

# Personal Service Corporations: Issues in Identifying the Proper Taxpayer

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## Abstract

*Personal Service Corporations (PSCs) constitute a commonly employed entity through which individuals conduct business operations. Use of a PSC can provide many potential tax benefits. As a consequence, the Service has frequently challenged the recognition of PSCs and sought to tax income allegedly earned by a PSC to its shareholder(s)-employee(s). In this article, the issues relevant to Service-taxpayer disputes over PSCs are examined and relevant reform in the law proposed.*

## Introduction

Whether amounts allegedly earned by a personal service corporation (PSC) will be taxed directly to the corporation or the actual service provider under an assignment of income theory or Internal Revenue Code reallocation provision has long been a subject to Service-taxpayer dispute. Despite recent tax law changes detracting from their appeal, PSCs remain an attractive vehicle for adding flexibility to one's available retirement plan options, garnering otherwise unavailable tax exempt employee fringe benefits, obtaining potential tax deferral,<sup>1</sup> and tax savings from income splitting.

Tax disputes concerning PSCs have centered upon issues and concepts having relevance extending far beyond their application to PSCs. These issues include: (1) Whether the corporation should be recognized for tax purposes; (2) Whether income declared by the PSC should be attributed to the shareholder-employee under an assignment of income doctrine; (3) Whether a principal-agency relationship should be recognized as held by the PSC and shareholder-employee; (4) Whether income should be reallocated between the PSC and shareholder-employee under I.R.C. Section 482 or 269A.

In this article these issues will be analyzed and reform of certain relevant aspects of the law proposed.

## Sham

According to the sham argument a corporation should be disregarded for tax purposes where it lacks economic substance and only serves a tax evasion or avoidance purpose. Where applicable in the PSC setting the sham argument will result in income claimed earned by the

corporation being instead taxed directly to the corporation's shareholders. The Service has met with little success in attacking PSCs as a sham,<sup>2</sup> and in recent years has largely refrained from raising this argument. In rejecting the sham argument courts have consistently applied the approach used in the landmark Supreme Court case of Moline.<sup>3</sup> According to Moline the validity of an incorporated entity will be recognized if either: (1) The corporation formed for was a valid business purpose; or (2) Incorporation is followed by the carrying on of business activity.

The Service's lack of success in raising this argument has resulted in its placing greater reliance upon the assignment of income doctrine and Internal Revenue Code reallocation provisions as means of having income be taxed directly to the employee- owners of a PSC rather than the PSC.

## Assignment of Income

One of the fundamental tenets of income taxation is that income should be taxable to the taxpayer who earns it. This principle is reflected in the assignment of income doctrine and its companion fruit-tree metaphor.<sup>4</sup> According to the fruit-tree metaphor income will be taxed to the taxpayer (tree) whose services earned the income (fruit) or who owns the right or interest in the property (tree) giving rise to the income. The assignment of income doctrine was primarily devised to deter tax avoidance or evasion through income shifting or fragmentation. Over time several exceptions to strict application of the assignment of income doctrine have been established. These exceptions generally concern

situations not considered engaged in primarily for income shifting or fragmentation.<sup>5</sup> The principal exception relevant to PSCs is that pertaining to principal-agent relationships. Pursuant to this exception amounts earned by an agent on behalf of the principal will be attributed to the principal rather than the agent even should it be the efforts of the agent that generate the income.

Lack of a principal-agency relationship has been found and the assignment of income doctrine applied despite the presence of a PSC where: (1) The PSC was largely disregarded, did not enter an arrangement to render services and owned no assets;<sup>6</sup> (2) State law required that only an individual and not the corporation can render services.<sup>7</sup>

Likewise difficulty is encountered in supporting a principal-agency relationship where the service-provider either acts outside of the scope of his agency or does not hold himself out to third parties as an agent.

Recent cases reflect two approaches emerging as dominant in resolving whether a principal-agent relationship exists. These approaches are the triangle agency theory (contract theory) and the flexible approach.

### The Triangle Agency Theory

Pursuant to the triangle agency theory (contract theory) two elements must exist in order for a principal agency relationship to be deemed extant.

First, the entity must possess the right to control or direct the service provider in some meaningful sense. Second, the entity must have a contract or similar indicium with the party for whom services are rendered recognizing the entity's right to control the service provider.

For purposes of the first element meaningful control will be deemed present if a valid contract exists between the entity and service provider, which is complied with and limits the service provider in some meaningful way, e.g. where to work and amount to be paid.

