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The Separate Tax Status of Loan-Out Corporations

Mary LaFrance

48 Vand. L. Rev. 879 (1995)

When professionals and other persons who offer their goods and/or services to the public conduct their businesses through corporations, the Treasury has acknowledged that for federal income tax purposes it must treat those corporations as separate and distinct from their controlling shareholder-employees, even where there is only a single shareholder-employee, provided that the corporation has a business purpose and the taxpayer consistently respects the corporate form. However, the Treasury has refused to accord equal dignity to incorporated workers who offer their services not to the public at large but to a single recipient or a small number of recipients. The rationale for denying the separate taxpayer status of these "loan-out" corporations is that the party "borrowing" the services of the corporation's employee is the true employer under common law rules designed to distinguish between independent contractors and employees.

This Article examines the tax benefits of incorporating a service business and the principles which have evolved to prevent taxpayer abuse of those benefits, and evaluates the Treasury's rationale for using worker reclassification to deny loan-outs the tax benefits available to other closely-held corporations. The examination reveals that the common law worker classification standards are not an appropriate test of whether a corporation or its employee is the principal in a transaction. Although paternalism and administrative convenience arguments may favor classifying workers as employees under some circumstances, these arguments deserve little weight where the worker makes the affirmative decision to form a loan-out, thus acknowledging employee status and disputing only the identity of the employer. In effect, the government's position in the loan-out cases denies the taxpayer the opportunity to select the employment contract that will provide the greatest after-tax returns.

Taken to its logical consequence, the government's worker reclassification approach to disregarding loan-outs would treat any controlled corporation as the agent of its controlling shareholder, a position inconsistent with settled principles of tax law. It is also unnecessary, in light of the anti-abuse rules which are already available to distinguish fraudulent transactions. The Article concludes that the Treasury's effort to disregard properly formed loan-outs through worker reclassification lacks a sound basis in policy and that it increases, rather than decreases, the inequities of the tax system.

The Separate Tax Status of Loan-Out Corporations

Mary LaFrance*

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1. INTRODUCTION

The professional corporation has long been popular with physicians, lawyers, accountants, and other professionals who offer their services to the public. Yet incorporation can offer benefits even to service providers who, because their services are rendered in a capacity historically associated with "employee" status, do not fit the mold of these "traditional" professionals. The desire to avoid employee classification, and to obtain the benefits of the corporate form and independent contractor status, often motivates workers to create an employee loan-out corporation.

In the typical loan-out, an individual service provider forms a corporation¹ in which she is the sole or majority shareholder as well

1. The loan-out may be either a C corporation or an S corporation. In many cases, however, the C corporation offers greater benefits. A C corporation, for example, offers some employee-owners greater potential for tax deferral. See notes 38, 45, 50, and accompanying text. In addition, a controlling shareholder in a C corporation enjoys numerous tax benefits unavailable to controlling shareholders of S corporations. See notes 16, 25, 32-37, and accompanying text; see generally Irving M. Grant and William R. Christian, 1 *Subchapter S Taxation* §§ 1.12, 5.01-5.02 (Shepard's/McGraw Hill, 3d ed. 1990) (recognizing that C corporations offer certain employee fringe benefit tax advantages); Lorence C. Bravenec, *Federal Taxation of S Corporations and Shareholders* § 3.4.1 (PLI, 2d ed. 1988) (discussing the tax consequences of employee fringe benefits in S corporations). On the other hand, S corporations generally avoid the corporate level tax, and therefore, within reasonable limits, can distribute some of their earnings as dividends, thereby reducing payroll taxes. But see *Spicer Accounting, Inc. v. United States*, 918 F.2d 90, 92 (9th Cir. 1990) (reclassifying certain payments to an S corporation shareholder as salary where the shareholder did not purport to receive any salary for his services and characterized all such payments as dividends). Note, however, that if the S corporation shareholder receives dividends in place of salary, the shareholder must pay quarterly estimated taxes, I.R.C. § 6654(a), (c)(1), (c)(2) (1994), thereby precluding the tax deferral that results from delaying a salary payment. See notes 39-42 and accompanying text. S status can also be advantageous if the corporation will continue to receive income after the death of the employee-owner, for example when the employee-owner's services give rise to deferred income in the form of royalties, residuals, and profit participations. The heir who inherits the stock of a C corporation cannot necessarily zero out these revenues by taking a large salary if she is unable to provide sufficiently valuable services to justify such compensation. Thus, the heir faces potential double taxation. Electing S status after the service provider's death, however, would solve this problem while preserving the benefits of C status during the service provider's lifetime. Because a C corporation can offer the benefits of

as the sole or principal employee.² The corporation then negotiates with a third party—the “borrower”—to “lend” the services of the controlling shareholder-employee for a price. The “borrower” pays the contract amount to the loan-out, which in turn pays a salary (and perhaps a token dividend)³ and may also provide fringe benefits such as a retirement plan, a medical reimbursement plan, and various types of insurance to the shareholder-employee. The salary and benefits provided to the shareholder-employee, when combined with the other deductible expenses of the loan-out (which may include additional payments to the shareholder-employee as interest, rents, or royalties), ordinarily reduce the corporation’s taxable income for the year to zero, or almost zero. Thus, even if the loan-out is a C corporation, it will incur little or no corporate level tax.⁴

By performing services as an employee of a corporation of which she is the principal shareholder, the service provider can enjoy the limited liability and certain additional benefits that state law typically affords corporations. The worker also obtains a variety of tax benefits that might otherwise be unavailable. For example, highly compensated individuals may take fuller advantage of their business expense deductions by incorporating and having the corporation bear

deferral and greater deductions, and can avoid double taxation during the service provider’s lifetime by paying a high salary to the shareholder-employee, the discussion in this Article assumes C status unless otherwise specified.

Unless otherwise indicated, all section references herein are to the Internal Revenue Code of 1986 (the “Code”), as amended to date.

2. Although the typical loan-out described here involves a single employee-owner so that one individual can exercise control over the entity, multiple employee-owners can also form a loan-out. In addition, a loan-out may have employers that are not owners.

3. Because the Internal Revenue Service (the “Service”) may attempt to recharacterize an unreasonably large salary payment or other deductible expenses paid to the shareholder as a dividend, which is not deductible, a C corporation loan-out may pay a token dividend. In many cases, however, there is little risk that a loan-out’s salary payment to its employee-owner will be recharacterized as a dividend; ordinarily, the market value of the employee’s services will equal or exceed the amount that the loan-out pays to that employee as salary.

4. In addition to the ordinary corporate income tax, a C corporation that fails to zero out its income may be subject to a special 39.6% tax on any “personal holding company income” that is not distributed to the shareholders as dividends. See I.R.C. §§ 541-543 (1994); see Treas. Reg. § 1.543-1(b)(8)(iii), Example (1) (1994) (indicating that an actor’s loan-out corporation that retains most of its service income has personal holding company income); see, for example, *Kenyatta Corp. v. Commissioner*, 86 Tax Ct. 171, 188-89 (1986) (imposing personal holding company tax on an athlete’s loan-out). Even if personal holding company status can be avoided, a loan-out that does not zero out its income may be subject to an “accumulated earnings tax” of 39.6% on some or all of its undistributed earnings, in addition to the regular corporate tax. I.R.C. §§ 531-537 (1994).

their expenses and deduct them in full, leaving only net profits to be paid out as highly-taxed salary.⁵

Furthermore, by virtue of her status as principal shareholder—and often as president—of the corporation, the shareholder-employee normally has the power to control all decisions of the corporation, including the execution of contracts, the amount and timing of salary payments, the selection of a taxable year, and the nature of any fringe benefits provided. These benefits make loan-outs especially valuable to individuals working in fields where there are frequent job changes, substantial unreimbursed business expenses, and less-than-optimal employer-provided fringe benefits and retirement plans.

Professional corporations of the more traditional sort have gained grudging recognition from the government of their status as “true” corporations that are separate taxpayers rather than mere conduits for their shareholders.⁶ Under a variety of legal doctrines, however, the Internal Revenue Service (“IRS”) has challenged the

5. One Service official has reported auditing 30 entertainment industry loan-outs, with annual income ranging from \$90,000 to \$18.5 million. Compensation paid to loan-out officers ranged from nothing to 94% of corporate revenues, and other deductions ranged from 6% to 82% of revenues. Robert Marich, *Music Industry Makes Debut on IRS Hit Parade*, *Hollywood Reporter* 1, 19 (June 23, 1993).

6. In 1961 Professor Boris Bittker challenged the separate status of corporations formed by professionals such as lawyers and physicians (commonly known as “professional corporations”). Boris I. Bittker, *Professional Associations and Federal Income Taxation: Some Questions and Comments*, 17 *Tax L. Rev.* 1 (1961). Bittker argued that such entities were not “associations taxable as corporations” under the definition set forth in § 7701(a)(3), because they lacked three of the four corporate characteristics. *Id.* at 6-21. Under the state laws in effect at that time, professional corporations lacked limited liability because the professionals who owned the corporations remained personally liable for malpractice claims. *Id.* at 8-13. In addition, because a shareholder could be required to terminate his relationship with the entity under certain circumstances dictated by the statute (for example, loss of license to practice, retirement, bankruptcy, or death), professional corporations lacked continuity of life. *Id.* at 15-17. Finally, since only a qualified practitioner could be a transferee, interests in the entity could not be freely transferred. *Id.* at 17-21.

The Treasury embraced Bittker’s critique in 1965 by adopting Treas. Reg. § 301.7701-2(h). This regulation imposed stricter requirements on professional associations than on other associations seeking corporate status, and would have denied corporate status to virtually any professional association. Courts, however, uniformly invalidated this regulation as exceeding the Treasury’s rulemaking authority. See, for example, *Kurzner v. United States*, 413 F.2d 97, 110-12 (5th Cir. 1969) (holding the Treasury regulation to be arbitrary and discriminatory); *Holder v. United States*, 289 F. Supp. 160, 164-66 (N.D. Ga. 1968), *aff’d per curiam*, 412 F.2d 1189 (5th Cir. 1969) (holding the Treasury regulation invalid as inconsistent with the Code); *O’Neill v. United States*, 410 F.2d 888, 895-99 (6th Cir. 1969) (same); *United States v. Empey*, 406 F.2d 157, 164-70 (10th Cir. 1969) (same). The Service finally conceded the issue in Rev. Rul. 70-101, 1970-1 *Cum. Bull.* 278, in which it recognized the corporate status of professional associations organized pursuant to state statutes governing professional corporations, and the Treasury finally revoked the controversial regulation in 1977. Treas. Dec. 7515, 1977-2 *Cum. Bull.* 482. For a brief history of this regulation, see *Richlands Medical Association v. Commissioner*, 60 *Tax Ct. Mem. Dec.* (CCH) 1572, 1577-79 (1990), *aff’d*, 953 F.2d 639 (4th Cir. 1992).

status of employee loan-out corporations, usually with the goal of denying the shareholder-employee the tax benefits that otherwise would flow from doing business in the corporate form. In some cases, the government has attempted to disregard the loan-out's corporate existence completely; in others, it has respected the corporation's existence but has sought to reallocate the entity's tax attributes in whole or in part to its employee-owner.

Part II of this Article examines the tax and nontax benefits loan-outs achieve under current law. Part III evaluates the government's traditional, as well as more recent, rationales for either challenging the existence of the loan-out corporation as a separate taxpayer or reallocating its tax attributes while respecting its separate status. Part III then attempts to distinguish those challenges that have a sound basis in law and policy from those that represent unprincipled overreaching in the name of revenue enhancement. In particular, Part III criticizes the government's efforts to disregard properly formed loan-out corporations by reclassifying the owner-employee as an employee of the borrowing party under common law principles designed to distinguish between employees and independent contractors. Part IV suggests an alternative approach that respects the corporate form by applying an agency analysis to the relationship between the loan-out and its shareholder-employee. This approach preserves the government's ability to make reallocations when necessary to conform to arm's length pricing standards, and to "pierce the veil" of those corporations that are essentially shams. The Article concludes that the apparent formalism of the loan-out structure is merely a symptom of inequities in the tax treatment of corporations and individuals which should be systematically addressed by Congress. Until then, instead of using worker reclassification principles to disregard a properly formed employee loan-out corporation, the government should recognize the separate taxpayer status of such an entity to the same extent as traditional professional corporations and other corporations providing goods and services to the public at large. In this way, a loan-out corporation can provide a "safe harbor" for workers whose independent contractor status would be uncertain if they remained unincorporated.

II. BENEFITS OF THE LOAN-OUT STRUCTURE

A. *Benefits Unrelated to Income Taxation*

The limited liability that corporations enjoy under state law offers a powerful incentive to incorporate virtually any business enterprise. Moreover, by forming more than one corporation, an individual may isolate the risks associated with each project undertaken, protecting the profits generated by one project from the liabilities arising from another.⁷

The need for asset protection may arise also in the context of a divorce. State law may treat a person's professional goodwill or right of publicity as a marital asset for purposes of a property settlement. If the professional incorporates, contributes these intangibles to the corporation, and shares ownership of the entity with children or other family members, then only those shares of stock owned by the professional will be subject to division.

Contributing valuable intangibles to a corporation,⁸ and issuing shares to family members, may reduce federal estate tax liability, because only the decedent's shares of stock will pass through the estate.

Finally, the party offering compensation for services may wish to engage an independent contractor rather than an employee in order to place their arrangement outside the scope of state worker's compensation laws.

B. *Benefits Related to Income Taxation*

If loan-outs offered only nontax benefits to taxpayers, the government would have little reason to challenge their corporate status.

7. In industries such as advertising and entertainment, suits for defamation, invasion of privacy, copyright or trademark infringement, infringement of the right of publicity, and misappropriation of ideas are common. In addition, a tort or breach of contract suit presents a potential liability for any service-provider. For example, a jury recently found actress Kim Basinger liable for over \$8 million in compensatory and punitive damages in an action for breach of an oral contract to appear in a film. Stephen Galloway, *Basinger Told to Pay All \$8.1 Mil*, *Hollywood Reporter* 1, 18 (Sept. 29, 1993). The verdict in the Basinger case was reversed on appeal because the jury instructions failed to distinguish between Basinger as an individual and Mighty Wind, Inc., her loan-out corporation. Bill Zwecker, *Actress Spared \$8 Million Penalty*, *Chicago Sun-Times* (Sept. 23, 1994). Use of a loan-out in such situations can limit the entertainer's liability and protect personal assets.

8. A recent federal estate tax case held that a deceased author's name was an asset included in her estate for tax purposes. *Estate of Andrews v. United States*, 850 F. Supp. 1279, 1295 (E.D. Va. 1994).

In general, the tax benefits available to loan-out corporations compare favorably with those available to individuals under their two unincorporated alternatives—(1) providing services as a direct employee of the unrelated party consuming the services; and (2) providing services as a sole proprietor. Not every benefit listed here will be meaningful to every individual service-provider; rarely, however, will a loan-out offer a worker no tax advantage at all.⁹

1. Expense Deductions

For many service providers, the most significant tax benefit of using a loan-out is the increased deductibility of their business, medical, and, in some cases, even personal expenses. The loan-out structure almost always provides more generous deductions than traditional employee status, and in certain cases proves superior even to sole proprietor status.

By attributing business expenses to her loan-out rather than to herself as an employee, a service provider can take advantage of the ability of corporate taxpayers (like sole proprietors) to deduct their business expenses without regard to the limitations imposed on traditional employees. For example, a corporation or sole proprietor is allowed a one hundred percent deduction for most ordinary and necessary business expenses.¹⁰ Individual employees, however, may deduct their unreimbursed business expenses only to the extent that their aggregate miscellaneous itemized deductions exceed two percent of their adjusted gross income,¹¹ with no carryover of excess deduc-

9. Until the 1980s, loan-outs offered additional tax advantages, including greater flexibility in selecting a taxable year and the potential for deducting larger retirement contributions than those available to self-employed persons through Keogh plans. As a result, loan-outs were used even more widely than they are today. See generally *Leavell v. Commissioner*, 104 Tax Ct. No. 6, 1995 U.S. Tax Ct. LEXIS 8, *97 n.11 (Jan. 30, 1995) (Laro, J., dissenting); Richard E. Halporin, *Use of Loan-Outs Has Been Limited, But Advantages Remain*, 65 J. Tax. 74 (1986) (noting that the tax advantages of a loan-out have decreased, but that loan-outs still provide some benefits). Because of the recent increase in individual tax burdens, some tax specialists are again urging entertainers to consider incorporation. Gerald Damsky, *Impact of New Tax Law on Entertainers*, Ent. L. & Fin. 5 (Sept. 1993).

10. This deduction is subject, of course, to any other generally applicable limits on the deductibility of business related expenses. See, for example, I.R.C. § 274(n) (1994) (limiting the deduction for meals and entertainment to 50%).

11. I.R.C. § 67(a)-(b) (1994). The 2% floor on unreimbursed employee business expenses discourages individuals from deducting expenses that are at least partly personal in nature. See General Explanation of the Tax Reform Act of 1986, H.R. 3838, Pub. L. No. 99-574, 99th Cong., 2d Sess. 79. It also simplifies the government's enforcement task, reduces the frequency of taxpayer error, and eliminates the requirement that taxpayers undertake extensive record-keeping. *Id.* at 78. The Code allows certain "qualified performing artists" to deduct 100% of

tions.¹² Obviously, whether a worker is characterized as an employee or an independent contractor can make a significant difference in the tax liability of a worker in an industry such as the entertainment industry, where employment related expenses can absorb up to forty percent of a worker's earnings.¹³

In addition, a loan-out, like a sole proprietor, can deduct its business expenses in calculating its adjusted gross income, whereas an employee may deduct business expenses only *after* calculating adjusted gross income. Moving these deductions from "below the line"

their unreimbursed employee expenses, but limits this relief to performing artists with adjusted gross incomes that do not exceed \$16,000 and with unreimbursed employee expenses exceeding 10% of the gross income earned from services in the performing arts as an employee of at least 2 employers during the taxable year. I.R.C. § 62(a)(2)(B), (b) (1994). Therefore, this exception would be of little use to highly paid performers.

