH) 1309 (1976).

86 *Id.*

87 *Id.*

88 621 F.2d 865 (7th Cir. 1980).

89 *Id.* at 869. The Seventh Circuit said that it was inappropriate "to achieve, through recourse to the assignment-of-income doctrine, essentially the same result as would follow from treating the Corporation as a 'sham' for tax purposes." Theoretically, however, the assignment-of-income and sham corporation doctrines remain distinct. See text accompanying notes 8-9 *supra*.

90 621 F.2d at 869.

91 See notes 34-38 *supra* and accompanying text.

92 621 F.2d at 870.

93 37 B.T.A. 271 (1938); See notes 39-43 *supra* and accompanying text.

income doctrine did not apply in *Fox*, it should likewise not apply to *Foglesong*.⁹⁴

The court concluded by adding that there were “more precise devices for coping with the unacceptable tax avoidance which is unquestionably present in this case.”⁹⁵ The court indicated that section 482 was one of these more precise devices.⁹⁶ The court therefore reversed and remanded the case for redetermination using section 482.

On remand, the Tax Court reexamined the case under section 482 (*Foglesong* III).⁹⁷ The Tax Court found for the Commissioner, concluding that section 482 applied. The court relied on its previous analysis of the dual business requirement issue in *Keller*.⁹⁸

On appeal, the Seventh Circuit again concluded that section 482 did not apply, because the dual business requirement had not been met (*Foglesong* IV).⁹⁹ The court believed that section 482 could not be properly applied to an individual who worked exclusively for his personal service corporation.¹⁰⁰ The Seventh Circuit thus disagreed with the Tax Court’s expansive interpretation of section 482. The Seventh Circuit noted that *Foglesong* had worked exclusively for his corporation and had not attempted to offset one business’s losses against another’s profits.¹⁰¹

Thus, it appears that *Foglesong* IV has provided a refuge for one-man personal service corporations, at least in the Seventh Circuit. To fall within this refuge, however, the taxpayer must carefully consider the following guidelines:

(a) The taxpayer must establish that his personal service corporation is a viable, taxable entity. The personal service corporation must follow all corporate formalities to ensure the separateness needed to avoid the sham corporation doctrine.

(b) The taxpayer must work exclusively for his personal service corporation. The taxpayer is advised to sign a contract with the corporation evidencing this intention.

(c) The taxpayer should not use the personal service corporation income to offset the losses of another corporation.

94 621 F.2d at 870.

95 *Id.* at 872. The court noted that there was “no need to crack walnuts with a sledgehammer.” *Id.*

96 *Id.*

97 77 T.C. 1102 (1981).

98 *Id.* at 1104. See notes 71-77 *supra* and accompanying text for a discussion of *Keller*.

99 691 F.2d at 851.

100 *Id.*

101 *Id.* at 852-53. In *Ach and Borge*, the taxpayers had attempted to offset losses of one business with another business’s profits. See notes 63-70 *supra* and accompanying text.

(d) The taxpayer must take precautions to avoid Code section 269A.¹⁰²

III. New Developments— Section 269A

Even after *Foglesong IV*, one-man personal service corporations may still encounter difficulties. According to the Tax Equity and Fiscal Responsibility Act of 1982¹⁰³ (TEFRA), any personal service corporation formed or used to avoid or evade income taxes will be subject to Code section 269A.¹⁰⁴ This new Code section applies to all taxable years beginning after December 31, 1982.¹⁰⁵

Under section 269A, the Secretary has the power to allocate income between the personal service corporation and its employee-owners if necessary to prevent income tax evasion or avoidance, or to clearly reflect income.¹⁰⁶ Section 269A applies to any personal service corporation that (a) performs substantially all of its services for *one* other entity;¹⁰⁷ and (b) was formed principally to avoid or evade income taxes.¹⁰⁸

Thus, section 269A would have applied to a case such as *Rubin v. Commissioner*.¹⁰⁹ Recall that in *Rubin*, the taxpayer's personal service

102 See Part III *infra*.

103 Pub. L. No. 97-248, § 250, 1982 U.S. CODE CONG. & AD. NEWS (96 Stat.) 3 (to be codified at scattered sections of 26 U.S.C.). The key question after TEFRA takes effect will be the reason the corporation was formed, not whether it was a truly separate entity.

104 I.R.C. § 269A (West Supp. 1982) provides:

(a) GENERAL RULE—If—(1) 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 (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.

(b) DEFINITIONS

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

...

(c) EFFECTIVE DATE—The amendments made by this section shall apply to taxable years beginning after December 31, 1982.

105 I.R.C. § 269A (c) (West Supp. 1982).

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

107 I.R.C. § 269A (a)(1) (West Supp. 1982).

108 I.R.C. § 269A (a)(2) (West Supp. 1982).

109 See notes 44-46 *supra* and accompanying text. It is important to note that § 269A was

corporation performed services for only one corporation.¹¹⁰ On the other hand, Foglesong would have escaped liability under section 269A, because his personal service corporation performed services for, or on behalf of, two corporations.¹¹¹

How the judiciary will interpret section 269A's requirement, that substantially all the services be performed for one entity,¹¹² is open to speculation. A personal service corporation providing 90% of its services to one corporation and 10% to another corporation might fall within section 269A. A taxpayer must keep this in mind when forming a personal service corporation. If the personal service corporation legitimately performs services for two or more corporations, then section 269A should present no problems. However, if the taxpayer performs "token" services for another corporation only in an attempt to escape section 269A, a court will likely recognize this scheme and take measures to prevent it.