The cases of Johnson<sup>8</sup> and Sargent,<sup>9</sup> each of which involve the use of PSCs by a professional athlete illustrate the application of the triangle agency theory. Johnson concerned a professional basketball player who formed a PSC with which he entered into a contract. The player's paychecks were issued according to his wishes by the team to his PSC, despite the lack of a contract between the PSC and the team. The court accepted *arguendo* that the PSC had control of Johnson. Nevertheless, the court held that the amount paid by the team attributable to Johnson's services was directly taxable to Johnson due to the lack of a relevant contrac-

tual relationship between the team and the PSC.

Recently, the Eighth Circuit in Sargent held that a principal-agency relationship existed under the triangle agency theory. In reaching this decision the Court reversed a Tax Court decision which held that a principal-agency relationship could not exist with regard to a member of a sports team, due to the team having a common law employee-employer relationship with the athlete. Sargent concerned a professional hockey player who formed a PSC with which he entered into a contract to perform services as a professional hockey player and consultant for a fixed salary. The PSC then entered into a contract with a professional hockey team pursuant to which the PSC would provide the team with the player's services in return for a salary. Both the contract between the player and the PSC were complied with. The player was covered by a deferred compensation plan provided by the PSC rather than the traditional NHL pension plan. Based on these facts the Eighth Circuit held that the requisites of the triangle agency theory had been satisfied and that a principal-agency relationship between the PSC and the player should be recognized. According to the Eighth Circuit to adopt the Tax Court's view would both be: 1) inconsistent with other Tax Court decisions that upheld principal-agency relationship under the triangle theory, despite a common law employment relationship existing between the service provider and third party, and 2) inequitable in that it would enable the PSC of an independent contractor to establish a principal-agency relationship, but not the PSC of an employee.

### The Flexible Approach

According to the flexible approach the resolution of whether a principal-agency relationship exists is to be based upon scrutiny of all relevant facts and circumstances. This standard was pronounced in Fogarty v. United States<sup>10</sup> and its application clarified in Schuster v. Commissioner.<sup>11</sup>

Fogarty concerned a priest who was subject to a vow of poverty, chastity and obedience to his order. The priest was extended an invitation by the University of Virginia to interview for a teaching position in the University's Department of Religious Studies. The order directed the priest to undergo the interview and pursue the position. The University was aware of the priest being a member of an order, and that his acceptance and retention of a teaching position was dependent upon the dictates of the order. No agreement however was entered into between the order and the University. Paychecks were made payable to the priest individually, but deposited in an account of the order. Pursuant to the priest's vows he was unable to personally keep or obtain the paychecks received while a member of the order.

The priest did not file an income tax return reflecting the amounts earned, due to his belief that they had been earned in his capacity as an agent of the order.

The Claims Court held that the priest was in fact taxable on the amounts due to not being an agent. The court reached this decision by applying the triangle agency theory, and finding that no contract or similar indicium existed between the order and the university. On appeal the Federal Circuit affirmed the Claims Court decision, but on different grounds. Rather than apply the triangle agency theory to determine if a principal-agency relationship existed, the court applied a facts and circumstances approach, finding the following six factors to be of particular relevance: (1) The degree of control exercised by the order over the member; (2) The ownership rights to the wages held between the member and the order; (3) The mission or purpose of the order; (4) The type of work performed by the member compared with the order's mission (purpose); (5) The dealings between the member and the third party in the hiring process; (6) The dealings between the employer and the order.

The case of Schuster concerned facts substantially analogous to those of Fogarty and provides needed insight into implementation of the factors mentioned in Fogarty. Schuster involved a nun, subject to a vow of poverty, chastity and obedience who accepted a position as a nurse midwife with the permission of her order. The order had the right to have the nun withdraw from her work, and required that she remit amounts received to the order. As in Fogarty although the third party was aware of the nun being a member of the order, no contractual relationship existed between the order and the third party. The nun reported none of the amounts earned as income, believing herself to be an agent of the order. This position was challenged by the Service which agreed that the amounts should be taxable to the nun.

The Tax Court held in favor of the Service finding that the triangle agency theory had not been satisfied due to the lack of any contractual type relationship between the order and the third party. On appeal the Seventh Circuit affirmed the decision using the flexible approach. In reaching the conclusion the Court found factors 1, 2, 5 and 6 militated against finding a principal-agency relationship. In this regard the court found: Factor 1 - The third party had greater control of the worker on a daily basis than did the order; Factor 2 - The checks were made payable to the worker (nun) rather than the order; thus providing the nun with preferable ownership rights; Factor 5 - The worker did not hold herself out as an agent of the order either in applying for or interviewing for the job; Factor 6 - The order had only nominal dealings with the third party. Although the order and third party corresponded by

mail no departure from standard procedure was engaged in by the third party despite a request to do so by the order.