12. In addition, employee status makes it more difficult for the taxpayer to qualify for a home office deduction. I.R.C. § 280A(c)(1) (1994). The Supreme Court's decision in *Commissioner v. Soliman*, 113 S. Ct. 701 (1993), currently makes a home office deduction unavailable to service providers who render most of their services at a location outside their dwelling. It appears likely, however, that Congress will eventually overrule *Soliman*, at least in part. See *Tax Deductions: Sen. Hatch Proposes to Restore Full Deductibility of Home Office Expenses*, 48 Daily Tax Rep. (BNA) d4 (March 14, 1994) (reporting on House bill H.R. 3402 and Senate bill S. 1924).

13. See B. Paul Husband, *Tax Issues for Show Business Workers*, Ent. L. & Fin. 3, 7 (June 1993) (discussing the importance of the independent contractor/employee distinction). Entertainers and athletes may retain coaches, secretaries, agents, business managers, and/or personal managers. See Jessica Seigel, *Screen Test: IRS Audits Hollywood; Industry Practices Being Examined*, The Arizona Republic E1 (Jan. 31, 1993) (reporting that fees paid by individual entertainers to agents and publicists are subject to the 2% floor). An agent's commission alone typically absorbs 10% of an entertainer's gross compensation, personal managers may receive 15% to 25%, and business managers may account for another 5%. Donald E. Biederman, et al., *Law and Business of the Entertainment Industries* ¶ 9.01 at 471-73 (Auburn House, 1987). Because entertainers tend to change jobs frequently, their travel, public relations, and entertainment-related expenses can be substantial, as can the other costs associated with seeking new employment and maintaining a high profile within the industry. An employer such as a studio often will not reimburse these work-related expenses because the artist will not have incurred them under its direction or even while in its employ.

Entertainers may also incur medical expenses that do not qualify for a medical expense deduction because they are primarily cosmetic, or because they do not exceed the 7.5% statutory floor on medical expense deductions. See text accompanying note 17. If these expenses can be treated as business expenses, then the loan-out can deduct them without regard to either the 7.5% floor or the 2% floor. Unfortunately for taxpayers, there is significant doubt about the availability of a business expense deduction for medical or cosmetic procedures, or physical conditioning incurred to preserve or enhance an entertainer's appearance or abilities. Compare *Reginald Denny*, 33 Bd. Tax App. 738, 743 (1935) (allowing film actor to deduct the cost of dental bridge to replace teeth knocked out in a prizefight picture) with *Sparkman v. Commissioner*, 112 F.2d 774, 776-78 (9th Cir. 1940) (affirming Tax Court Memorandum Opinion denying an actor's deduction for artificial teeth to improve his enunciation), Rev. Rul. 71-45, 1971-1 Cum. Bull. 51 (denying deduction for a singer's throat treatment), and Rev. Rul. 58-382, 1958-2 Cum. Bull. 59 (ruling that an airline employee could deduct the cost of medical exams required by an employer to establish his fitness to maintain his position, but could not deduct the cost of treatment to maintain fitness). See generally Robert Marich, *Plastic Surgery Deductions Not Real, IRS Says*, Hollywood Reporter 4, 28 (June 22, 1994) (discussing the status of tax deductions that relate to the entertainment industry).

to "above the line" will result in a lower figure for adjusted gross income, thereby giving the loan-out and the sole proprietor an advantage in calculating two deduction ceilings that are based on adjusted gross income: the Section 68 phase-out of certain itemized deductions and the Section 151(d) phase-out of personal exemptions.¹⁴ Therefore, loan-outs and sole proprietors enjoy a decided advantage over conventional employees with respect to their unreimbursed expenses.

Loan-outs, like sole proprietors, also enjoy tax advantages with respect to medical expenses. A corporation that pays the medical expenses (including, but not limited to, health insurance premiums) of its employees (including spouses and dependents) may deduct those costs as business expenses,¹⁵ and the employees generally may exclude them from their gross income.¹⁶ In contrast, an employee who pays such expenses out of pocket may deduct them as personal medical expenses only to the extent they exceed 7.5 percent of her adjusted gross income.¹⁷ Sole proprietors receive the same treatment. Although sole proprietors may deduct thirty percent of their health insurance premiums,¹⁸ any additional health care costs are subject to the 7.5 percent floor.¹⁹ Of course, if an employer provides medical

14. For single taxpayers, the § 68 phase-out commenced at an adjusted gross income of \$111,800 for the 1994 taxable year (subject to increases for inflation in subsequent years). Rev. Proc. 94-72, 1994-50 Int. Rev. Bull. 14; I.R.C. § 68(b)(2) (1994). This phase-out, which applies after the 2% floor, reduces certain itemized deductions—including unreimbursed employee expenses—by 3% of the taxpayer's adjusted gross income over the cap, up to a maximum reduction of 80%. I.R.C. § 68(a), (d) (1994). The phase-out of personal exemptions under § 151(d)(3) commences at the same adjusted gross income level. I.R.C. § 151(d)(3) (1994); Rev. Proc. 93-49, 1993-2 Cum. Bull. 581.

15. I.R.C. § 162 (1994); Treas. Reg. § 1.162-10 (1994); Temp. Treas. Regs. §§ 1.162-10T, 1.167-7 (1994).

16. I.R.C. §§ 105(b), 106 (1994); Treas. Reg. § 1.105-1 (1994). Because this exclusion is unavailable to shareholders who own 2% or more of an S corporation, I.R.C. § 1372 (1994), C status is more advantageous.

17. I.R.C. § 213(a) (1994). Unless restricted as part of national health reform, the flexible spending accounts offered by some corporate employers can help workers avoid the 7.5% threshold even without forming loan-outs, but only to the extent that the employee accurately can predict her deductible medical expenses for the ensuing year. I.R.C. § 125 (1994); Prop. Treas. Reg. § 1.125-2, Q & A-7(b)(6), 2 Stand. Fed. Tax Rep. (CCH) ¶ 7322 (1994).

18. I.R.C. § 162(l) (1995) as amended by Pub. L. No. 104-7, 104th Cong., 1st Sess. (1995), 109 Stat. 93 (expired Dec. 31, 1993). The 25% deduction was also available to shareholders owning 2% or more of S corporations. I.R.C. § 162(l)(5) (expired Dec. 31, 1993). H.R. 2497, if enacted, would have created a 100% deduction for health insurance costs of the self-employed. Recent political developments have prompted some commentators to question whether the deduction can be revived or increased.

19. As in the case of retirement benefits, a union may provide a generous enough health insurance plan to make this feature of the loan-out less significant for union members. Nonetheless, the coverage limits under a union plan may be such that the member can benefit from a supplemental plan that the loan-out provides.

benefits to employees on a discriminatory basis under a self-insured medical reimbursement plan, some or all of the excess benefits will be gross income to the recipients.²⁰ However, it is relatively easy for most loan-outs to provide nondiscriminatory health insurance benefits because they employ only one or two persons.²¹

A loan-out can also deduct—and the employee can exclude—the cost of disability coverage,²² certain employee death benefits,²³ and up to fifty thousand dollars of employee life insurance.²⁴ No such deductions are available to employees or sole proprietors.²⁵

The recent increase in effective tax rates for high income service providers makes the deductions and tax-free fringe benefits available through incorporation even more advantageous. In addition to the actual increase in statutory rates, the 1993 amendments, which permanently extended the phase-out of most itemized deductions for individuals with an adjusted gross income above a specified amount, imposed a greater effective tax burden.²⁶ Thus, to the extent a service-provider can shift these itemized deductions to her loan-out, the deductions will yield greater tax savings.

2. Retirement Benefits

Through a C corporation loan-out, many individuals can obtain better retirement plans than they would obtain through either a sole proprietorship or a more traditional employment relationship. The taxpayer who forms a loan-out can enjoy the “best of both worlds” because the rules governing corporate plans are somewhat more liberal than those governing self-employed plans, and yet, like a sole proprietor, an employee-owner has an opportunity to design her own retirement plan. Indeed, for many workers who, if unincorporated, would be considered employees rather than sole proprietors for tax purposes,²⁷ forming a loan-out may be the only way to obtain a substantial retirement plan.

20. I.R.C. § 105(h) (1994); *Estate of W. Favre Slater v. Commissioner*, 21 Tax Ct. Mem. Dec. (CCH) 1355, 1370, 1382-83 (1962).

21. I.R.C. § 105(h)(3)(A), (h)(7) (1994); Treas. Reg. § 1.105-11(e) (1994).

22. I.R.C. §§ 106, 162 (1994).

23. I.R.C. §§ 101(b), 162 (1994).

24. I.R.C. §§ 79, 162 (1994); Treas. Reg. § 1.79-1(c)(2)(i) (1994). Again, some unions may provide comparable benefits.

25. I.R.C. § 101(b)(3) (1994). These benefits are also unavailable to shareholders who own 2% or more of an S corporation, another reason to prefer C status. I.R.C. §§ 105(g), 1372 (1994).

26. See note 14.

27. See Part III.B.3 (discussing government's approach to classifying workers as employees or independent contractors).

A sole proprietor enjoys some advantages over the typical employee when it comes to funding a retirement plan. Due to their relative lack of bargaining power as well as the nondiscrimination requirements of federal tax laws, most employees cannot design their own retirement plans. Instead, they must accept the terms of their employer's plan, if their employer offers one at all. Therefore, employees may be compelled to accept features that are not to their liking—the nature of the plan (for example, defined contribution or defined benefit), the investment options, the vesting schedule, the amount of the employer's annual contribution, or, of increasing concern in recent years, the financial condition of the employer or fund sponsor.²⁸ Employees cannot supplement a less than optimal employer's retirement plan by setting up an additional plan of their own.²⁹ In addition, some full-time workers may have no access to a retirement plan at all, either because their employers do not offer plans or because they are employed under short term contracts with different employers and do not remain in one job long enough to participate in any employer's plan.

In contrast, an individual who works as a sole proprietor or forms a loan-out enjoys greater latitude in establishing and customizing a retirement plan. Such a plan generally allows significantly larger contributions than could be made to an employee's individual retirement account ("IRA"),³⁰ and may give the worker more freedom

28. See, for example, Georgette Jasen, *Scrutinize Plans Offered By Employers*, Wall St. J. C-1 (May 17, 1994) (recommending that employees seek out more information about employee investment plans); James H. Smalhout, *Avoiding the Next Guaranteed Bailout: Reforms for the Pension Insurance Program*, 11 Brookings Review 12, 12 (March 22, 1993) (discussing federal pension guarantees); *U.S. Private Pensions Were Underfunded by \$71 Billion in 1993*, Wall St. J. C-18 (Dec. 6, 1994) (discussing need for private pension reforms); John Markoff, *A Legal Thicket Amid the Redwoods*, N.Y. Times D-1 (June 4, 1993) (discussing a corporate takeover in which the target's pension liability was assigned to an insurance company whose parent later went bankrupt).

29. An individual retirement account ("IRA") contribution may not exceed \$2,000 per year (\$2,250 for a spousal IRA). I.R.C. §§ 219(b), (c)(2)(A), 408(o)(1)-(2) (1994). Moreover, a worker covered by an employer's plan cannot deduct any contributions to an IRA unless the worker's adjusted gross income falls below prescribed limits (\$35,000 for single taxpayers, \$50,000 for married filing jointly). I.R.C. § 219(g) (1994).

30. The Code currently allows an employer-maintained defined contribution plan to shelter the lesser of \$30,000 or 25% of an employee's first \$150,000 of compensation per year. I.R.C. §§ 415(c)(1), 401(a)(17) (1994). In the case of a defined benefit plan, the annual contribution limit is based on the projected benefits, which may not exceed the lesser of \$90,000 or the participant's average compensation for her three highest paid years. I.R.C. §§ 404(a)(1)(A), 415(b)(1) (1994). The limits are similar for Keogh (self-employed) plans. I.R.C. §§ 401(c), 415(b)(1), (c)(1) (1994) (setting limits for defined benefit and defined contribution plans). These limits often can be increased by combining a defined benefit and a defined contribution plan. I.R.C. § 415(e) (1994).

Where a loan-out's owner-employee belongs to a union that provides retirement benefits through a multi-employer plan (funded by contributions from either the loan-out or the borrowing entity, depending on the terms of the collective bargaining agreement), the opportunity to create a separate retirement fund through a loan-out may be more limited. Typically, the mandatory employer contribution to the guild plan is a specified percentage of the member's compensation for services covered by the collective bargaining agreement, but that percentage generally falls well below the maximum allowed by the Code. Although guild members cannot supplement the guild plan with a deductible IRA, those who incorporate can direct their loan-outs to contribute additional amounts to a separate retirement plan. In the past, the Service has applied the statutory limitations on benefits and contributions separately to loan-out plans and guild plans benefiting the same worker. In other words, the individual was not required to aggregate the two plans, and thus the use of the loan-out enabled the worker to enjoy retirement benefits substantially in excess of those available to unincorporated workers. See, for example, Priv. Ltr. Rul. 7816007 (Jan. 17, 1978) (ruling that actor's guild plan and loan-out plan need not be aggregated for § 415 purposes). This determination apparently applies only where the borrowing entity, rather than the loan-out, makes the guild plan contributions. *Id.*; C. Frederick Reish and Ilene H. Ferenczy, *The Hollywood Pension Dilemma Intensifies with Recent IRS Audit Focus*, 2 J. Tax. Employee Benefits 99, 100-01 (1994). This "double-dipping" has become customary in the entertainment industry, because most guild plans require producers to contribute directly to the guild plans, thus bypassing the loan-outs. See, for example, Screen Actors Guild Codified Basic Agreement of 1989 for Independent Producers, Sec. 32.K(3); Directors Guild of America Basic Agreement of 1990, Sec. 12-105(c); Writers Guild of America Agreement, 1988, Art. 17.A. See Reish and Ferenczy, 2 J. Tax. Employee Benefits at 99, 101. However, the government's tolerance of this double-dipping is inappropriate. Where a single income stream arising from a single transaction supports both sets of retirement contributions, only one plan should be found to exist. If entertainers continue to double-dip in this way, either the loan-out plan or the guild plan should be disqualified for tax purposes.

Not surprisingly, the Service now seems poised to reverse its earlier position. Using one of two possible approaches, the Service apparently intends to scrutinize closely those individuals who maintain loan-out retirement plans in addition to guild plans. Under the first approach, the rules limiting pension benefits would be applied by aggregating the taxpayer's guild and loan-out plans. In this case, the use of a loan-out would still allow the worker to increase his benefits beyond those available under the guild plan alone by increasing his total tax-deferred contribution (aggregating the loan-out plan with the guild plan) to the statutory maximum. See I.R.C. § 413(b)(7) (1994) (stating that, if anticipated employer contributions exceed the stipulated limitations, the Secretary will determine which portion of the employer's contribution will be nondeductible); Treas. Reg. § 1.415-8(e) (1994) (allowing multi-employer plans to be aggregated with nonmulti-employer plans to the extent that such plans provide benefits to a common participant); see also Priv. Ltr. Rul. 9325055 (March 30, 1993) (aggregating individual employer's plan with multi-employer plan). Under the second and more stringent approach, however, the loan-out plan would be disqualified altogether. This second theory is premised on the notion that the Taft-Hartley Act allows only the "employer" to make contributions to a plan, and that only the studio (or other outside payor), which is a party to the collective bargaining agreement, can be an "employer" for this purpose. Reish and Ferenczy, 2 J. Tax. Employee Benefits at 99, 102. This approach, however, is unduly harsh. Most loan-outs are parties to the relevant collective bargaining agreements, *id.* at 101, and when producers contribute directly to guild plans they, in effect, act as agents for the loan-outs maintained by the workers on whose behalf they contribute.

Even if the government adopts the more stringent approach, however, a person who earns some income that falls outside guild jurisdiction (for example, income earned as a producer) can establish a separate loan-out solely for earning that income. While a Screen Actors Guild ("SAG") member's compensation for acting would be subject to a mandatory contribution to the SAG retirement plan, the member's compensation as producer would not be. Nor would it be subject to the requirements of any other guild plan, because producers have no collective bargaining agreements. See Michael D. Scott, *Multimedia: Law and Practice* § 29.03-.04 (Prentice Hall, Supp. 1994) (describing the history and guild contract policies of the Producers

than is available under an employer's plan to determine the size of contributions and the nature of the investment plan. However, the Service often reclassifies as employees certain workers who wish to be treated as sole proprietors for tax purposes, thereby disqualifying their individual retirement plans, known as "Keogh" plans. In order to avoid such reclassification and preserve their individualized retirement plans, these workers may form loan-outs.³¹

Guild of America). If the loan-out is not a party to any collective bargaining agreement involving the payee, then the loan-out plan would not be aggregated with any guild plan for purposes of the benefits and contributions limitations. To prevent such aggregation, the worker should earn guild-related income as a direct employee of a producer or studio, in which case there would then be no legal justification for aggregating the two plans. See C. Frederick Reish and Ilene H. Ferenczy, *Retirement Plan Tips for Talent Guild Members; Dealing with IRS Scrutiny*, Ent. L. & Fin. 5 (Aug. 1994).

31. If the user of services and the loan-out belong to an affiliated service group, then the loan-out's employee will be treated as an employee of the user of services for purposes of several important restrictions applicable to tax-sheltered retirement plans, including the minimum participation standards, the nondiscrimination requirements, the minimum vesting standards, the limitations on benefits and contributions under § 401(a), and the top heavy rules under § 416. See I.R.C. § 414(m)(2) (1994) (defining affiliated service group). The proposed regulations indicate that the affiliated service group rules are directed toward service entities in health, law, performing arts, engineering, architecture, accounting, actuarial science, consulting, insurance, and other businesses where capital is not a material income producing factor. See Prop. Treas. Reg. § 1.414(m)-1(f)(2), 6 Stand. Fed. Tax Rep. (CCH) ¶ 19,162 (1995). However, the rules apply only where the loan-out is partly owned by employees of the borrowing entity. I.R.C. § 414(m)(2)(B) (1994). Where no such relationship exists, the employees of the loan-out should not be treated as employees of the borrower for any of the purposes listed above. Thus, the affiliated service group rules should not defeat the individual's enjoyment of the benefits of a custom designed retirement plan.