IV. Evaluation of the Judicial Approach

Have the pre-*Foglesong* IV courts deciding section 482 controversies exceeded their judicial authority? This question must be answered affirmatively. The courts have unnecessarily expanded section 482 beyond its practical limitations.

The courts have expanded the dual business requirement to include employee-owners working exclusively for their personal service corporations.¹¹³ In doing so, the courts have allowed many legitimate personal service corporations to fall prey to the Commissioner's section 482 power to allocate income.¹¹⁴ Undeniably, the Commissioner's power under a *Keller*-type interpretation of section 482's dual business requirement is nearly absolute.¹¹⁵ Of course, the Commissioner's allocation is subject to the "substantially equivalent" or

passed in order to overturn the result reached in cases like *Keller v. Commissioner* "where the corporation served no meaningful business purpose other than to secure tax benefits which would not otherwise be available." H.R. REP. NO. 76, 97th Cong., 2d Sess. 634 (1982). Congress wanted to eliminate personal service corporation partnerships. See note 71 *supra*.

110 See note 45 *supra*.

111 See text accompanying note 82 *supra*.

112 See note 104 *supra*.

113 See notes 71-77 *supra* and accompanying text.

114 Had the Seventh Circuit affirmed the Tax Court in *Foglesong* IV, this would have constituted a prime example of a legitimate corporation becoming a victim of the courts' expansive interpretation of § 482's dual business requirement.

115 Personal service corporations would have been annihilated under a *Keller*-type interpretation of the dual business requirement. The Commissioner would have indirectly been able to eliminate many personal service corporations by directly eliminating the corporation's identity for tax purposes. See note 117 *infra*.

“arm’s-length” test,¹¹⁶ but this check on the Commissioner will often be unavailable to the taxpayer.¹¹⁷

The *Foglesong* IV court is the first court, and hopefully not the last, to realize the practical consequences of overextending the dual business requirement.¹¹⁸ The Seventh Circuit has successfully balanced the policy behind section 482 (preventing income splitting)¹¹⁹ with the policy of recognizing corporations as separate, legal entities.¹²⁰

Other courts have permitted the Commissioner to invoke section 482 in situations not intended for its use.¹²¹ In addition, Congress has now added section 269A to the Commissioner’s arsenal for attacking personal service corporations.¹²² This new Code section will undoubtedly prove invaluable to the Commissioner since countless personal service corporations will fall within section 269A’s parameters.

Considering these developments, the courts should not expand section 482 to a *Keller* extreme. The *Foglesong* IV court must have considered¹²³ these arguments before giving section 482 a fair interpretation. *Foglesong* IV provides a fair interpretation of section 482’s dual business requirement; it is an interpretation that many personal service corporations can “live” with.

V. Conclusion

The Seventh Circuit has established a refuge for one-man personal service corporations in *Foglesong* IV. The other circuits should

116 See note 58 *supra*.

117 The “substantially equivalent” or “arm’s-length” test will be more difficult to meet after TEFRA because TEFRA has eliminated the advantages of corporate pension plans. Because the allowable pension plan contributions have been decreased, the employee-owner’s compensation package will be less. See TEFRA, Pub. L. No. 97-248, §§ 235-36, 238, 240, 1982 U.S. CODE CONG. & AD. NEWS (96 Stat.) 3.

118 See notes 114-15, 117 *supra*.

119 The court stated that “section [482] was intended to apply to cases where the profits of one business have been offset against the losses of another to reduce or escape tax liability.” 691 F.2d at 850.

120 *Id.* at 851.

121 Section 482 should not apply in cases where the taxpayer makes no attempt to offset the losses of one business with the profits of another. Nor should § 482 apply where the taxpayer works exclusively for his personal service corporation. Therefore, § 482 should not have applied to cases like *Keller* and *Foglesong*. See notes 71-77, 99-100 *supra* and accompanying text.

122 See Part III *supra*.

123 691 F.2d at 852. The court emphasized the fact that *Foglesong* had worked exclusively for his corporation and that he had made no attempt to offset the losses of another business against his corporation’s profits.

follow the Seventh Circuit's lead. The Seventh Circuit has wisely realized the drastic effects that the Tax Court's expansive interpretation of section 482 would have upon personal service corporations.¹²⁴ By continuing to broadly interpret section 482, the courts would extinguish many personal service corporations. Such a change should come only from Congress, and the *Foglesong IV* court was quick to realize this.

One-man personal service corporations have waged an ongoing war with the Commissioner since their inception. After *Foglesong IV*, the Commissioner should have called a cease fire to the war on personal service corporations. Unfortunately, the Commissioner will probably rebuild his forces and initiate a new offensive, using section 269A as his primary weapon. The Commissioner, like a modern-day mercenary, will continue to fight any war as long as money is at stake. For many one-man personal service corporations the battle is over, but for others it is only beginning.¹²⁵

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124 See note 115 *supra*.

125 Aside from § 482 and § 269A, personal service corporations may become extinct because Congress has eliminated many of their corporate advantages. Corporate pension plans are no longer more attractive than individual pension plans. See TEFRA, Pub. L. No. 97-248, §§ 235-36, 238, 240, 1982 U.S. CODE CONG. & AD. NEWS (96 Stat.) 3.