### An Analytical Perspective

The triangle agency theory and the flexible approach both conflict with one another as well as established agency law. The triangle agency theory elevates form over substance by mechanically requiring that there be a contractual relationship between the principal and third party without inquiring into either the nature of such relationship or whether the services to be provided conform to the purpose of the principal.

In contrast to the triangle agency theory, the flexible approach places greater emphasis on substantive requirements. Although not requiring a contractual relationship between the principal and third party the flexible approach is more onerous than the triangle agency theory. This is particularly evident when one considers the importance of relative control of the worker by the principal and third party. The difference in the approaches can also produce what appears to be inequitable results when one considers that a principal-agency relationship will often be recognized as extant between a PSC and an shareholder-employee who possesses control of the PSC, and not between a religious order and a member who is under an enforceable vow of poverty, with a duty to remit all remuneration, and who provides services consistent with the purpose of the order. The treatment of agents who are contractually bound to remit amounts to their principal is clearly analogous to common law employees. The vow of poverty taken in order to be a member of the order has been recognized as enforceable,<sup>12</sup> and corresponds to a duty to remit amounts earned to the order. In contrast to the flexible approach established law suggests that whether day to day control of the worker is present or whether the worker has temporarily received an amount which the worker is obligated to remit is not decisive in resolving whether a principal-agency relationship exists. Likewise, strict application of the flexible approach appears incongruous in cases such as Schuster and Fogarty in that these cases lack the tax avoidance or evasion aspects with which the assignment of income doctrine is concerned.

In order to minimize conflict between the Circuits and abet tax administration and planning a more uniform standard for principal-agency relationships should be developed. This standard should reflect the accepted definition of agency relationships for other legal purposes.

The Restatement of Agency Second<sup>13</sup> defines an agency as a fiduciary relationship that results where pursuant to mutual assent one party acts on behalf of

another and is subject to the other's control. Although it is generally desirable to have a written principal-agency agreement, such is not generally required if the principal-agency relationship is found extant in light of all relevant facts and circumstances. Factors often relevant to finding a principal-agency relationship include: the agent's acting within the scope of the agency, and in accordance with the purpose of the principal, whether the third party perceives the person to be acting as an agent, and whether the principal or the agent was primarily looked toward for providing the good or service.

Neither the presence of day to day control nor a direct contractual relationship between the principal and third party is expressly required by the Restatement for a principal-agency relationship to exist. Rather it is mutual assent and some control between the principal and agent that is required. Despite this it would appear that some knowledge of the principal-agent relationship should be held by the third party in order for the full legal consequence related to a principal agency relationship to be present, i.e., the principal being vulnerable to liability under the notion of respondeat superior. Bearing these elements in mind the following factors are proposed as determinative of a principal-agency relationship. (1) Meaningful control of the agent by the principal; (2) Acts of the agent being in conformity with the purpose of the principal; (3) The principal being entitled to any amounts earned from the providing of goods or services by the agent; and (4) Knowledge by the third party of the worker being an agent of the principal.

In applying this standard all four of these factors should be satisfied in order to find a principal-agency relationship. These requisites support mutual assent between the principal and agent, and should avoid an assignment of income problem because of the principal's preferential right to the amounts earned by the agent. In addition, as a result of factor 4, the principal should possess the risk of liability to the third party in conformity with the notion of respondent superior.

### **Loaned Employee**

Where the shareholder-employee of a PSC works for but one party during the taxable year the issue arises as to whether a service provider can be a common law employee of one party and an agent for another.<sup>14</sup> In Sargent the Tax Court ruled that the two were incompatible and the service provider subject to tax on the entire amount earned due to being an employee of the team. Finding an employee-employer relationship was rooted in the team's control over the player's day to day activities. This control was evidenced by the service provider being subject to the coach's instructions, and the team's strategy, as well as being required to attend training sessions, the team determining the amount of

time the worker could play as well as where the services would be rendered, and what position the worker would play.

Both the triangle agency theory and flexible approach implicitly reject the view that one can not simultaneously be what would normally be considered an employee of one party while carrying out such services as the agent of another. Neither test requires that either day to day control over the worker or a comparison of the relative control of the third party or PSC over the service provider is to be determinative. In Sargent use of the triangle agency theory to reject the concept of employment precluding agency with another is evident in the Eighth Circuit's reversal of the Tax Court's decision. While the flexible approach appears to place greater importance on relative control of the service provider, this is but one of the factors to be taken into consideration.