Most loan-outs can also avoid the aggregation rules applicable to leased employees. The leased employee rules treat certain "loaned" employees as employees of the "borrowing" entity for purposes of the same retirement plan rules to which the affiliated service group provisions apply, and for purposes of several other employee benefit provisions as well. See I.R.C. § 414(n) (1994) (identifying when a leased employee will be treated as an employee of the borrowing entity). Some loan-out arrangements will be exempt from the leased employee rules because the borrowing arrangement will last less than one year or will not be "substantially full-time." However, even if a loan-out arrangement might otherwise trigger the leased-employee rules, the fact that the leased employee is usually highly compensated will make the rules easy to avoid. Section 414(n) was designed to prevent an employer from avoiding the nondiscrimination rules by leasing its relatively low paid workers from another entity in order to exclude them from its retirement plan. In contrast, the borrower in a loan-out transaction borrows (from an unrelated corporation) the personnel who otherwise would be considered highly compensated employees. The loan-out can then provide retirement benefits superior to those provided by the unrelated borrower without causing the latter to run afoul of the nondiscrimination provisions of § 401(a)(4). Technically, this is because the loan-out can easily qualify for the safe harbor exception of § 414(n)(5), which applies when leased employees constitute no more than 20% of the borrower's nonhighly compensated work force (a requirement easily satisfied where the leased worker is, in fact, highly compensated), and each leased employee participates in a money purchase pension plan of the leasing entity that provides for immediate participation, full and immediate vesting, and a contribution rate of at least 10% of compensation. I.R.C. § 414(n)(5) (1994). See also Treas. Reg. § 1.401-1(b)(1)(i) (1994) (defining money purchase pension plans as

In addition, the tax laws generally allow employees to borrow as much as fifty thousand dollars from their pension plans without adverse tax consequences as long as they pay the loan back within five years.³² While the tax law permits such loans for virtually all employees,³³ an employer is not required to permit such borrowing.³⁴ Thus, the controlling shareholder-employee of a loan-out can enjoy borrowing privileges that might not be available from an outside employer. Furthermore, these borrowing privileges are unavailable to both sole proprietors and shareholders who own five percent or more of an S corporation.³⁵ Thus, the worker who incorporates her service business has a unique opportunity to maximize the benefits of a tax-qualified retirement plan. As an employer itself, of course, the loan-out is subject to the same nondiscrimination rules that apply to any employer offering a qualified plan.³⁶ This should present no problem where the loan-out has only one or two employees, and all such employees are highly compensated.³⁷

3. Tax Deferral

Certain taxpayers may enjoy a modest tax deferral by using a loan-out. The loan-out may accomplish this deferral in two ways: (1) by shifting income recognition to a later taxable year; and/or (2) by postponing the date on which taxes are actually due.

contribution plans that employ contribution formulas based on a percentage of the employee's compensation); Rev. Rul. 73-302, 1973-2 Cum. Bull. 220.

Finally, as long as the leased employee does not own 5% or more of the borrowing entity, the arrangement will also withstand scrutiny under the "leased owner" rules of Proposed Regulation § 1.414(o)-1 (1994), which are designed to prevent evasion of the nondiscrimination rules in situations where the borrowing entity leases only its highly compensated personnel and provides inferior benefits to its own employees, while the lending entity provides superior benefits to the leased employees.

32. I.R.C. § 72(p) (1994).

33. Even if they are employees, shareholders who own more than 5% of an S corporation may not borrow from their pension plans without being subject to a tax equal to 5% of the amount borrowed (100% if the transaction is not corrected within the taxable period). I.R.C. § 4975(a)-(c)(1)(B), (d), (f)(4) (1994); 29 U.S.C. § 1108(d) (1988 & Supp. 1993) (related ERISA provision).

34. If the employer allows its employees to borrow from their pension plans, it must make those loans available on a nondiscriminatory basis. I.R.C. § 4975(c)(1)(B), (d)(1)(A)-(B) (1994).

35. A sole proprietor who borrows from her plan would be subject to the same penalty tax as a shareholder who owns more than 5% of an S corporation. See note 33. See also I.R.C. § 401(c)(1), (3) (1994) (defining "owner-employee").

36. See I.R.C. §§ 401(a)(4), 414(q) (1994) (nondiscrimination rules); *id.* § 416 (rules for top-heavy plans).

37. Thus, the employee-owner seeking to maximize this benefit without extending it to other workers should limit the loan-out's hiring as much as possible, and form only independent contractor or temporary arrangements with other workers.

If the loan-out uses a fiscal year rather than a calendar year for tax reporting, then in some cases a calendar year shareholder-employee may be able to defer both federal and state income tax liability from one calendar year to the next.³⁸ By having the loan-out adopt a fiscal year that spans two calendar years and by postponing most or all of the employee-owner's taxable distribution (salary, interest, rents, and/or royalties) until the end of the loan-out's fiscal year, the shareholder-employee will recognize income during the second calendar year rather than the first. This deferral mechanism allows the owner-employee to direct income to the calendar year in which she may be subject to a lower effective tax rate.

A second, though less significant, deferral benefit arises from the fact that a taxpayer using a loan-out can postpone the date on which she pays taxes. Suppose that a television production entity pays a large part of a writer's compensation in a lump sum in January of 1995. If the writer is a sole proprietor, no payroll taxes will be withheld.³⁹ If she reports her income on a calendar year basis, her federal income tax (and other self-employment taxes) on this compensation will be due in equal quarterly installments during 1995.⁴⁰ Suppose, instead, that the payor makes the January 1995 payment to the writer's loan-out, and the loan-out's taxable year ends in December of 1995. If the loan-out pays the entire amount as salary to the writer in December of 1995, payroll taxes will be withheld only at that later time. Thus, the writer pays her tax liability all at once, in December of 1995,⁴¹ rather than in four equal installments during 1995,⁴² and enjoys the time value of the delayed payment.

The writer will enjoy even greater deferral of tax liability if, absent the loan-out, she would be classified for tax purposes as an employee of the production entity. If she were to receive her salary as an employee, the production entity would be required to withhold her payroll taxes at the time of payment.⁴³ Thus, she would prepay her

38. The Code prevents United States citizens or residents who form loan-outs incorporated under foreign law from exercising this option. I.R.C. §§ 898, 7701(a)(5) (1994).

39. An exception applies if she is a nonresident alien. I.R.C. § 1441 (1994).

40. I.R.C. §§ 1402, 6017, 6654 (1994).

41. If the loan-out used a fiscal year, of course, the salary payment could be delayed until 1996, and the writer would pay taxes at the later year's tax rate. The writer would enjoy the time value of the deferral plus, where applicable, the benefit of any decrease in her effective rate of tax.

42. The loan-out will not have to pay quarterly estimated taxes either, as long as it zeroes out its income for the taxable year.

43. I.R.C. § 3402(a) (1994).

income tax (as well as her social security taxes) on her income from those services at the time she received her compensation—in this case, January of 1995. If the payor instead pays the compensation to the writer's loan-out in January of 1995, this constitutes a payment to an independent contractor, and requires no withholding taxes; withholding is required only when the loan-out pays the writer her salary. If the loan-out makes this salary payment at the end of the taxable year—in this case, December of 1995—the taxpayer will enjoy the time value of the deferred withholding. Thus, by using a loan-out, this taxpayer enjoys a deferral of up to one year, a benefit unavailable to a direct employee of the production entity.⁴⁴

Although all loan-outs can defer tax *within* the shareholder's taxable year, not all can defer tax to the next taxable year. Adopting a fiscal year for tax accounting purposes is generally not an option for loan-outs that are S corporations or "personal service corporations" ("PSCs") for purposes of Section 441.⁴⁵ Because PSCs generally are not permitted to adopt a fiscal year unless they meet certain stringent statutory requirements,⁴⁶ a loan-out that is also a PSC will have more

44. Of course, a writer who is either an employee of the production entity or a sole proprietor can always negotiate for a deferred payment by the service recipient. However, leaving the money in the payor's hands interest-free deprives the payee of its time value. Even if interest accrues, the delayed payout increases the risk of nonpayment if the payor should become financially unsound. With a loan-out, the employee-owner has the security of knowing that the payment for services has been received, and can choose how the loan-out invests this income during the period preceding the salary payment.

45. I.R.C. §§ 441, 444, 1378 (1994). A corporation is a PSC under § 441 if: (1) it is a C corporation, Temp. Treas. Reg. § 1.441-4T(d)(1)(i) (1994); (2) its "principal activity" during the statutory "testing period" consists of providing personal services "substantially performed by employee-owners"; and (3) employees own more than 10% of the corporation's stock, I.R.C. §§ 441(i)(2), 269A(b) (1994); Temp. Treas. Reg. 1.441-4T(d)(1)(iv). For this purpose, an "employee-owner" is any employee who owns, on any day during the testing period, any of the corporation's outstanding stock, I.R.C. § 441(i)(2) (1994); Prop. Treas. Reg. 1.269A-1(b)(2), 48 Fed. Reg. 13438-39 (1994). See also Temp. Treas. Reg. § 1.441-4T(h)(1) (1994) (describing defining characteristics of PSCs); Temp. Treas. Reg. § 1.441-4T(f)-(g) (1994) (defining "principal activity" and "substantially performed"). The testing period is the taxable year preceding the taxable year for which PSC status is at issue (unless the corporation is newly formed). Temp. Treas. Reg. § 1.441-4T(d)(2) (1994).

46. I.R.C. § 441(i)(1) (1994); Temp. Treas. Reg. 1.441-4T(c) (1994). Unless the taxpayer can establish a sufficient "business purpose" for using a fiscal year, see I.R.C. § 441(i)(1), a PSC may adopt a fiscal year only if: (1) it effectuates a deferral of no more than three months (that is, the fiscal year cannot end earlier than September 30), I.R.C. § 444(b) (1994); Temp. Treas. Reg. § 1.444-1T(b)(1) (1994); and (2) by the end of each calendar year, it pays the shareholder(s) compensation that, in the aggregate, satisfies the minimum distribution requirement of § 280H. I.R.C. § 444(c)(2) (1994).

A distribution that passes either of two tests satisfies the § 280H minimum distribution requirement. Under the "preceding year test," the PSC must, by the end of the calendar year, pay to its employee-owners a pro rata portion of the total compensation they received during the prior taxable year. I.R.C. § 280H(c)(1)(A) (1994); Temp. Treas. Reg. § 1.280H-1T(c)(1)(i), (c)(2) (1994). This option would be painless only if the PSC paid no compensation (or relatively little)

limited tax deferral opportunities than a C corporation. This rule prevents significant tax deferral through the use of a loan-out whenever the entity falls within the Section 441 definition of a PSC.

Fortunately for many service-providers, under the current Treasury regulations this limit on deferral opportunities does not apply to all loan-outs. The definition of a PSC under Section 441 excludes many loan-outs because their principal activity is not considered to be the performance of personal services. Under the temporary regulations, a PSC's principal activity⁴⁷ during the testing period⁴⁸ is the performance of personal services *only* if those services are performed in one or more of the following fields: "health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting."⁴⁹ A worker whose principal services fall outside of these areas can still use a fiscal year corporation to defer income recognition.⁵⁰

to its shareholder-employees in the previous taxable year—for example, where a high earning year is preceded by a low earning year. Alternatively, under the "three year average" test, the PSC must pay the employee-owners, by the end of the calendar year, the same percentage (up to a maximum of 95%) of its taxable income earned between the start of the fiscal year and December 31 (before deducting any payments includible in the shareholders' gross income) that the PSC has been paying (on average) to the employee-owners during the preceding three taxable years. I.R.C. § 280H(c)(2) (1994); Temp. Treas. Reg. § 1.280H-1T(c)(1)(i), (3) (1994). For purposes of the minimum distribution requirement, payments to the employee-owners do not include dividends and gains from sales and exchanges of property between the PSC and its employee-owners. I.R.C. § 280H(f)(1) (1994).

47. Personal services will constitute the corporation's "principal activity" if those services account for more than 50% of the corporation's compensation to its employees. Temp. Treas. Reg. § 1.441-4T(f) (1994).

48. Combined with the 50% "principal activity" test, the use of the prior taxable year as the testing period can cause the PSC status of a corporation to fluctuate yearly. For example, assume that a performer's loan-out earns most of its Year 1 income from acting services, but earns most of its Year 2 income from directing, producing, or writing services. Because acting is a personal service for purposes of § 441, whereas directing, writing, and producing apparently are not, see text accompanying notes 52-53, this corporation would be a PSC in Year 2 (a year during which it performed no personal services) but not in Year 3 (a year during which it may have performed exclusively personal services). Thus, under the temporary regulations, PSC status in certain fields can be volatile.

49. Temp. Treas. Reg. § 1.441-4T(e)(1)-(2) (1994) (cross-referencing the list in I.R.C. § 448(d)(2)(A) (1994) and Temp. Treas. Reg. § 1.448-1T(d)(4)(i) (1994)). The temporary regulations vaguely define "consulting" to include "the provision of advice and counsel" and to exclude all other services. Temp. Treas. Reg. § 1.448-1T(d)(4)(iv).

50. In contrast, because S corporations are subject to essentially the same limitations in selecting a taxable year as a C corporation that is a PSC, this deferral opportunity is unavailable to most S corporations, regardless of whether the principal activity of the corporation is in one of the listed fields. I.R.C. §§ 1378, 444 (1994).

Although the listed fields include the “performing arts,” the regulation’s narrow definition of this field excludes many services in the entertainment industry:

[T]he performance of services in the field of the performing arts means the provision of services by *actors, actresses, singers, musicians, entertainers, and similar artists* in their capacity as such. The performance of services in the field of the performing arts does not include the provision of services by persons who themselves are not performing artists (*e.g.*, persons who may manage or promote such artists, and other persons in a trade or business that relates to the performing arts).⁵¹

The emphasized language appears to exclude the services of many highly compensated “behind-the-scenes” players in the entertainment industry—writers, directors, agents, producers, promoters, designers, art directors, composers, choreographers, and technicians.⁵² The definition’s application to certain other categories of performers, including television journalists, is ambiguous. In addition, the definition expressly excludes the “provision of services by athletes,”⁵³ although the temporary regulations fail to define those “services.” Finally, this narrow definition of “personal services” allows some

51. Temp. Treas. Reg. § 1.448-1T(e)(4)(iii) (1994) (emphasis added). See Temp. Treas. Reg. § 1.441-4T(e) (1994) (cross-referencing I.R.C. § 448(d)(2)(A) and the regulations thereunder). The definition of “performing arts” in the temporary § 448 regulations is the same narrow definition that applies to § 441. I.R.C. § 448(d)(2). See also Temp. Treas. Reg. § 1.448-1T(e)(4) (1994); Temp. Treas. Reg. § 1.441-4T(e) (stating that any activity of the taxpayer described in § 448(d)(2)(A) and the regulations thereunder will be considered personal services).

52. See Priv. Ltr. Rul. 9416006, 1994 PRL LEXIS 62 (1994) (holding that director’s loan-out is not a “qualified PSC” under § 448(d)(2) because directing services are not in the “performing arts” field).

53. The temporary regulations state flatly that “the performances of services in the field of the performing arts does not include the provision of services by athletes.” Temp. Treas. Reg. § 1.448-1T(e)(4)(iv) (1994). Surely, however, this would not be the case if the athlete’s loan-out principally performed services not in athletics but in one of the other listed fields, such as consulting or the performing arts. For example, in a given year an athlete’s loan-out might receive more than 50% of its service income from the athlete’s product endorsements or other nonathletic activities. See, for example, Kevin Goldman, *Is There Life After Basketball? Companies That Use Jordan Are About to Find Out*, Wall St. J. B-1 (Oct. 7, 1993) (reporting that basketball player Michael Jordan earned \$36 million from endorsements in 1992, and only \$4 million from playing basketball). Endorsements are not athletics; nor do they fit into any of the other listed fields, with the possible exception of acting. It may be difficult to determine how much, if any, of an athlete’s endorsement income is attributable to “acting” in commercials—if, indeed, appearing as one’s self in a commercial is considered “acting” at all. A professional athlete may also work as a performing artist in other settings—as a recording artist, for example, or as a performer appearing in films, television shows, or music videos, or making personal appearances in a variety of settings. Many, if not most, of these services properly could be considered services in the performing arts and could cause the athlete’s loan-out to be a PSC. An athlete receiving much of her income from rendering such nonathletic “personal services” could take the precaution of using a separate loan-out only for athletic services. This loan-out would not be a PSC for purposes of § 441 and, thus, could adopt a fiscal year.

workers providing multiple services to the same payor to use fiscal year loan-outs, even though some of the services provided are "personal services" for purposes of Section 441.⁵⁴

As a matter of policy, it is not at all clear why deferral should be available to workers in some service industries but not in others.⁵⁵ Even if it could be demonstrated that abuses have been historically more prevalent in the listed fields, a prophylactic rule would seem appropriate to prevent future abuses in other fields that are equally service oriented.⁵⁶ This discontinuity could be eliminated either by repealing the fiscal year restrictions or by broadening the definition of personal services.⁵⁷ Under the current definition, it is clear that many

54. For example, a performer's loan-out may agree that its employee will both direct and act in a film. If the contract with the borrower designates most of the compensation as payment for directing rather than acting, the performer's loan-out may avoid characterization as a PSC for § 441 purposes. Even greater flexibility is available if the contract specifies that the performer will act and serve in a capacity such as "executive producer," a position less clearly defined than that of director. Provided that the allocation is not demonstrably unreasonable, it should be respected for tax purposes.

55. Neither the legislative history of § 441 nor the Treasury's rule-making record explain this seemingly arbitrary classification scheme for "personal services." See 52 Fed. Reg. 48524-25 (Dec. 23, 1987) (Temporary Treasury Regulations, Explanation of Provisions) (noting that before deciding to use the same narrow definition of personal services that applies to § 448, the drafters of the § 441 regulations considered numerous alternative definitions). However, the scheme mirrors that used in § 448 and the temporary regulations thereunder to determine which taxpayers may use the cash method of tax accounting. I.R.C. § 448(d)(2)(A); Temp. Treas. Reg. § 1.448-1T(e)(4)(i) (1994).

56. In its public comments on the proposed § 448 regulations, members of the American Bar Association's Section of Taxation focused on the exclusion of athletes:

Since there is no mention of athletes in the statute or the legislative history surrounding I.R.C. section 448, we question the regulatory authority to specifically exclude athletes. While athletes may not be generally regarded as providing services in the field of "performing arts," the services rendered by many athletes are somewhat difficult to distinguish from those rendered by many entertainers. In fact, many athletes are entertainers in the traditional sense. Thus, we are not sure there is any policy reason for excluding athletes from the definition of performing artists.

Section of Taxation, American Bar Association, *Comments on Proposed Treasury Regulations Section 1.448*, reprinted in *Tax Notes Today* (Dec. 24, 1987). One can imagine some lively debates over whether professional figure skaters, ice dancers, gymnasts, ballet dancers, and wrestlers are athletes or entertainers.

57. I.R.C. § 1202 (1994), which creates a capital gains exclusion for certain corporate stock but denies this treatment for stock issued by corporations engaged in specified service industries as well as those engaged in "any other trade or business where the principal asset of the trade or business is the reputation or skill of one or more of its employees," suggests one possible model for such a broadened definition of personal services. The Temporary Regulations' passive activity loss rules, which define a "personal service activity" as personal services in "health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting; or [a]ny other trade or business in which capital is not a material income-producing factor" provide another model. Treas. Reg. § 1.469-5T(d) (1994). See also Daniel N. Shaviro, *Passive Loss Rules* § III.B.2.f (Tax Management, 1993) (discussing standards for material participation in a personal service activity); Prop. Reg. 1.414(m)-2(f)(1) (1994) (adopting

athletes, entertainers, and other service providers can continue to defer taxation of their service income by incorporating and adopting a fiscal year.⁵⁸

4. International Tax Consequences of Loan-Out Arrangements

Because of the wide variation in foreign income tax laws as well as the international income tax treaties that govern transnational service income, it is difficult to generalize about the international tax consequences of loan-outs for services performed outside an individual's country of residence. It is fair to say, however, that any special advantages of a loan-out in the international context must be evaluated on a case-by-case basis.

In some cases, the use of a loan-out for transnational service activities is not advantageous at all. For example, if tax credits in the worker's residence country will fully offset the income tax imposed by the source country, then a loan-out generally will be unhelpful.⁵⁹ However, if the source country tax exceeds the residence country tax or is otherwise not fully creditable, the service provider may wish to explore methods of reducing or eliminating the source country tax so that she will be taxed only in the country of residence. Depending on the exact terms of the source country's tax laws and the applicable tax treaty, the use of a loan-out can facilitate this reduction or elimination.

In the absence of a treaty, income from performing personal services in the United States is generally considered "effectively

the material income producing factor test for aggregating retirement plans maintained by affiliated service groups).

58. Indeed, if the government is unsuccessful in its ongoing efforts to disregard loan-out corporations formed by athletes as well as those formed by writers, directors, and other workers who provide services outside of the listed fields (discussed in Part III), the Treasury will have a stronger incentive either to seek congressional clarification of the standards for disregarding the corporate form, or to exercise its rulemaking powers by broadening the regulatory definition of PSCs to apply to services currently excluded. Although this change could reduce or eliminate the opportunity for tax deferral, it would not address the government's other concerns about the use of loan-outs.

59. Many United States entertainers use their loan-outs for domestic contracts only because their individual foreign taxes are creditable against their United States taxes. Some countries might tax a United States loan-out on gross revenues, or might disallow some of the loan-out's deductions, thus imposing a tax on the corporation that would not be creditable in the United States, where the loan-out has no federal tax liability because it zeroes out its income, and cannot pass its foreign tax credits to its shareholders unless it is an S corporation. See I.R.C. § 1366(a)-(b) (1994); Schuyler M. Moore, *The Filmed Entertainment Industry* ¶ 1002.03 (CCH Tax Transactions Library); Halperin, 65 J. Tax. at 79 (cited in note 9); Thomas N. Lawson and Bruce M. Stigitz, *Tax Planning for Entertainers, Artists and Athletes: The Continued Viability of Loan-Out Corporations after Tax Reform*, Ent. L. Rep. 14-16, 36-52 (Aug. 1989).

connected" with the conduct of a United States trade or business, and is therefore taxed in the same manner regardless of whether the earner (an individual or a corporation) is a United States resident.⁶⁰ The tax consequences, however, may be different where a tax treaty applies. Many treaties bar the source country from taxing nonresident individuals on income generated by rendering personal services in an independent capacity in the source country *unless* either: (1) the income is attributable to a "fixed base regularly available to the individual" in the source country; or (2) the individual spends more than 183 days of the taxable year in the source country.⁶¹ With proper tax planning, many visiting service-providers can avoid having a fixed base in the source country, and can observe the 183-day limit, thus avoiding source country tax if they are working in an independent capacity.⁶²

60. I.R.C. §§ 864(b), 871(b) (1994); Treas. Reg. § 1.864-2(a) (1994). A de minimis exception applies to nonresident alien individuals who are present in the United States for no more than 90 days and whose compensation for services performed within the United States does not exceed \$3,000 and is borne by a foreign employer. I.R.C. § 864(b)(1) (1994).

61. See, for example, U.S.-United Kingdom Income Tax Treaty, 31 U.S.T. S668, Art. 14. (1975) (Hereinafter, all United States tax treaties will be identified solely by the name of the treaty partner—for example, "United Kingdom.") Although this approach is typical, some treaties are less generous. See generally Joseph Isenbergh, 2 *International Taxation* ¶¶ 39.3-.4 at 379-81 (Little, Brown, 1990) (discussing the 183-day rule). The 1981 U.S. Model Treaty, which was withdrawn in 1992, did not define "fixed base," but appeared to associate it with an office or other place of business. See *id.* at ¶¶ 39.2-.3 at 378-80 (discussing "fixed base" in the U.S. Model Treaty and other treaties); 1981 U.S. Model Income Tax Treaty, Art. 14, reprinted in Isenbergh, 2 *International Taxation* Appendix A at 461. The concept appears to be similar to a permanent establishment. See note 63. The Organization for Economic Cooperation and Development's 1992 Model Income Tax Treaty ("1992 OECD Model Treaty") does not define "fixed base." 1992 OECD Model Treaty, reprinted in 1 *Tax Treaties* ¶ 2001 (Warren, Gorham & Lamont, 1995). However, the commentary to the 1992 OECD Model Treaty indicates that:

It has not been thought appropriate to try to define ["fixed base,"] but it would cover, for instance, a physician's consulting room or the office of an architect or lawyer. A person performing independent personal services would probably not as a rule have premises of this kind in any other State than of his residence. But if there is in another State a centre of activity of a fixed or a permanent character, then that State should be entitled to tax the person's activities.

OECD Committee on Fiscal Affairs, Model Tax Convention on Income and on Capital, Commentary on Article 14 ¶ 4 at C(14)-2 (March 1994) ("1992 OECD Commentary"). See also Rev. Rul. 75-131, 1975-1 Cum. Bull. 389 (adopting same approach based on similar language in 1963 OECD Commentary). A theater, concert hall, club, or soundstage conceivably could be a fixed base if the entertainer performed there regularly, although, even in that case, it is arguable whether such a facility would be sufficiently at the artist's disposal to be considered "regularly available." Because of this uncertainty, a taxpayer seeking treaty protection from source country taxation should try to avoid any activities that could lead to a finding of either a fixed base or a permanent establishment in the source country.

62. The treaty exception for services rendered in an independent capacity applies to individuals, not entities. See, for example, 1981 U.S. Model Income Tax Treaty, Art. 14, reprinted in 1 *Tax Treaties* ¶ 1022 at 1419; Rev. Rul. 54-119, 1954-1 Cum. Bull. 156 (finding that

In contrast, if a nonresident alien worker is an employee, treaty rules generally subject the worker to source country tax even if the worker observes the 183-day limit, *unless* the employer is a nonresident.⁶³ Thus, under the general treaty rules governing personal services income, both a nonresident independent contractor and a nonresident employee of a foreign corporation typically can spend up to six months working in the treaty country without paying any source country tax.⁶⁴ In the latter case, the foreign corporation also generally avoids source country taxation as long as it does not have a permanent establishment in the source country.⁶⁵

Because of these provisions, a service provider will often seek to avoid being characterized as an employee of the source country entity for which she performs services by forming a loan-out corporation in the residence country, and making sure that all relevant con-

the income of a Canadian corporation attributable to an entertainer's personal appearances was not personal services income, and was exempt from United States tax in the absence of a permanent establishment). Services are considered to be rendered in an independent capacity unless the individual is an employee. See generally, Boris I. Bittker and Lawrence K. Lokken, *Fundamentals of International Taxation* ¶ 66.3.9 at 66-59 to 66-63 (Warren, Gorham & Lamont, 1991) (discussing treaty modifications).

63. Specifically, employees are exempt from source country tax only if all of the following conditions are satisfied: (1) the employee is present in the source country for no more than 183 days of the individual's taxable year; (2) the employer is a nonresident; and (3) the employee's compensation is not borne by a permanent establishment of the employer in the source country. See, for example, Canada, Art. 15, 56 Stat. 1399, T.I.A.S. 11087 (1980). See generally Isenbergh, 2 *International Taxation* ¶ 39.4 (cited in note 61) (discussing the 183-day rule). The term "permanent establishment" generally refers to "a fixed place of business through which the business of an enterprise is wholly or partly carried on." See, for example, Canada, Art. 5; 1992 OECD Model Income Tax Treaty, Art. 5. The term typically would include, for example, an office and certain dependent agents or employees who habitually enter binding contracts in the source country on behalf of the principal, but it would not include independent agents such as those who normally represent performing artists. See generally Bittker and Lokken, *Fundamentals of International Taxation* ¶ 66.3.9 at 66-59 to 66-63 (discussing treaty modifications); Isenbergh, 2 *International Taxation* ¶ 38.13 at 363-65 (discussing permanent establishments arising by imputation from agents).

64. Numerous private letter rulings have exempted foreign entertainers under treaty provisions. See, for example, Priv. Ltr. Rul. 7736003 (June 8, 1977) (Ireland); Priv. Ltr. Rul. 7751092 (Sept. 27, 1977) (Ireland); Priv. Ltr. Rul. 7913077 (Dec. 28, 1978) (Ireland); Priv. Ltr. Rul. 8015068 (Jan. 15, 1980) (Japan); Priv. Ltr. Rul. 8336071 (June 9, 1983) (Netherlands); Priv. Ltr. Rul. 8309055 (Nov. 29, 1982) (Netherlands); Priv. Ltr. Rul. 8028024 (April 15, 1980) (Netherlands); Priv. Ltr. Rul. 7832031 (May 10, 1978) (Netherlands); Priv. Ltr. Rul. 7802039 (Oct. 14, 1977) (Netherlands); Priv. Ltr. Rul. 7829134 (April 24, 1978) (Netherlands); Priv. Ltr. Rul. 7850037 (Sept. 14, 1978) (Netherlands); Priv. Ltr. Ruls. 7744036, 7744037 (Aug. 8, 1977) (Netherlands); Priv. Ltr. Rul. 7802038 (Oct. 14, 1977) (Austria); Priv. Ltr. Rul. 7811092 (Dec. 19, 1977) (Austria); Priv. Ltr. Rul. 7917105 (Jan. 26, 1979) (Austria); Priv. Ltr. Rul. 7933027 (May 15, 1979) (Austria); Priv. Ltr. Rul. 8024067 (March 20, 1980) (Austria); Priv. Ltr. Rul. 8027057 (April 10, 1980) (Austria); Priv. Ltr. Rul. 8029070 (April 24, 1980) (Austria); Priv. Ltr. Rul. 8311022 (Dec. 10, 1982) (Austria); Priv. Ltr. Rul. 8337036 (June 13, 1983) (Austria); Priv. Ltr. Rul. 8339079 (June 29, 1983) (Austria); Priv. Ltr. Rul. 8439039 (June 26, 1984) (Austria); Priv. Ltr. Rul. 7821113 (Feb. 27, 1978) (Belgium).

65. But see note 63 (noting the potentially broad definition of permanent establishment).

tracts with the source country entity name the loan-out as the principal.⁶⁶ Under the United States tax treaty rules described above, the foreign loan-out itself avoids source country tax if it lacks a permanent establishment in the taxing state.⁶⁷ As long as the shareholder-employee observes the 183 day limit, she avoids source-country tax if her salary is paid by a nonresident corporation that has no permanent establishment in the source country. Thus, as long as the source country's tax authority respects the foreign loan-out's corporate status, neither the loan-out nor its employee will be subject to source country taxation on services income.

Although these treaty provisions benefit many service providers, certain workers in the entertainment industry face special limitations. Many newer treaties include an "artistes and athletes" clause that allows the source country to tax athletes and many other entertainers on their source country performing income above a specified (and usually low) amount.⁶⁸ With some exceptions, this clause typically applies without regard to the entertainer's status as employee or

66. Sometimes a non-United States resident may form a loan-out in a country other than her residence country to take advantage of a favorable United States tax treaty. However, "Limitations on Benefits" provisions contained in newer treaties bar a resident of a nontreaty country from exploiting the provisions of a United States treaty with a second country by conducting their United States activities through a controlled corporation in that second country. See, for example, France, Art. 24A, 19 U.S.T. 5280, T.I.A.S. 6518 (1967).

67. See Treasury Dep't Technical Explanation of the Convention Between the United States of America and Canada With Respect to Taxes on Income and On Capital, 1986-2 Cum. Bull. 275, 277-78. See also Rev. Rul. 67-321, 1967-2 Cum. Bull. 470 (ruling that a French corporation producing a floor show in a United States hotel lacked a permanent establishment under the French treaty where contracts for terms of 10 weeks were executed outside the United States).

68. A number of United States tax treaties currently in force contain artistes and athletes clauses. See, for example, Australia, Art. 17, T.I.A.S. 10773 (1982); Barbados, Art. 17, T.I.A.S. 11090 (1980); Belgium, Art. 14, 23 U.S.T. 2687, T.I.A.S. 7463 (1970); Canada, Art. 16 (cited in note 63); the People's Republic of China, Art. 16, S. Treaty Doc. No. 30, 98th Cong., 2d Sess. (1984); Cyprus, Art. 19, T.I.A.S. 10965 (1984); Egypt, Arts. 17 & 18, 33 U.S.T. 1809, T.I.A.S. 10149 (1981); Finland, Art. 17, S. Treaty Doc. No. 11, 101st Cong., 2d Sess. (1990); France, Art. 15A (cited in note 66); Germany, Art. 17, S. Treaty Doc. No. 10, 101st Cong., 2d Sess. (1990); Iceland, Art. 18, 26 U.S.T. 2004, T.I.A.S. 8151 (1975); India, Art. 18, S. Treaty Doc. No. 5, 101st Cong., 2d Sess. (1990); Indonesia, Art. 17, T.I.A.S. 11593 (1988); Italy, Art. 17, T.I.A.S. 11064 (1984); Jamaica, Art. 18, 33 U.S.T. 2865, T.I.A.S. 10206 (1980); Japan, Art. 17, 23 U.S.T. 967, T.I.A.S. 7365 (1971); Malta, Art. 18, 34 U.S.T. 3527, T.I.A.S. 10567 (1982); Mexico, Art. 18, S. Treaty Doc. No. 7, 103d Cong., 1st Sess. (1992); Morocco, Art. 16, 33 U.S.T. 2545, T.I.A.S. 10194 (1977); New Zealand, Art. 17, T.I.A.S. 10772 (1982); Norway, Arts. 13 & 14A, 23 U.S.T. 2832, T.I.A.S. 7474 (1971); the Philippines, Art. 17, 34 U.S.T. 1277, T.I.A.S. 10417 (1976); Romania, Arts. 14 & 15, 27 U.S.T. 165, T.I.A.S. 8228 (1973); Spain, Art. 19, S. Treaty Doc. No. 16, 101st Cong., 2d Sess. (1990); Sweden, Art. 11, 54 Stat. 1759, Treaty Ser. No. 958 (1939); United Kingdom, Art. 17 (cited in note 61).

independent contractor,⁶⁹ or to the existence of a fixed base in the source country.⁷⁰ The clause treats artistes and athletes rather harshly compared to other service-providers; however, this special treatment appears to reflect the fact that artistes and athletes may derive a substantial amount of income from short visits to numerous countries during the taxable year, and also have more freedom than many workers to select a tax haven as their country of residence.⁷¹

Artistes and athletes clauses typically include a second provision targeting certain loan-outs. This provision is intended to allow the source country to tax the full amount of income earned by the efforts of a foreign entertainer or athlete (rather than just the performer's salary) whenever the income accrues to a foreign corporation in which the performer is a direct or indirect profit participant.⁷² Thus, zeroing-out the loan-out's income through payments to the owner-employee would not reduce the source country tax. No permanent establishment or fixed base is required.

However, loan-outs still benefit many service-providers in the international context. First, the artistes and athletes clause does not apply to workers who are neither artistes nor athletes. Thus, visiting

69. Most of the artistes and athletes clauses in the treaties listed in note 68 draw no distinction between employees and independent contractors. A few apply only to independent contractors. See, for example, Belgium, Art. 14; Japan, Art. 17.

70. See, for example, France, Art. 15A (cited in note 66); see Bittker and Lokken, *Fundamentals of International Taxation* ¶ 66.3.9 at 66-62 (cited in note 62) (discussing treaty rules for artistes and athletes).

71. See generally Isenbergh, 2 *International Taxation* ¶ 39.8 at 384 (cited in note 61) (noting that the frequency with which performers and athletes move around would allow them a virtual exemption from taxation under standard treaty provisions governing performance of services). For an impassioned, but unsuccessful, plea to end this discrimination against entertainers, see Hearing Transcript, Senate Committee on Foreign Relations, Subcommittee on Economic and Social Affairs (April 12, 1951) (statement of Adrian McCalman, President, Artists Managers Guild), reprinted in *Tax Notes International* (April 21, 1990).