### **Reallocation**

In addition to I.R.C. Section 61 and the assignment of income doctrine, I.R.C. Section 482 and 269A constitute statutory provisions that can be used to bolster the amount of income attributed the service provider rather than the PSC. Unlike the assignment of income doctrine, which where applicable will result in all or most of the income involved being attributed to a particular party, where a reallocation provision has been applicable courts have tended to classify at least some of the amount involved as taxable to the PSC if valid.

Section 482 - According to I.R.C. Section 482, the Commissioner is authorized to allocate items of gross income, deductions, credits, or allowances, between two or more controlled organizations, trades, or businesses where such is necessary to prevent the evasion of taxes or to clearly reflect the income of the organizations, trades or businesses.

Section 269A - According to I.R.C. Section 269A the Secretary is authorized to allocate all income, deductions, credits, exclusions, and other allowances between a PSC and its shareholder-employees if necessary to prevent the avoidance or evasion of Federal income taxes or to clearly reflect income. Two requisites must be met before Section 269A can be applied: (1) Substantially all of the services of the PSC must be performed for (or on behalf) of another corporation, partnership or entity; and (2) The principal purpose for forming, or availing of the PSC is the avoidance or evasion of Federal income tax by reducing the income of, or securing the benefit of an expense, deduction, credit, or other exclusion.

Although directly applicable to PSCs, Section 269A has been rarely utilized in litigation. This is in part due

to the statute only being effective for the taxation of transactions occurring after December 31, 1982. Obstacles to effective use of the statute by the Service include the narrowness of the statute, and the need to establish: (1) The PSC having to provide services for another entity; and (2) The principal purpose of forming or availing of the PSC is tax avoidance or evasion or the securing of a tax benefit. This is particularly true in light of proposed regulations suggesting that the formation of the PSC to enable utilization of enhanced retirement plans does not constitute a proscribed interest.

In light of these statutory obstacles, it is likely that the more flexible Section 482 reallocation will remain significantly more prevalent in tax controversies concerning PSCs.

The Service has met with some success in asserting reallocation of income between a PSC and owner employer in scenarios involving a clear tax avoidance purpose or where the third party appears to have clearly not engaged in an exclusive contract with the PSC and to have primarily been looked to by the third party rather than the PSC for the rendering of services.<sup>16</sup> Reallocation under I.R.C. Section 482 in these type situations is reflected in the trilogy of Ach,<sup>17</sup> Borge<sup>18</sup> and Rubin.<sup>19</sup>

In Ach the taxpayer transferred a profitable business to a corporation owned by her son for an amount substantially below the market price. Prior to the transfer the acquiring corporation had losses which it could not utilize due to insufficient income. As a result of the transaction the loss corporation sought to use its losses to offset the income generated by the acquired business. Following the transfer the taxpayer became the president and treasurer of the son's corporation. The Tax Court viewed the transaction as a clear attempt to avoid taxes and the taxpayer as remaining in business through her ties to the transferred business. As a consequence the Court reallocated some 70% of the transferred business to the taxpayer.

A result similar to that in Ach was reached in the case of Borge. Borge concerned an entertainer who controlled an unprofitable corporation engaged in the poultry business. The taxpayer entered into a contract with the corporation to render services for a salary well below that which the taxpayer actually commanded for his services. The difference between the amount earned by the corporation from his services and the salary that was to be paid the taxpayer could effectively be offset by the losses produced by the poultry business. Funding the corporation did little to enhance the taxpayer's already established entertainment business, as a result a substantial amount of the entertainment earnings were allocated to the taxpayer.

In Rubin Section 482 was applied by the Tax Court to reallocate income to the taxpayer despite the underlying tax avoidance motive not being as blatant as in Ach and Borge. Rubin involved a taxpayer established in the textile industry who formed a corporation with his brothers which in turn provided his services for a salary to another corporation controlled by the taxpayer. The taxpayer provided services beyond those provided for in the contract to the corporation. Both the Tax Court, and Second Circuit found that the taxpayer had clearly engaged in a separate trade or business and that the amount he received was not arms length, particularly in light of his control over both corporations and thus reallocated a substantial amount of income to him.