72. See 1992 OECD Model Treaty, Art. 17 (cited in note 61); 1992 OECD Commentary (cited in note 61). Most of the treaties listed in note 68 contain such a loan-out clause; exceptions include Belgium, Romania and Sweden. Article 18 of the Japan treaty, however, has a look-through provision that reaches loan-outs regardless of the type of services they provide. See 1980-1 Cum. Bull. 455, 469-70 (containing the Treasury Department's technical explanation of United Kingdom treaty). See generally Isenbergh, 2 *International Taxation* ¶ 39.10 at 385-86; Halperin, 65 *J. Tax.* 74 (cited in note 9); Bittker and Lokken, *Fundamentals of International Taxation* ¶ 66.3.9 at 66-62 (cited in note 62). The intended scope of the clause is rather unclear. While its terms are broad enough to encompass any entity that pays out a portion of its income to the individual service provider, if the clause were applied this broadly it would treat all foreign employers as "fronts" for their employees. This clause apparently is aimed at loan-out entities that defer a substantial portion of the shareholder-employee's earnings until those earnings are subject to reduced rates of tax, or no tax at all, by the source country. See 1980-1 Cum. Bull. 455, 469. Thus, in combination, these two provisions of the typical artistes and athletes clause are intended to prevent an individual nonresident from using a loan-out that lacks a permanent establishment in the source country as a means of avoiding source country taxation.

service-providers in other fields may still employ loan-outs to exploit the treaty exemptions for independent contractors and employees of nonresident entities.

In addition, even within the entertainment and sports industries workers can still use loan-outs to avoid taxes under some circumstances. Some treaties—older ones in particular—either lack an artistes and athletes clause altogether⁷³ or contain a version that applies only to services rendered in an independent capacity.⁷⁴ And even when the clause applies to dependent services as well, the term artistes and athletes has been interpreted narrowly. For example, the United States Treasury Department's technical explanation of the United Kingdom treaty indicates that while the term artiste includes "entertainers such as theater, motion picture, radio, or television artistes, and musicians and athletes, for their personal activities as such," it *excludes* "producers, directors, technicians and others who are not artistes and athletes."⁷⁵ Similarly, the Organization for Economic Cooperation and Development ("OECD") has acknowledged that it is "not possible to give any precise definition of 'artiste.'"⁷⁶ Specifically, the OECD has interpreted the term "artiste" in Article 17 of its Model Convention to exclude "producers, film directors, choreographers, technical staff, etc.," as well as "impresarios" and other "support staff of artistes and athletes."⁷⁷ While the overall scope of this exclusion is far from clear, it is beyond question that many enter-

73. See, for example, Austria, 8 U.S.T. 1699, T.I.A.S. 3923 (1956); Denmark, 62 Stat. 1730, T.I.A.S. 1854 (1948); Greece, 5 U.S.T. 47, T.I.A.S. 2902 (1950); Hungary, 30 U.S.T. 6357, T.I.A.S. 9560 (1979); Ireland, 2 U.S.T. 2294, T.I.A.S. 2355 (1949); Korea, 30 U.S.T. 5253, T.I.A.S. 9506 (1976); Luxembourg, 15 U.S.T. 2355, T.I.A.S. 5726 (1962); the Netherlands, S. Treaty Doc. No. 6, 103d Cong., 1st Sess. (1993); Pakistan, 10 U.S.T. 984, T.I.A.S. 4232 (1957); Poland, 28 U.S.T. 891, T.I.A.S. 8486 (1974); Russia, S. Treaty Doc. No. 39, 102d Cong., 2d Sess. (1993); and Switzerland, 2 U.S.T. 1751, T.I.A.S. 2316 (1951).

74. See, for example, Belgium, Art. 14 (cited in note 68).

75. 1980-1 Cum. Bull. 455, 469. One commentator has suggested that this definition would also exclude coaches, trainers, and managers. Halperin, 65 J. Tax. at 79 (cited in note 9).

76. OECD, *The Taxation of Income Derived from Entertainment, Artistic and Sporting Activities*, in 2 *Issues in International Taxation* 52-53 (OECD, 1987) (*Issues in International Taxation*). For example, while "conference lecturers and persons interviewed on television are clearly not 'artistes' in the meaning of Article 17," there are "a variety of . . . situations where . . . appearance on television or in public could generally be seen as 'acting' for entertainment purposes." *Id.* at 53. See also OECD Commentary at C(17)-1 to C(17)-2 (cited in note 61) (similar, giving examples).

77. OECD, 2 *Issues in International Taxation* at 53. Both the Treasury Department's technical explanation of the United Kingdom treaty and the OECD interpretations of its 1977 and 1992 Model Conventions are silent on whether the clause applies to writers, but the exclusion of directors, producers and choreographers strongly suggests an intent to exclude all behind-the-scenes personnel, including writers.

tainment related services are insulated from the harsh effects of the typical artistes and athletes clause, and that workers outside the sports and entertainment fields are completely excluded from its scope.⁷⁸

III. CHALLENGING THE LOAN-OUT STRUCTURE

The tax and nontax benefits described in Part II make incorporation attractive to many individuals in service industries. When a service corporation is controlled by one or even two of its employees, however, the government has frequently viewed efforts to obtain these tax benefits as abusive, and has therefore sought to disregard the structure of the loan-out arrangement, either by denying taxpayer status to the loan-out or by reallocating the loan-out's gross income to its employee-owner(s).

To achieve these results, the government has resorted to several means of attack: (1) the assignment of income doctrine,⁷⁹ including the sham incorporation doctrine; (2) Section 482;⁸⁰ (3) Sections 269 and 269A;⁸¹ and (4) the reclassification of the loan-out's employee-shareholder as an employee of the party receiving the loan-out's services. This Part examines each of the government's rationales for disregarding the structure of a loan-out transaction, first addressing those doctrines that do not involve reclassifying the loan-out's employees, and then focusing special attention on the worker reclassification approach, as typified by *Sargent v. Commissioner*.⁸²

78. This exclusion creates tax planning opportunities when an entertainer is employed in two capacities, for example, as actor and director. The entertainer's income from acting in a film would trigger tax under an artistes and athletes clause, whereas the entertainer's income as director of that same film would be beyond the reach of that provision. Entertainers or athletes whose work abroad can be classified under several headings have an incentive to allocate more of their income to the services that fall outside the scope of the artistes and athletes clauses. The allocation must be a reasonable one, because the tax authorities are likely to scrutinize any allocation that is highly favorable to the taxpayer. OECD, 2 *Issues in International Taxation* at 53; 1992 OECD Commentary at C(17)-2 (cited in note 61); Victor Abrams, et al., *International Taxation of Entertainers and Athletes: Report by Organization for Economic Cooperation and Development Spotlights the Area*, 10 Ent. L. Rep. 3, 6 (1988). It is interesting to note that the services that fall outside the typical artistes and athletes clause include many of the same services that the definition of personal services under § 441 appears to exclude. See notes 47-54 and accompanying text.

79. I.R.C. § 61 (1994).

80. I.R.C. § 482 (1994).

81. I.R.C. §§ 269, 269A (1994).

82. 93 Tax Ct. 572 (1989), rev'd, 929 F.2d 1252 (8th Cir. 1991).

A. Challenges Not Involving Worker Reclassification

1. Assignment of Income and Sham Incorporation

In its efforts to disregard the loan-out's corporate form, the government has in some cases attempted to reallocate all of the corporation's income, deductions, and other tax attributes to the controlling shareholder-employee as the true earner of the income from services. This approach takes two forms: (1) the assignment of income doctrine under Section 61 of the Code as developed by courts in *Lucas v. Earl*⁸³ and its progeny; and (2) the sham incorporation doctrine.⁸⁴ In theory, the doctrines are distinct: a corporation need not be a sham in order for a court to find that a different taxpayer was the true earner of the income reported by the corporation.⁸⁵ However, because a sham corporation cannot be a taxpayer, any invocation of the sham incorporation doctrine in the income tax context necessarily invokes the assignment of income doctrine, although many applications of the assignment of income doctrine do not invoke the sham incorporation doctrine.

The published opinions in tax cases involving corporations controlled by sole shareholder-employees do not always clearly distinguish the assignment of income doctrine from either the sham incorporation doctrine or Section 482.⁸⁶ For example, the Tax Court stated

83. 281 U.S. 111 (1930).

84. The sham incorporation doctrine has been traced to the Supreme Court's decision in *New Colonial Ice Company v. Helvering*, where the Court stated that:

As a general rule a corporation and its stockholders are deemed separate entities and this is true in respect of tax problems. Of course, the rule is subject to the qualification that the separate identity may be disregarded in exceptional circumstances where it otherwise would present an obstacle to the due protection or enforcement of public or private rights.

292 U.S. 435, 442 (1934) (footnotes omitted).

85. *Haag v. Commissioner*, 88 Tax Ct. 604, 611 (1987) (noting that a finding that the corporation in question is not a sham does not preclude application of the assignment of income doctrine); *Borge v. Commissioner*, 405 F.2d 673, 678 (2d Cir. 1968); *Jones v. Commissioner*, 64 Tax Ct. 1066, 1076 (1975) (applying the assignment of income doctrine to a corporation held not to be a sham for tax purposes). Compare *Commissioner v. Bollinger*, 485 U.S. 340, 349-50 (1988) (holding that a corporate subsidiary need not be a sham in order to act as an agent for its parent).

86. See, for example, *Keller v. Commissioner*, 77 Tax Ct. 1014, 1030-34 & n.21 (1981), aff'd 723 F.2d 58 (10th Cir. 1983) (treating assignment of income and sham incorporation arguments as equivalent, and identifying § 482 as a means of combatting tax avoidance and of facilitating application of the assignment of income doctrine); *Borge*, 405 F.2d at 676-77 (applying § 482 even though the corporation did not participate at all in the income-generating transactions); *Laughton v. Commissioner*, 40 Bd. Tax App. 101, 105 (1939), remanded, 113 F.2d 103 (9th Cir.

in one case that applying the assignment of income doctrine to reallocate all of the income of a PSC to its controlling shareholder would be the equivalent of treating the corporation as a sham.⁸⁷

A corporation will be treated as a sham and therefore disregarded for tax purposes when the shareholder-employee disregards the corporate formalities⁸⁸ or when the corporation performs no "meaningful business function."⁸⁹ Failure to identify the corporation to other parties as the principal in the contracts and transactions that give rise to the income and deductions at issue has also led courts to treat the corporation as a sham.⁹⁰ Although in such a case the as-

1940) (finding that whether a controlled corporation is a principal or merely an agent of an employee-shareholder depends on whether the corporation is recognized as an entity separate from the employee-shareholder); *Philipp Bros. Chemicals, Inc. v. Commissioner*, 435 F.2d 53, 57 (2d Cir. 1970) (quoted in *Keller*, 77 Tax Ct. at 1034) (stating that § 482 "rests on the well-settled policy that income is taxable . . . to the party who earns it and that it is economic reality rather than legal formality which determines who earns income"); *Jones*, 64 Tax Ct. at 1073-79 (applying distinctly separate analyses under §§ 61 and 482 but reaching the same holding under each approach).

87. *Fatland v. Commissioner*, 48 Tax Ct. Mem. Dec. (CCH) 1107, 1112 (1984) (adding that "the assignment of income doctrine has no place in the personal service context as long as even minimum respect is given to the corporate entity"). Accord *Keller*, 77 Tax Ct. at 1031 (finding that a 100% reallocation would render the corporation "a nullity for federal income tax purposes"). This suggestion is overbroad, for income may be reallocated from one taxpayer to another without denying either taxpayer's existence. See *Keller*, 77 Tax Ct. at 1042 ("Mere existence . . . does not carry automatic immunity from the assignment of income doctrine") (dissenting opinion); *Wilson v. United States*, 530 F.2d 772, 778 (8th Cir. 1976) (holding that a finding that a corporation is not a sham does not preclude applying assignment of income principles to reallocate the corporation's income to shareholder-employees). Only where the corporation is deemed to earn no income at all could reallocation have the effect of treating the corporation as a sham, and even then the corporation may simply be inactive during that particular taxable year.

88. "Once incorporated, the personal service business must be run as a corporation. Its shareholder-employees must recognize, respect, and treat their personal service corporation as a corporation. The corporation must accept the disadvantages as well as advantages of incorporation." *Achiro v. Commissioner*, 77 Tax Ct. 881, 895-96 (1981). Accord *Patterson v. Commissioner*, 25 Tax Ct. Mem. Dec. (CCH) 1230, 1235-36 (1966) (finding an intormingling of personal and corporate accounts plus failure to respect corporate formalities); *Roubik v. Commissioner*, 53 Tax Ct. 365, 379-81 (1969) (finding that the corporation existed as a "mere set of bookkeeping entries and bank accounts").

89. See, for example, *Patterson*, 25 Tax Ct. Mem. Dec. (CCH) at 1234-36 (finding that the corporation should not be recognized for tax purposes where it failed to serve any "meaningful business function"); *Foglesong v. Commissioner*, 621 F.2d 865, 868-69 (7th Cir. 1980) (finding legitimate business purpose for a corporation sufficient to make commission income taxable to the corporation).

90. Compare *Roubik*, 53 Tax Ct. at 379 (noting that physicians supposedly employed by a radiology services corporation were personally obligated to the hospitals where they worked); *Keller*, 77 Tax Ct. at 1027 (holding that when an income source failed to substitute petitioner's service corporation for petitioner in its records for an entire year, petitioner remained directly taxable on income received from that source); *Hagy v. United States*, 778 F. Supp. 897, 898-900 (W.D. Va. 1991) (same); *Evatt v. Commissioner*, 63 Tax Ct. Mem. Dec. (CCH) 3194 (1992) (same); with *Laughton*, 40 Bd. Tax App. at 103-04, 107 (finding that an actor's corporation, which was clearly identified in its contracts, was a separate taxable entity); *Haag*, 88 Tax Ct. at

signment of income doctrine would offer a sounder rationale if the corporation has transacted any other business in its own name,⁹¹ the corporation's failure to act as a principal in *any* business transactions could demonstrate a complete absence of business purpose.

Under current law, however, an entity that satisfies the tax definition of a corporation will not be treated as a sham for tax purposes as long as the taxpayer can satisfy either of the two tests set forth by the Supreme Court in *Moline Properties v. Commissioner*:⁹² (1) the corporation is formed for a purpose equivalent to a business activity;⁹³ or (2) the incorporation is followed by the carrying on of a business.⁹⁴ According to the Tax Court, the business purpose under either test does not need to be one served only by incorporation; any income-earning purpose will suffice.⁹⁵

In loan-out cases, the government has often contended that even where the corporation is not a sham the shareholder-employee should be taxed as the true earner of the income under the broader assignment of income doctrine. Generally, it has succeeded only when

608-13 (holding that a professional corporation's income was not allocable to the taxpayer); *Fox v. Commissioner*, 37 Bd. Tax App. 271, 276-77 (1938) (holding that a corporation had a separate identity from the petitioner, who was the corporation's president and owned 98% of its stock); *Pacella v. Commissioner*, 78 Tax Ct. 604, 618-19 (1982) (finding that physician's corporation was clearly identified to patients and contracting parties as the service provider); *Hospital Corp. of America v. Commissioner*, 81 Tax Ct. 520, 584 (1983) (recognizing corporation's existence in part because unrelated parties did so).

91. See, for example, *Keller*, 77 Tax Ct. at 1027 n.14 (citing *Roubik*, 53 Tax Ct. 365).

92. 319 U.S. 436 (1943). For further discussion of *Moline Properties*, see notes 288-92 and accompanying text.

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

319 U.S. at 438-39. See also *Jones*, 64 Tax Ct. at 1076 (holding that a court reporting corporation that had not been organized for a legitimate business purpose but nevertheless engaged in substantial business activity was not a sham for tax purposes); *Keller*, 77 Tax Ct. at 1030 (holding that even if a taxpayer's desire to obtain the benefits of a medical reimbursement and pension plan did not comprise a business purpose, that desire was immaterial when the taxpayer's corporation engaged in business activity); *Pacella*, 78 Tax Ct. at 618-19 (similar).

94. *Moline Properties*, 319 U.S. at 438-39. Numerous cases have held that the quantum of business activity that satisfies the *Moline Properties* standard may be minimal. See, for example, *Sparks Farm, Inc. v. Commissioner*, 56 Tax Ct. Mem. Dec. (CCH) 464, 472 (1988); *Hospital Corp. of America*, 81 Tax Ct. at 579; *Strong v. Commissioner*, 66 Tax Ct. 12, 24 (1976), *aff'd* without pub. opin., 553 F.2d 94 (2d Cir. 1977); *Harrison Property Management Co., Inc. v. U.S.*, 475 F.2d 623, 626-27 (Ct. Cl. 1973); *Paymer v. Commissioner*, 150 F.2d 334, 336-37 (2d Cir. 1945).

95. See, for example, *Hospital Corp. of America*, 81 Tax Ct. at 582-87, and cases cited in notes 93-94.

the conduct of the parties involved in the loan-out arrangement is inconsistent with the claim that the corporation is the principal. Notably, however, the Tax Court has rejected the suggestion that the assignment of income doctrine should apply to a corporation simply because the corporate form was chosen for its tax advantages.⁹⁶

As early as 1938, the Board of Tax Appeals recognized a loan-out corporation as a separate taxable entity in *Fox v. Commissioner*,⁹⁷ where a newspaper cartoonist formed a corporation (Reynard) of which he was the president and ninety-eight percent shareholder. The cartoonist entered into an employment contract with Reynard under which he agreed to render his exclusive cartooning services in exchange for a salary. He also contributed to the corporation his copyrights in all cartoons he had previously created. Reynard then entered into contracts with the syndicate that distributed the cartoons to newspapers. The cartoonist's salary from Reynard was considerably less than the guaranteed minimum Reynard received under its contract with the syndicate. Both before and after forming Reynard, the cartoonist personally executed licensing agreements permitting third parties to use his cartoon characters, and for several years he received the royalty payments personally.⁹⁸ On advice of his attorney, he later assigned his rights under those contracts to

96. See, for example, *Davis v. Commissioner*, 64 Tax Ct. 1034, 1044 (1975) (holding that the transfer of valuable property rights with a known potential to produce income was a logical and legitimate reason for a physician to establish corporations and give stock to his children). Accord *Foglesong*, 621 F.2d at 869, 873 (refusing to weigh business purposes against tax avoidance to determine whether income should be reallocated from a professional corporation to the taxpayer); *Hospital Corp. of America*, 81 Tax Ct. at 583 (stating that petitioner's intent to obtain tax advantages by incorporating did not require a holding that the corporation was a sham). This is one application of the broader principle that a taxpayer is free to plan and carry out transactions in a manner that minimizes taxes. *Gregory v. Helvering*, 293 U.S. 465, 469 (1935); *Higgins v. Smith*, 308 U.S. 473, 477 (1940). Compare *Aldon Homes, Inc. v. Commissioner*, 33 Tax Ct. 582, 597 (1959) (disregarding construction corporations that lacked employees) and *Shaw Construction Co. v. Commissioner*, 35 Tax Ct. 1102, 1114 (1961) (disregarding corporations with no offices, employees, payroll, furniture, or equipment), aff'd 323 F.2d 316 (9th Cir. 1963) with *Bush Hog Manufacturing Co. v. Commissioner*, 42 Tax Ct. 713, 722-23 (1964) (recognizing business purpose of corporations formed to distribute products in new areas); *Nat Harrison Associates, Inc. v. Commissioner*, 42 Tax Ct. 601, 618 (1964) (recognizing business purpose of foreign corporation formed by domestic corporation to carry on its overseas operations). This position has been legislatively rejected in the context of § 269A, see notes 148-52 and accompanying text, but it appears to have continued vitality with respect to determining whether a corporation satisfies the *Moline Properties* tests.

97. 37 Bd. Tax App. 271 (1938).

98. *Id.* at 274-75. Unlike many loan-outs, Reynard sold property (the completed cartoons) rather than services. In some cases, a writer's loan-out might do the same.

Reynard, and Reynard thereafter reported the royalty payments as corporate income.⁹⁹

The Commissioner sought to reallocate all of Reynard's income from the syndicate and the other licensees to the shareholder under *Lucas v. Earl*. The Board of Tax Appeals, however, found no basis for disregarding the existence of Reynard as a separate taxpayer, since its corporate identity had been respected by the taxpayer and "recognized by all who had dealings with it."¹⁰⁰ The court also refused to treat the cartoonist as the true earner of the income, because he was not a party to the syndicate contracts and had assigned his copyrights and licensing agreements to Reynard.¹⁰¹

In *Laughton v. Commissioner*,¹⁰² British actor Charles Laughton formed a corporation under the laws of Great Britain, acquired beneficial ownership of one hundred percent of its stock, and entered into an exclusive employment contract with the corporation, which in turn contracted to lend the actor's services to various United States movie studios for specified projects.¹⁰³ A preexisting contract between Laughton and one studio was canceled by mutual consent, and on the same day the loan-out entered a contract with that studio for Laughton's services. In connection with each loan-out contract, Laughton executed a personal guarantee of his services.¹⁰⁴ His salary from the loan-out was considerably less than the sums the loan-out received from the studios, but he also received substantial sums from the loan-out in the form of secured loans.¹⁰⁵ Although the corporation was ostensibly engaged in the business of producing motion pictures, it did not begin doing so until after the taxable years in question, apparently because of a shortage of capital.¹⁰⁶

The Commissioner characterized Laughton's loan-out as "merely the agent and *alter ego* of the petitioner," and asked the Board of Tax Appeals (the "Board") to treat the corporation's contracts with the studios as "anticipatory arrangements for the deflection of

99. *Id.* Because Reynard adopted a March fiscal year, the cartoonist no doubt enjoyed a significant degree of income deferral. *Id.* at 275. Since a cartoonist does not render services in the "performing arts" within the meaning of § 441, see text accompanying notes 51-52, this deferral would still be available under current law.

100. 37 Bd. Tax App. at 277.

101. *Id.* at 277-78.

102. 40 Bd. Tax App. 101 (1939).

103. Laughton was neither an officer nor a director of the corporation. *Id.* at 103.

104. *Id.* at 103-04. For a discussion of personal guarantees, see note 150.

105. *Id.* at 105.

106. *Id.*

income.”¹⁰⁷ The Board, however, refused to disregard the corporation’s existence or to apply the assignment of income doctrine, finding that the corporation was “an entity separate and apart from the petitioner,” that it was “created for business reasons,”¹⁰⁸ and that the loan agreements “were in accordance with the general practice in the industry, where one studio or producer had a long term contract for the services of an actor.”¹⁰⁹ Although the Board seemed to consider it relevant that independent film production “was the ultimate aim and purpose for which the company was organized”¹¹⁰—a fact that would distinguish *Fox* and make Laughton’s intended business more capital-intensive than the typical loan-out—the Board described the case as “comparable” to *Fox*, noting that “Laughton’s only relationship with the contracts for the loaning of his services was to consent to the performance of the services provided for in such loan contracts.”¹¹¹ This analogy to *Fox* suggests that the Board did not rest its decision in *Laughton* solely on the existence of a business purpose unrelated to lending the actor’s services, for that factor was absent in *Fox*. It also suggests that the Board was untroubled by Laughton’s status as sole shareholder.¹¹² Finally, it seems to make Laughton’s option to withhold consent irrelevant.

On appeal, the Ninth Circuit remanded the *Laughton* case for consideration of whether the disparity between the actor’s corporate salary and the fees the corporation charged for his services should cause the transactions to be recharacterized as “a single transaction by Laughton in which he received indirectly the larger sum paid by the producers.”¹¹³ In other words, the court sought a determination of whether the transfer of Laughton’s services to his corporation was a sham, even if the corporation itself was not a sham.¹¹⁴ Thus, the appellate court attempted to distinguish between sham incorporation and broader assignment of income principles.¹¹⁵

107. *Id.*

108. *Id.* at 106-07.

109. *Id.* at 106.

110. *Id.* (explaining the corporation’s “failure to engage extensively in the production of motion pictures during the taxable years . . . as due to a lack of capital”).

111. *Id.*

112. The Board’s lack of concern may be attributed to the fact that the shareholder did not control the corporation’s board of directors. *Laughton*, 113 F.2d at 104-05.

113. *Id.* The court’s concern over arm’s length pricing anticipated the next round of challenges to loan-out arrangements—reallocation under the enactment of § 482. See notes 123-41 and accompanying text.

114. *Laughton*, 113 F.2d at 104.

115. The government generally will prevail when both doctrines point to the same conclusion, as was the case in *Patterson*, 25 Tax Ct. Mem. Dec. (CCH) 1230, in which a professional boxer formed a loan-out corporation of which he and his manager were the sole shareholders

In *Johnson v. Commissioner*,¹¹⁶ the Tax Court added a new gloss to the assignment of income doctrine. In *Johnson*, basketball player Charles Johnson contracted with a Panamanian corporation, PMSA, to render his services in professional sports for six years in exchange for a salary far smaller than either the compensation PMSA was to receive from Johnson's team for the years in question or the compensation he had received under his individual contract with the team in each of the preceding two years.¹¹⁷ The team, however, insisted on continuing to contract with Johnson as an individual, although it agreed to pay his compensation to a corporate licensee of PMSA, provided that Johnson executed a legal assignment. In addition to his salary from PMSA, Johnson received a series of large interest-free loans from the corporation.¹¹⁸ The Service treated the total amounts paid by the team to PMSA's licensee as income to Johnson.

Acknowledging that "[r]ecognition must be given to corporations as taxable entities" even when their income derives from the personal services of an employee, the Tax Court found it impossible to resolve the issue by applying the "per se actual earner test" of *Lucas v. Earl*, and shifted the inquiry to a two-part test of "who controls the earning of income."¹¹⁹

An examination of the case law from *Lucas v. Earl* hence reveals two necessary elements before the corporation, rather than its service-performer employee, may be considered the controller of the income. First, the service-performer employee must be just that—an employee of the corporation whom the corporation has the right to direct or control in some meaningful sense. . . . Second, there must exist between the corporation and the person or entity us-

and arguably the sole employees. *Id.* at 1231. The boxer sought to treat his income from boxing matches as income of the corporation. *Id.* at 1234. The Tax Court, however, found that the corporation performed no meaningful business function, that frequently it was not named in the contracts under which it supposedly earned the income in question, and that the shareholders consistently failed to observe the corporate formalities and to distinguish their personal accounts from the corporate accounts in their recordkeeping. *Id.* at 1235-36. *Patterson* is a blueprint for how not to conduct business in the corporate form.

116. 78 Tax Ct. 882 (1982), *aff'd* 734 F.2d 20 (9th Cir. 1984).

117. The opinion states ambiguously that the smaller salary was payable "for . . . life" until Johnson had ceased to perform services for any athletic team for two years. *Id.* at 886-87.

118. Although the court's opinion does not indicate who owned PMSA, Professor Elliott Manning has inferred from the generous interest-free loans that Johnson was the beneficial owner. Elliott Manning, *The Service Corporation—Who is Taxable on Its Income: Reconciling Assignment of Income Principles, Section 482, and Section 351*, 37 U. Miami L. Rev. 657, 662 n.17 (1983).

119. 78 Tax Ct. at 890-91.

ing the services a contract or similar indicium recognizing the corporation's controlling position.¹²⁰

The court determined that even though the first element could be satisfied if the PMSA-Johnson agreement was a valid contract giving PMSA the right to control Johnson's services, the corporation's role in the transaction should still be disregarded because the second element was lacking. Unlike the entertainers in *Fox* and *Laughton*, the recipient of Johnson's services contracted with Johnson himself rather than with PMSA. As a result, Johnson's contract with PMSA was equivalent to a gratuitous assignment of income.¹²¹

In sum, the assignment of income doctrine has facilitated the government's efforts to disregard loan-out arrangements only when the conduct of the parties fails to comport with their characterization of the transaction for tax purposes. The mere fact that the employee is also the controlling shareholder is insufficient to disregard the role of the corporation in earning the income.¹²² The limited applicability of the assignment of income doctrine makes it relatively easy for well-advised taxpayers to avoid its application in effecting their loan-out transactions.

2. Section 482

The government has also attempted to discourage the use of loan-outs by applying Section 482, which allows the Treasury to reallocate gross income, deductions, credits, and allowances among trades or businesses that are "owned or controlled directly or indirectly by the same interests" to the extent necessary to reflect income clearly or prevent tax evasion.¹²³ As a service provider, the loan-out's control-

120. 78 Tax Ct. at 891 (citations omitted). The court noted that the tension between the principles of *Lucas v. Earl* and recognition of corporate status was "most acute when a corporation operates a personal service business and has as its sole or principal employee its sole or principal shareholder." *Id.* at 890 n.13. The court added that in such cases § 482 normally provides "a smoother route" to identifying the taxpayer.

121. The court expressly did not decide whether Johnson's contract with PMSA was a sham. *Id.* at 890 n.12.

122. This is consistent with the broader rule that wholly-owned corporations are not presumed to be alter egos or common law agents of their controlling shareholders. See *Moline Properties*, 319 U.S. at 440; *DeVeguar v. Commissioner*, 28 Tax Ct. 1055 (1957) (stating that the activities of wholly-owned United States corporations would not be imputed to the foreign taxpayer who controlled them, for purposes of determining whether he was engaged in a United States trade or business).

123. The text of § 482 provides, in relevant part:

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 dis-

ling shareholder-employee is in the trade or business of providing services to an employer—the loan-out—and the loan-out is in the trade or business of providing those same services to a third party. Thus, although the matter is not free from doubt, and while the court has not clearly stated its rationale, recent decisions of the Tax Court have consistently held that a corporation and its shareholder-employee are engaged in two separate “trades or businesses” for purposes of Section 482.¹²⁴ Unlike the sham incorporation doctrine, re-

tribute, 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.

I.R.C. § 482 (1994).

124. In early decisions applying § 482 to shareholder-employees, the Tax Court appeared reluctant to find that rendering services as an employee of a corporation constituted a trade or business separate from that of a corporation. For example, in *Rubin v. Commissioner*, the Tax Court applied § 482 to a controlling shareholder-employee even though it refused to hold that being an employee constituted a trade or business, finding instead that the individual taxpayer “operated an independent business and merely assigned to the corporation a portion of the income therefrom . . .” 56 Tax Ct. 1155, 1161 (1971), aff’d 460 F.2d 1216 (2d Cir. 1972), acq. 1972-2 Cum. Bull. 3. Likewise, in *Borge v. Commissioner*, the Tax Court and the Second Circuit applied § 482 where an entertainer performed some of his artistic and professional services under a contract with his controlled corporation and performed the remainder of those services “on his own behalf aside from the contract.” 26 Tax Ct. Mem. Dec. (CCH) 816, 818, 820 (1967) aff’d 405 F.2d 673 (2d Cir. 1968). And, in *Ach v. Commissioner*, 42 Tax Ct. 114 (1964), aff’d 358 F.2d 342 (6th Cir. 1966), the Tax Court found a § 482 reallocation appropriate where an individual taxpayer purported to sell her profitable dress business to an insolvent corporation owned by her children, but continued to manage it without compensation and also failed to transfer ownership of the business’s valuable intangibles. *Id.* at 124-25. The Tax Court concluded that “sufficient aspects of the business remained with [her] so as not to deprive her of the status of a separate ‘organization,’ ‘trade,’ or ‘business,’ within the meaning of section 482.” *Id.* at 125. However, in a later series of cases, the Tax Court expressly recognized that for purposes of § 482 a shareholder-employee was engaged in a trade or business separate from that of the corporation simply by virtue of being the corporation’s employee. It reached this conclusion with minimal analysis in *Keller*, 77 Tax Ct. at 1022, a decision that the Tenth Circuit affirmed, *Keller*, 723 F.2d 58 (10th Cir. 1983). The Tax Court continued to apply this rule in *Pacella*, 78 Tax Ct. at 618, and *Fatland*, 48 Tax Ct. Mem. Dec. (CCH) at 1109. The Seventh Circuit reached the opposite conclusion in *Foglesong*, 621 F.2d 865 (7th Cir. 1980), rev’g and remanding, 35 Tax Ct. Mem. Dec. (CCH) 1309 (1976), on remand, 77 Tax Ct. 1102 (1981), rev’d, 691 F.2d 848 (7th Cir. 1982).

Both the § 482 regulations and the legislative history of the precursors of that section support the Tax Court’s conclusion in the later-decided cases (*Keller*, *Pacella*, and *Fatland*) that mere employment can constitute a trade or business for purposes of § 482. House Committee on Ways and Means, Revenue Act of 1934, H.R. Rep. No. 704, 73d Cong., 2d Sess. 24 (1934), 1939-1 Cum. Bull. (Part 2) 554, 572 (directing that the term “organizations, trades, or businesses” be construed broadly); Treas. Reg. § 1.482-1A(a)(2) (1994) (defining “trade” or “business” as “any trade or business activity of any kind, regardless of whether or where organized, whether owned individually or otherwise, and regardless of the place where carried on”). The Treasury agrees with this interpretation, as indicated by its nonacquiescence in *Foglesong*. Rev. Rul. 88-38, 1988-1 Cum. Bull. 246. See generally Manning, 37 U. Miami L. Rev. at 659-62 (cited in note 118); Albert Feuer, *Section 482, Assignment of Income Principles and Personal Service*

allocation under Section 482 does not require the government to establish that the loan-out is a sham since it allows for reallocation even among bona fide business entities.¹²⁵ With respect to allocations of loan-out income, Section 482 often is largely indistinguishable from common law assignment of income principles.¹²⁶

Generally, Section 482 applies to transactions between commonly controlled businesses that do not reflect arm's length pricing.¹²⁷ For example, if a loan-out were to pay little or no salary to its controlling shareholder-employee, Section 482 would allow the Commissioner to impute a higher salary and, therefore, impose a higher tax on the shareholder-employee.¹²⁸

Corporations, 59 Taxes 564 (1981); John J. McFadden, *Section 482 and the Professional Corporation: The Foglesong Case*, 8 J. Corp. Tax. 35 (1981); James P. Fuller, *Section 482 Revisited*, 31 Tax L. Rev. 475, 480 (1976); Warren C. Seieroe and Lawrence Gerber, *Section 482-Still Growing at the Age of 50*, 46 Taxes 893, 896 (1968); Vincent T. Volpe, Comment, *Section 482 and the Personal Service Corporation*, 26 S.L.U. L. J. 155 (1981); Robert W. Wood, *The Keller, Foglesong, and Pacella Cases: 482 Allocations, Assignments of Income, and New Section 269A*, 10 J. Corp. Tax. 65 (1983).

125. See, for example, *Borge*, 405 F.2d at 676-77 (recognizing that an actor's poultry business was a legitimate corporation but allocating a portion of that corporation's income to its sole shareholder who alone was responsible for producing that income through his entertainment services).

126. On some occasions, the government and the courts have used § 482 where the common law assignment of income doctrine could have produced (or indeed did produce) equivalent results. For example, in *Jones v. Commissioner*, 64 Tax Ct. 1066 (1975), the Tax Court first found an assignment of income under § 61, then went on to allocate (apparently all of) the corporation's gross income and allowable deductions to the reporter under § 482, finding that a court reporter's arrangement failed to satisfy the arm's length standard because: (1) federal law required the services in question to be performed by an individual rather than a corporation; (2) the reporter failed to enter an employment agreement with the corporation; (3) he remained under the control of the judge to whom he was assigned; and (4) he personally certified the transcripts. *Id.* at 1076. However, where the assignment of income doctrine is inapplicable because the purported earner is clearly the principal in the transaction or the proper formalities were observed, § 482 can still authorize reallocation where the specific standards of the statute and the regulations thereunder are needed to sort out complex transactions and interrelationships. Compare *Damm v. Commissioner*, 36 Tax Ct. Mem. Dec. (CCH) 793, 796 (1977) (distinguishing *Rubin*, where the purported earner was in fact a party to the income-generating contract, thus making an analysis under § 482 more appropriate than an assignment of income analysis, from the case before it, where the purported earner never entered the contract). See Wood, 10 J. Corp. Tax. at 76-77 (cited in note 124) (discussing the importance of formalities in avoiding assignment of income challenges). See generally Joseph W. Burdett, *Foglesong's Sec. 482 Approach May Threaten Closely-Held Personal Service Corporations*, 53 J. Tax. 330 (1980). The Commissioner's discretion under § 482 is broader than under assignment of income principles. See, for example, *Wilson*, 530 F.2d at 776 (referring to the Commissioner's "broad discretion" under § 482). Section 482 also allows reallocation of nonincome items.