An issue that has arisen in recent years concerning the application of Section 482 to reallocate income between a PSC and an employee-owner concerns whether the Section 482 prerequisite of a separate trade, business or organization is satisfied where the worker has an exclusive and binding contract with the PSC and engages in no separate business activities. As reflected by case law the Service maintains that Section 482 is applicable in these circumstances. Implicit in this position is the view that the employee-owner can be viewed as engaged in a separate trade or business by virtue of being an employee. In general courts have had little difficulty in finding Section 482 applicable to PSC and employee-owner relationships. As suggested by the Tax Court in Ach the fact that a party does not cease to be a taxpayer may be viewed as tantamount to being a trade, business or organization for Section 482 purposes. Cases like Keller<sup>19</sup> and Pacella<sup>20</sup> indicate however that no reallocation will generally be made where the combined amount of the salary and deferred compensation and benefits received by the employee-owner approximate the amount that would have been received had he (she) rendered the services outright to the third party. Cases reflect should the combination of salary received and retirement plan contributions made on behalf of the employee-owner be 86% or 87%, reallocation under Section 482 will not be necessary.<sup>21</sup>

## Conclusion

PSCs have long been a subject of dispute between the Service and taxpayers. In recent years the focus of such controversies has concerned whether income allegedly attributable to a PSC should instead be taxable to its employee-owner due to an assignment of income theory or rejection of a principal-agency relationship. To avoid undesirable consequences caution must be exercised in structuring PSC and employee-owner contracts as well as when employee-owner transactions with outside parties are structured.

### Suggestions For Future Research

There are several issues related to the Service-taxpayer dispute concerning PSCs in need of further inquiry. In this regard additional investigation should be made into the application of I.R.C. Section 482 and 269, as well as agency theory and its application in other areas of the law. Further research may also be made into this area by an empirical examination of relevant cases concerning PSCs or agency theory under the tax law through a method of analysis such as LOGIT.

ment of a personal service corporation to derive enhanced benefits from deferred compensation or retirement plans is an acceptable business purpose. Achiro, 71 TC 881 (1981).

21. Keller, 77 TC 1014 (1981) and Pacella, 78 TC 604 (1982).

### \*\*\*Footnotes\*\*\*

1. Although the potential deferral of taxes based upon differences between the tax year of a PSC and that of shareholder-employees has been reduced due to changes made in the tax law, some minimal deferral possibilities remain. See I.R.C. Section 444.
2. See for example Fox, 37 B.T.A. 271 (1938) and Laughton, 40 B.T.A. 101 (1939).
3. Moline Properties Inc. v. Commissioner, 319 U.S. 436 (1943)
4. Lucas v. Earl, 201 U.S. 111 (1930)
5. Exceptions to the rule exist with regard to: (1) Principal-agency relationship. Maryland Casualty Company, 251 U.S. 342 (1930); (2) Obligations imposed under state law requiring the splitting of income. Poe v. Seaborn, 282 U.S. 101 (1937); and (3) Income earned but not yet received by a cash method taxpayer on property prior to the transfer of the asset. Caruth, 865 F.2d 644 (5th Cir. 1989), aff'g 688 F.2d 1129 (U.S.D Ct N.D. TX. 1988).
6. Roubik, 53 TC 365 (1969).
7. Jones, 64 TC 1066 (1975).
8. Johnson v. U.S., 698 F.2d 372 (9th Cir. 1982)
9. Sargent, 929 F.2d 1252 (1990), rev'g 93 TC 572 (1989).
10. Fogarty v. U.S., 780 F.2d 1005 (Fed. Cir. 1986), aff'g, 6 Cls. Ct. 612 (1984).
11. Schuster v. Commissioner, 800 F.2d 672 (7th Cir. 1986) aff'g, 84 TC 764 (1985).
12. Order of St. Benedict, 234 U.S. 640 (1914).
13. Restatement of Agency Second at 1 and 135.
14. See for example Professional and Executive Leasing Inc., 862 F.2d 751 (9th Cir. 1988).
15. See Haag, 88 TC 604 (1988).
16. Ach v. Commissioner, 358 F.2d 342 (6th Cir. 1966), aff'g 42 TC 114 (1964), cert denied 385 U.S. 899. See also Foglesong v. Commissioner, 691 F.2d 848 (7th Cir. 1982).
17. Borge v. Commissioner, 405 F.2d 673 (2nd Cir. 1968) cert. denied 395 U.S. 933.
18. Rubin v. Commissioner, 56 TC 1155 (1971) aff'g per curiam 466 F.2d 1216 (2d Cir. 1971), rev'd on other grounds.
19. Keller, 77 TC 1014 (1981).
20. Pacella, 78 TC 604 (1982). Note that the establish-