127. Treas. Reg. § 1.482-1A(b)(1) (1994) dictates the arm's length standard.

128. See Treas. Reg. § 1.482-2(b) (1994) (describing the determination of taxable income when one member of a controlled group performs services for another). See, for example, *Ach*, 42 Tax Ct. at 125 (holding that income must be reallocated to an individual taxpayer when the record showed that she had rendered services to her children's corporation without compensation for several years); *Borge*, 405 F.2d at 675-77 (holding that income must be reallocated to an individual taxpayer who had entered into a five-year employment contract

However, the arm's length standard can be applied not only to the amount of taxable compensation paid out to the shareholder-employee, but also to the various tax benefits the taxpayer derives from earning service income through a loan-out: tax deferral when shareholder payments are made at the end of the corporation's taxable year (which may be a fiscal year if the corporation is not a PSC for Section 441 purposes), greater deductibility of business expenses, and the various tax-favored insurance, medical, retirement, and other fringe benefits. Even if the shareholder's taxable compensation satisfies arm's length standards, these tax advantages alone may be substantial enough to raise a question whether the shareholder-employee's return position evades taxes and/or fails to reflect clearly her income within the meaning of Section 482.

No cases have squarely addressed the government's power to use Section 482 to eliminate the tax benefit of deferral enjoyed by shareholder-employees who receive year-end salary payments.¹²⁹ In the case of a controlled fiscal-year corporation, courts determining whether to reallocate corporate income to shareholder-employees under Section 482 typically compare the total compensation the shareholder actually received during the calendar year with the amount she would have received had she operated as a calendar year sole proprietor. If the amounts are approximately equal, the court will not apply Section 482.¹³⁰ Where no fiscal-year entity is involved,

with his corporation when he was paid in only one year); *Rubin*, 56 Tax Ct. at 1159 (allowing reallocation where the shareholder-employee's services were rendered to parties other than the employing corporation); *Haag*, 88 Tax Ct. at 617 (describing as "most important" the fact that the petitioner provided medical services without compensation to his corporation during the years in issue); *Hospital Corp. of America*, 81 Tax Ct. at 597-602 (reallocating part of the corporation's income to controlling shareholder-employee to reflect reasonable compensation); *Jones*, 64 Tax Ct. at 1077 (permitting nearly 100% reallocation where federal law did not allow most of the services in question to be provided by a corporation).

129. In contrast, the Treasury's interpretation of § 269A indicates that "deferral of income" is the type of tax avoidance motivation that can trigger application of that section. Prop. Treas. Reg. § 1.269A-1(b)(6), 48 Fed. Reg. 13,438 (1983). See note 160 and accompanying text.

130. See, for example, *Keller*, 77 Tax Ct. at 1025; *Haag*, 88 Tax Ct. at 618-22. In *Keller*, the Tax Court declined to consider the government's attack on the professional corporation's adoption of a November fiscal year. The selection of a November year-end benefited the corporation because it was a partner in a partnership that had a different taxable year. Although the opinion does not identify the partnership's taxable year, it was probably a calendar year. *Keller*, 77 Tax Ct. at 1020, 1034; Halperin, 65 J. Tax. at 75 n.12 (cited in note 9). The *Keller* court expressed a cryptic "doubt whether . . . this presents a problem to be analyzed in the context of this case under section 61(a) and section 482." 77 Tax Ct. at 1034. In comparing "the net income which petitioner would have received absent incorporation," the court included the distributive share of partnership income that would have been taxable to the physician if he were an unincorporated, and, thus, a calendar year, taxpayer. *Id.* at 1029 and nn.18-19. The physician's corporation "took the position that as a partner . . . it was only required to report

so that a salary payment to a controlling shareholder is merely delayed within the taxable year, but not deferred to a later taxable year, the time value of the deferred payroll taxes will not, in many cases, be significant enough to warrant scrutiny under Section 482.

In a situation where deferral produced a substantial tax benefit to the shareholder-employee, it would seem that the Section 482 inquiry could focus properly on whether such a delay would have occurred in an arm's length transaction. No cases have addressed this question, however, and in most instances the answer would be hopelessly speculative. It is not unusual for a taxpayer dealing with an uncontrolled but creditworthy payor to negotiate delayed salary payments in an effort to delay payment of withholding taxes. On the other hand, with a less creditworthy payor, a worker agreeing to a deferred payment would face a risk of nonpayment that does not exist when the worker controls the payor.¹³¹

The question of whether Section 482 should be applied to reallocate expense deductions is more complex. In *Haag v. Commissioner*, the Tax Court's Section 482 inquiry focused in part on identifying deductions that would have been unavailable to the taxpayer as a sole proprietor.¹³² Disregarding these deductions meant that the taxpayer's taxable income during two of the years at issue would have been significantly higher than it would have been absent incorporation. The court, therefore, concluded that a reallocation was warranted.

Reallocation is certainly justified where the corporation's deductions arise from expenses that lack a business purpose. For example, if the controlling shareholder-employee caused the corporation to undertake activities generating expenses that would be nondeductible under the Section 183 hobby loss rules if undertaken by an

partnership income for the partnership year ending with or within the fiscal year of the corporate partner. . . ." *Id.* at 1020. The Tax Court and the Second Circuit adopted a similar approach in *Borge*, 405 F.2d at 675 n.6, 676 n.8.

131. The taxpayer's degree of access (as employee, not as shareholder) to the funds held by the corporation before the year-end disbursement should be relevant to this deferral question. If the employment contract does not entitle the owner-employee to accelerate the salary payments, then, as an employee, the shareholder is not in constructive receipt. In most cases, as a controlling shareholder, of course, she does have the power to compel a distribution, either by declaring a dividend or by altering the terms of the employment contract. To conclude, however, that this constitutes constructive receipt ignores the separate existence of any corporation that has a single controlling shareholder (or a controlling block of related shareholders). Compare *Hyland v. Commissioner*, 175 F.2d 422, 424 (2d Cir. 1949) (holding that a controlling shareholder of a close corporation was not in constructive receipt of salary even though he could have used his control to cause payment, but leaving open the question of the one-man corporation).

132. *Haag*, 88 Tax Ct. at 619-20.

individual, a reallocation of those expenses (and, hence, disallowance of the loss deductions) would be warranted.¹³³ Due to the lack of a profit motive, these would not be ordinary and necessary expenses, and thus—in Section 482 terms—they would not reflect an arm's length relationship between the employee and the corporation. However, because they were not ordinary and necessary in the first place, the deductions could also be disallowed under Section 162 without resort to Section 482.

In contrast, many deductions that are available to corporations but unavailable to individuals arise from expenditures that have a business purpose. One example would be ordinary and necessary business expenses that would have been deductible by an employee only to the extent that the employee's miscellaneous itemized deductions exceeded two percent of her adjusted gross income. These deductions should not necessarily trigger reallocation under Section 482 because they do not *by themselves* violate the arm's length standard; instead, they could reasonably have been incurred by *any* corporation employing the taxpayer.

In *Haag*, however, the loan-out's reasonable business expenses were so high that they left the shareholder-employee with a salary far below what the worker could have commanded in the open market.¹³⁴ Where an unreasonably low salary is the taxpayer's only compensation, the arm's length standard is not satisfied because the taxpayer would not have agreed to such a salary from an uncontrolled payor. In contrast, Section 482 should not apply where a salary that appears unreasonably low on its face is accompanied by a retirement plan or medical reimbursement plan sufficiently generous such that the individual worker's total compensation package satisfies the arm's length standard, even though its tax consequences to the worker are far more favorable than those of an arm's length salary without the tax-free fringe benefits. In fact, the government has not succeeded in using Section 482 to attack loan-outs by neutralizing the effects of retirement and medical benefits. Provided that the corporation actually engages in business activity, the Tax Court has repeatedly

133. I.R.C. § 183 (1994). See, for example, *Haag*, 88 Tax Ct. at 620 n.10 (noting that the government could have raised a § 183 argument to bolster its effort to reallocate a corporation's income to a controlling shareholder). Such a corporation might also be deemed a sham due to lack of a sufficient business purpose under *Moline Properties*. See notes 92-94, 288-92, and accompanying text. Section 269 could also be invoked to disallow these deductions. See, for example, *Borge*, 405 F.2d at 678.

134. *Haag*, 88 Tax Ct. at 622.

rejected the suggestion that Section 482 may be invoked when obtaining the benefits of retirement and medical reimbursement plans motivates incorporation.¹³⁵ As a result, the government has not had great success in reallocating loan-out income under Section 482.

Keller v. Commissioner,¹³⁶ which sharply divided the Tax Court sitting en banc, is a particularly notable example of the government's lack of success in using Section 482 to attack the various tax-advantaged fringe benefits enjoyed by incorporated workers.¹³⁷ In that case, the taxpayer was a physician who joined a partnership of other physicians and subsequently contributed his partnership interest to a professional corporation of which he was sole shareholder and director, and of which he and his wife were the sole employees. The corporation paid the taxpayer a salary and provided him with various benefits including a medical reimbursement plan and a defined benefit pension plan (which the Service conditionally determined was a qualified plan).¹³⁸ The taxpayer did not dispute that the primary reason he adopted the corporate form was to obtain the tax benefits of the pension and the medical expense reimbursement plans.¹³⁹

Although the government sought to tax all of the professional corporation's income to the taxpayer under either Section 482 or the assignment of income doctrine, the ten-judge majority ruled that the total compensation paid to the taxpayer (including not only his salary from the professional corporation, but also any pension contributions and medical expense reimbursements from that corporation) "was essentially equivalent to that which he would have received absent incorporation."¹⁴⁰ The court acknowledged that if only taxable income were considered, the taxpayer received less than he would have received absent incorporation, but the court found that this reduction resulted "from the Code provisions which specifically provide for deferral and nonrecognition of income."¹⁴¹

135. *Fatland*, 48 Tax Ct. Mem. Dec. (CCH) at 1109; *Achiro*, 77 Tax Ct. at 899-900; *Keller*, 77 Tax Ct. at 1030; *Pacella*, 78 Tax Ct. at 618. Where reallocation is warranted on other grounds, however, the Tax Court has disregarded a corporation's medical and pension deductions to approximate the taxable income the shareholder-employee would have received absent incorporation. See *Haag*, 88 Tax Ct. at 620-21 (noting, however, that an individual employed by a noncontrolled corporation would be reasonable to accept a lower taxable salary if these tax-favored benefits were also provided).

136. 77 Tax Ct. 1014.

137. The resulting congressional outrage spawned § 269A. See note 144 and accompanying text.

138. The taxpayer personally guaranteed all obligations of the corporation arising out of its relationship with the partnership. *Keller*, 77 Tax Ct. at 1016-17.

139. *Id.* at 1021.

140. *Id.* at 1025.

141. *Id.* at 1029.

3. Sections 269 and 269A

Troubled by the outcome in *Keller*, in 1982 Congress took aim at professional service corporations by enacting Section 269A. This section permits the government to reallocate "income, deductions, credits, exclusions, and other allowances" between a "personal service corporation" (PSC) and its employee-owners when two conditions are satisfied: (1) substantially all of the corporation's services are provided to a single entity; and (2) the corporation was formed for the principal purpose of avoiding federal income taxes.¹⁴² Section 269A, however, appears to be highly ineffective and largely redundant. As discussed below, its ineffectiveness as a means of challenging loan-outs in some respects parallels the failure of Section 269 to serve that same purpose.

Section 269A is, in effect, a specialized version of Section 269, which has long authorized the Treasury to disallow or reallocate any "deduction, credit or other allowance" whenever a person acquires control of a corporation for the "principal purpose" of "evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit or other allowance which such person . . . would not otherwise enjoy."¹⁴³ As discussed below, the two provisions are strikingly

142. I.R.C. § 269A(a) (1994).

143. I.R.C. § 269(a), (c) (1994). Numerous decisions have construed § 269 to apply to the acquisition of a controlling interest in a newly formed corporation, whether or not it is a PSC. See, for example, *Borge*, 405 F.2d at 677-78 (holding that a corporation was formed solely to avoid taxes within the meaning of § 269); *James Realty Co. v. United States*, 280 F.2d 394, 397-98 (8th Cir. 1960) (finding that the principal purpose of creating multiple corporations was to avoid federal income or excess profits tax). Thus, both provisions could apply to the formation of a PSC for the principal purpose of tax avoidance. However, whereas § 269 authorizes the Secretary either to reallocate or to disallow deductions, § 269A authorizes only reallocation.

Nothing in § 269A or its legislative history would appear to require the Secretary to apply the more lenient rule of § 269A to a PSC. However, § 269 authorizes reallocation only "among the corporations, or properties, or parts thereof." I.R.C. § 269(c)(2) (1994); Treas. Reg. § 1.269-4 (1994). Absent some guidance as to what constitutes a "part" of a corporation for this purpose, it is not clear whether § 269 authorizes reallocation to a noncorporate shareholder, as § 269A clearly does. If it does not, this would seem to be an artificial distinction, since any individual shareholder who incorporated separately would thereby become subject to § 269 with respect to the tax benefits of the lower tier corporation, while the unincorporated shareholder enjoying the same tax benefits would not. Nevertheless, the statutory language of § 269 is narrow, and would authorize reallocation in the case of loan-outs only if an individual employee-owner could be considered a "part" of the corporation. Of course, when a particular deduction is available to corporations but not to individuals, reallocation of that deduction to a corporation's shareholders under §§ 61, 482, or 269A has the same effect as disallowance under § 269. See, for example, *Borge*, 405 F.2d at 678 (using § 269 to disallow corporate deductions which would have been unavailable to a noncorporate taxpayer). This would be true, for example, of corporate deductions that, at the individual shareholder level, would constitute medical expenses below the

similar in that neither appears to apply when the taxpayer can demonstrate that the decision to incorporate either was not motivated principally by federal income tax considerations, or was motivated by federal income tax benefits that Congress intended to confer regardless of the taxpayer's motive for incorporating. In addition, the narrow range of circumstances in which Section 269A applies makes it an even less useful tool than Section 269.

PSCs are not defined as narrowly in Section 269A and Proposed Regulation Section 1.269A-1 as they are in Section 441. Specifically, neither Section 269A nor the proposed regulation lists the types of services that qualify as "personal." Thus, Section 269A apparently applies even to corporations formed by producers, directors, writers, composers, designers, athletes, coaches, and other individuals whose "behind-the-scenes" services Section 441 excludes from the definition of "personal services."

The legislative history indicates that Section 269A was enacted, at least in part, to "overturn the results 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."¹⁴⁴ Ironically, because the conjunctive nature of the statutory test makes it relatively easy for taxpayers to "plan around" Section 269A, many—if not most—loan-outs can withstand scrutiny under this section either because they do not render services to a single entity or because they are formed for a nontax avoidance purpose.

Loan-out employees often provide services to more than one entity, so that Section 269A would not apply. In the film industry, for example, it is common for a service provider to work for a number of different producers or studios during a relatively short period of time, or, in some cases, simultaneously. Likewise, athletes that compete exclusively or primarily in nonteam sports such as tennis, golf, or auto racing provide services to multiple organizations.¹⁴⁵

Some loan-outs, of course, face greater difficulty under the single entity test. In television, for example, an actor, director, or writer often will provide services exclusively to one party for extended

7.5% floor or unreimbursed employee expenses below the 2% floor, and expenses that would generate nondeductible hobby losses under I.R.C. § 183 (1994).

144. Conference Committee Report on Pub. L. No. 97-248 (Tax Equity and Fiscal Responsibility Act of 1982) (citation omitted). Accord 128 Cong. Rec. 22403 (Aug. 19, 1982) (comments of Senator Dole).

145. The emergence of professional team tennis conceivably could alter the application of § 269A to personal service corporations formed by any professional tennis players who provide substantially all of their compensated services to a team.

periods. Because an athlete engaged in a team sport typically plays for a single team for one or more years, she could also have difficulty under this test. Yet even television entertainers and team athletes often provide significant services to parties other than their chief employers; team athletes, for example, often work as actors, singers, “personalities,” or product endorsers. This outside activity alone might be sufficient to insulate an entertainer or athlete’s loan-out from Section 269A. Note, however, that for any worker a period of extended unemployment could cause the worker to “flunk” the single entity test, since the worker’s last employer might be her only employer during the measuring period. And workers that fit the traditional “employee” mold—for example, medical personnel working for a hospital or a professional partnership—clearly would have a problem under the single entity test.¹⁴⁶

Neither Section 269A nor Proposed Regulation Section 1.269A-1 explains what constitutes “substantially all” of a corporation’s services, or what period of time is to be considered in determining whether the corporation performs substantially all of its services for a single entity, critical questions for many service-providers.¹⁴⁷ Thus, depending on the testing period, a loan-out could be subject to Section 269A in one year but not in the subsequent year.

Even if a corporation provides substantially all of its services to a single entity such as a sports team or a television production

146. As a theoretical matter, of course, it is not entirely clear why the number of service recipients should be relevant to the question of whether the corporate status of the entity should be respected for tax purposes. The single entity test has little theoretical justification, and appears to derive simply from Congress’ desire to overrule *Keller*. Enacting § 269A for this purpose, however, was largely superfluous once Congress had created near-parity between corporate and self-employment retirement plans and had enacted the rules governing affiliated service organizations and leased employees. See notes 27-31, note 161 and accompanying text.

147. With respect to the “testing period,” the Treasury could adopt an approach similar to that used to define a PSC in the temporary regulations promulgated under § 441, which determine whether a corporation’s “principal activity” is the performance of personal services in a given year by reference to its activities in the preceding taxable year. Temp. Treas. Reg. § 1.441-4T(d)(1), (2) (1994). Alternatively, the Treasury could consider only the services rendered during the taxable year at issue, using the method advanced in the § 448 temporary regulations. Temp. Treas. Reg. § 1.448-1T(e)(4)(i) (1994). Either approach could cause the tax treatment of a loan-out to change significantly from one taxable year to the next. Alternatively, the test could examine the corporation’s principal activity during a period of longer duration—three out of the preceding five taxable years, for example. This approach, which is similar to that used in the hobby loss rules, I.R.C. § 183 (1994), would prevent a small one-time shift in revenue allocation from having a drastic effect on the loan-out’s tax treatment and would encourage long-term tax planning while still effecting the Congress’s intent to eliminate the perceived abuse in the *Keller* case. For corporations with shorter histories, of course, a different rule would be necessary. Section 183(e) offers a model for one possible approach, which would allow a retroactive determination once the corporation has existed for the testing period.

company during the testing period, Section 269A will still apply only if the "principal purpose" of forming the 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."¹⁴⁸ It has never been clear, however, which taxpayer motives (and what evidence thereof) should be sufficient to demonstrate a principal purpose of tax avoidance or evasion, thereby making the second part of the Section 269A test something of a cipher.

This inherent weakness in Section 269A is the same one that impeded the government's short-lived efforts to apply Section 269 to taxpayers who incorporated their sole proprietorships. Courts analyzing challenges under Section 269 were reluctant to disallow a tax benefit unless the taxpayer's enjoyment of the benefit would clearly frustrate the intent of Congress.¹⁴⁹ Section 269A, because it clearly

148. I.R.C. § 269A (1994).

149. The government initially believed that § 269 would enable it to disallow retirement plan deductions taken by PSCs, but the Treasury had virtually abandoned this effort by 1986, finding that "courts are reluctant to treat incorporation for pension benefits as evasion of tax." Gen. Couns. Mem. 39,553 (Sept. 3, 1986). See Frank V. Battle, Jr., *The Use of Corporations by Persons Who Perform Services to Gain Tax Advantages*, 57 *Taxes* 797, 803 (1979) (noting the government's failure to assert this claim over many years of litigation involving incorporated workers). See also *Achiro*, 77 *Tax Ct.* at 895 n.18 (criticizing Priv. Ltr. Rul. 7939003, which stated that § 269 applies when the principal purpose of incorporating was to take advantage of deductions for pension and medical plans). Compare note 135 and accompanying text (noting judicial reluctance to apply § 482 to retirement plans).

As noted earlier, taxpayers may incorporate to obtain tax benefits other than favorable retirement plans. Yet the government has made little use of § 269 to challenge the other tax benefits of incorporation, despite its modest success in *Borge* (discussed in note 133). An attempt to use § 269 to disallow standard corporate fringe benefits that a professional corporation provides would probably fail. Courts, and even the Treasury, have refused to find that every attempt to achieve tax benefits provided by Congress constitutes tax avoidance under § 269. The authorities generally distinguish tax benefits Congress intended to grant to taxpayers in return for the simple act of incorporation from those Congress did not intend as an automatic consequence of undertaking this formality. See, for example, *I.T. 3757*, 1945 *Cum. Bull.* 200 (allowing incorporation to gain benefits provided for Western Hemisphere trade corporations); *Rev. Rul. 70-238*, 1970-1 *Cum. Bull.* 61 (same); *Rev. Rul. 76-363*, 1976-2 *Cum. Bull.* 90-91 (finding that § 269 does not apply to formation of new corporation to carry on a specific portion of an existing corporation's business primarily to gain the benefits of subchapter S); *Achiro*, 77 *Tax Ct.* at 895 & n.18 (stating that the incorporation to secure the benefits of subchapter S does not amount to tax avoidance under § 269); *Supreme Investment Corp. v. U.S.*, 468 F.2d 370, 376 (5th Cir. 1972) (stating that § 269 was not intended to deny taxpayers those "tax benefits which Congress plainly intended that they should enjoy"); *Alinco Life Ins. Co. v. U.S.*, 373 F.2d 336, 340-41 (Ct. Cl. 1967) (allowing incorporation to obtain life insurance companies' tax benefits); *Barber-Greene Americas, Inc. v. Commissioner*, 35 *Tax Ct.* 365, 383-85 (1960) (allowing Western Hemisphere trade corporation benefit); *A.P. Green Export Co. v. U.S.*, 284 F.2d 383, 388-90 (Ct. Cl. 1960) (same); *Bijou Park Properties Inc. v. Commissioner*, 47 *Tax Ct.* 207, 214 (1966) (holding § 269 inapplicable to merger in which newly formed corporation received liquidation distribution of target's installment obligations); *Modern Home Fire & Casualty Ins. Co. v. Commissioner*, 54 *Tax Ct.* 839, 853 (1970) (holding that § 269 does not apply to subchapter S election); *Rocco, Inc. v. Commissioner*, 72 *Tax Ct.* 140, 152-53 (1979) (finding that § 269 does not apply to adoption of

reflects Congress's disapproval of the *Keller* decision, should have answered this concern. Surprisingly, it has not.

A taxpayer typically can assert any of a number of nontax motivations for forming a C corporation. As discussed earlier, the limited liability enjoyed by corporations offers one substantial (and extremely common) reason to incorporate. However, if evidence of such a purpose is sufficient to avoid application of Section 269A, then that section appears virtually useless because it can be avoided so easily.¹⁵⁰

cash method of accounting); *Borge*, 405 F.2d at 678-79 (using § 269 to disallow certain losses incurred after incorporation of a poultry business, based on a finding of tax "reduction through artifice," where the taxpayer incorporated to avoid disallowance of losses); Senate Committee on Finance, The Revenue Bill of 1943, H.R. 3687, S. Rep. No. 627, 78th Cong., 1st Sess. (1943), reprinted in 1944 Cum. Bull. 973, 1017 (noting that the application of the predecessor of § 269 turns on "whether the transaction or a particular factor thereof 'distorts the liability of the particular taxpayer' when the 'essential nature' of the transaction or factor is examined in the light of the 'legislative plan' which the deduction or credit is intended to effectuate") (quoting *Higgins*, 308 U.S. at 476-77); K. Martin Worthy, *IRS Chief Counsel Outlines What Lies Ahead for Professional Corporations*, 32 J. Tax. 88, 90 (1970) (questioning whether tax avoidance exists where professional corporation is formed to take advantage of tax benefits Congress deliberately granted); Treas. Reg. § 1.269-2(b) (1962) (following *Higgins* standard).

Where a loan-out's employee-owner might be considered a common law employee of the borrower, see Part III.B.3., the government apparently believes it still has a reasonable argument for disallowing deductions under § 269 if the incorporation was undertaken to secure tax benefits. Gen. Couns. Mem. 39,553 (Sept. 3, 1986). The General Counsel Memorandum concedes, however, that the § 269 argument is weaker than the arguments under §§ 61 and 482, and notably the government has not pursued a § 269 challenge in any loan-out cases arising after the effective date of § 269A.

150. There are reasons to question whether limited liability should always be treated as an adequate nontax motivation under § 269A (or, for that matter, § 269). For example, asserting limited liability as a nontax reason for incorporation seems less persuasive when the personal assets of the employee-owner back the corporation's obligations. Parties entering contracts with individually controlled corporations often require the corporation's owner to execute a personal guarantee under which the owner becomes liable in the event of any breach by the corporation. See, for example, *Hynes v. Commissioner*, 74 Tax Ct. 1266, 1285 (1980) (stating that it is not uncommon for a sole shareholder to personally guarantee a loan); *Riehlands Medical Ass'n*, 60 Tax Ct. Mem. Dec. (CCH) at 1584 (explaining that shareholder guarantees are not uncommon in the context of closely held corporations); *In re Byrd*, 41 Bankr. 555, 562-63 (E.D. Tenn. 1984) (stating that the plaintiff's regional credit manager usually requires a guarantee from a professional corporation's principal); Priv. Ltr. Rul. 8625003 (Technical Advice Memorandum) (Feb. 28, 1986) (involving athlete loan-outs). Arguably, the existence of such a personal guarantee undermines the parties' characterization of the corporation as the true principal in the transaction, since it suggests that both the provider and consumer of the services recognize that the duty to perform rests ultimately not with the corporation but with its controlling shareholder. Drawing this inference in *Borge*, 405 F.2d at 675, the Second Circuit interpreted the employee-owner's guarantee as an indication that the loan-out "did nothing to aid Borge in his entertainment business." Accord *Foglesong*, 691 F.2d at 851. Yet parent corporations often guarantee the debts of their subsidiaries, and individual controlling shareholders often guarantee the debts of their corporations, regardless of whether they are employee-owners. Thus, the Second Circuit's position in *Borge* seems extreme. In marked contrast, the Tax Court majority in *Keller* concluded that the employee-owner's "guarantee of the corporation's commitments to [the other contracting party] is an example of the respect shown for [the corporation] as an entity which

In addition, outside of the Section 269A context, at least one court has found a legitimate nontax motive where a taxpayer incorporates to create "a vehicle for subsequent expansion of the business."¹⁵¹ This premise, too, is dubious, since additional investors can also join a noncorporate vehicle such as a partnership, or (to a limited extent) an S corporation. Avoidance of federal estate taxes, foreign taxes, or even certain state or local taxes, would also appear to be an acceptable motive, for Section 269A (like Section 269) refers only to avoidance of federal income taxes.¹⁵² Yet many of the same tax

had its own business obligations." *Keller*, 77 Tax Ct. at 1032. Accord *Richlands Medical Ass'n*, 60 Tax Ct. Mem. Dec. (CCH) at 1584 (observing that the guarantee requirement underscores corporation's limited liability).

However, the question of whether personal guarantees undermine the status of the corporation as a separate taxpayer and a principal in a given transaction is quite different from the question of whether those guarantees undermine a taxpayer's claim that she formed the entity for a substantial nontax purpose. If the taxpayer routinely executes personal guarantees on behalf of the corporation, then, as a practical matter, there is no limited liability with respect to the transactions covered by those guarantees. See *Jones*, 64 Tax Ct. at 1074 (expressing "serious doubts" as to whether a court reporter incorporated in order to enjoy limited liability, where taxpayer personally certified the accuracy of his transcripts and was personally liable for certain obligations of the business). Nonetheless, such a taxpayer would still enjoy limited liability with respect to any claims that arose outside of the transactions to which the guarantees applied.

The argument that pursuit of limited liability is an adequate nontax motivation for forming a personal service corporation might also be unpersuasive where the taxpayer has the option, under state law, of forming a limited liability company ("LLC"), which could enjoy limited liability without being classified as a corporation for federal income tax purposes. However, because it is uncertain whether an LLC enjoys limited liability with respect to its activities in jurisdictions that do not recognize its LLC status, many taxpayers still have a reason to prefer incorporation. See Mark A. Sargent and Walter D. Schwidetzky, *Limited Liability Company Handbook* § 3.06[2][c] at 3-24 (Clark Boardman Callaghan, 1994-95). Furthermore, many states would not recognize an LLC with only one owner. *Id.* § 1.04 at 1-6. While an LLC can be formed in such a way that it constitutes a partnership for federal tax purposes, Rev. Rul. 93-30, 1993-16 Int. Rev. Bull. 4, a one-owner LLC would not be a partnership, see Rev. Proc. 95-10, § 4.01, 1995-3 Int. Rev. Bull. 20 (Jan. 17, 1995) (indicating that the Service will only consider ruling requests on classification of LLC as partnership if LLC has at least two members); I.R.C. §§ 761(a), 7701(a)(2) (1994) (defining "partnership"); Treas. Reg. § 301.7701-3(a) (1994) (same); *Allison v. Commissioner*, 35 Tax Ct. Mem. Dec. (CCH) 1069, 1076 (1976) (incorporating requirement of two or more persons into tax definition of partnership), although it is not clear whether it would be a sole proprietorship or a corporation. See also William D. Bagley and Philip P. Whyntott, *The Limited Liability Company: The Better Alternative* § 14.103 (1991).

In contrast, the individual entrepreneur seeking limited liability can almost always form an S corporation and enjoy limited liability while foregoing some of the tax benefits of a C corporation—notably, the deferral resulting from use of a fiscal year for tax reporting, and the tax-free fringe benefits which would be unavailable to major shareholders of S corporations. Thus, the choice of C status would be primarily or purely tax-motivated. However, the government has apparently never contended that an incorporated taxpayer who forgoes the S election should be foreclosed from citing limited liability as a business purpose sufficient to avoid application of § 269A.

151. *Foglesong*, 621 F.2d at 869 n.9.

152. See generally Moore, *The Filmed Entertainment Industry* ¶ 1002.01 at 1652 (cited in note 59).

benefits that reduce federal income taxes also tend to reduce other taxes. Because of this "piggy-backing," in some cases federal income tax avoidance motives can be recharacterized as nonfederal income tax avoidance motives.

Unfortunately, little guidance is available to resolve these ambiguities. Because there have been no reported decisions¹⁵³ and only one private letter ruling¹⁵⁴ directly applying Section 269A and its proposed regulations, their scope and validity remain uncertain.¹⁵⁵ The proposed regulation under Section 269A cuts a broader swath than the statutory language, stating that a "principal purpose" of tax

153. Although one appellate opinion mentions § 269A, those comments are dicta. See notes 164-68 and accompanying text.

154. By finding § 269A inapplicable on facts very similar to those of *Keller*, the letter ruling itself raises serious questions about the efficacy of § 269A. In that ruling, Priv. Ltr. Rul. 8737001 (April 13, 1987), a physician incorporated his share of a medical partnership, and was the corporation's sole shareholder and sole physician-employee. The corporation adopted a retirement plan and a medical reimbursement plan, and used a fiscal year, even though the physician himself used a calendar year. The Service concluded that the physician did not incorporate for the principal purpose of tax avoidance, for two reasons: (1) the reduction in the physician's tax liability resulting from incorporation was "relatively insignificant" once pension contributions were disregarded (as required by § 269A); and (2) the fact that the corporate form provided the physician with limited liability under state law was a significant nontax purpose for incorporation, even though this limited liability did not extend to his own professional malpractice. The ruling does not indicate whether, or under what circumstances, limited liability by itself would establish a sufficient nontax purpose.

Strangely, the ruling never even mentions *Keller*. Yet, the only material differences between the facts in the letter ruling and the *Keller* case are that: (1) the physician in *Keller* asserted no nontax purpose for incorporation (although almost certainly he, like the physician in the ruling, could have asserted some degree of limited liability, even though state law might have prevented limitation of his own medical malpractice liability); and (2) the physician in *Keller* may have enjoyed a greater overall reduction in tax liability as a result of incorporation (although the absence of figures in the ruling makes this conclusion speculative). The Service's reluctance to apply § 269A in the letter ruling seems inconsistent with the aggressive position the Treasury's proposed regulation suggests, and is especially odd since the proposed regulation was promulgated four years before the letter ruling. Based on Priv. Ltr. Rul. 8737001, it is not at all clear whether, if the *Keller* facts were presented to the Service today, § 269A would change the outcome at all. See also *Leavell*, 1995 U.S. Tax Ct. LEXIS at *80 (Swift, J., concurring) (noting that government, without adequate explanation, conceded that § 269A did not apply to basketball player's loan-out); *id.* at *83 n.4 (Laro, J., dissenting) (noting that government "disavowed" application of § 269A because athlete's primary purpose in incorporating was to enable him to "claim the benefits of free agency").

155. The proposed regulation has been roundly criticized for its ambiguity on essential points, and the government's prolonged inaction suggests that the regulation is unlikely to go into effect, at least without substantial revision. See, for example, Robert Lewis Jackson, *Attorney Calls for Withdrawal of PSC Regs.*, 92 Tax Notes Today 116-34 (June 4, 1992) (criticizing the proposed regulations as inadequate); *Section 269A—Service Corporations to Avoid Tax*, 19 Tax Notes 186 (April 18, 1983) (discussing a practitioner's reaction); 19 Tax Notes at 587 (May 16, 1983) (discussing a practitioner's reaction); Lisa Klinger, *Proposed 269A Regulations Criticized As Vague and Expansive*, 20 Tax Notes 321 (July 25, 1983) (summarizing criticisms at Service hearing).

avoidance is "evidenced when use of the corporation either reduces the income of any employee-owner, or secures for any employee-owner one or more tax benefits which would not otherwise be available."¹⁵⁶ "Tax benefits" are defined broadly as "any expense, deduction, credit, exclusion or other allowance which would not otherwise be available."¹⁵⁷ A particular tax benefit is one that would "not otherwise be available" to the owner-employee when it would be unavailable to that person if performing the services "in an individual capacity."¹⁵⁸ The proposed regulation includes a nonexhaustive list of specific benefits that meet this definition:¹⁵⁹ accumulation of income by the corporation, use of multiple classes of stock for income splitting, income deferral through use of a taxable year different from that of the shareholder(s),¹⁶⁰ life insurance plans, accident and health plans, and meals and lodging furnished for the employer's benefit.¹⁶¹

Although the proposed regulation does not explain whether "in an individual capacity" means as a sole proprietor, as a partner in a partnership, or as an employee, the benefits it lists, together with the legislative history of Section 269A,¹⁶² suggest that the focus should be on benefits that would be unavailable to partners and sole proprie-

156. Prop. Treas. Reg. § 1.269A-1(a)(2), 48 Fed. Reg. 13,438 (1983). Under a proposed safe harbor, a PSC will be deemed not to have a principal purpose of tax avoidance if no employee-owner's federal income tax liability (including the corporation's tax liability) is reduced in any 12 month period by more than the lesser of \$2,500 or 10% of the tax liability she would have incurred "in an individual capacity." Prop. Treas. Reg. § 1.269A-1(c) (1994). The taxpayer who would reap the greatest benefit from forming a loan-out would typically not satisfy this safe harbor.

157. Prop. Treas. Reg. § 1.269A-1(b)(6).

158. Prop. Treas. Reg. § 1.269A-1(b)(4).

159. Prop. Treas. Reg. § 1.269A-1(b)(6).

160. Deferral is specifically mentioned in the discussion of § 269A contained in the post-enactment "Blue Book." Staff of Joint Committee on Taxation, 97th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, H.R. 4961, 326 (Comm. Print 1982) ("TEFRA"). This tax avoidance device became less significant, however, after enactment of § 441, which forced most PSCs to adopt the same taxable years as their controlling shareholders. Tax Reform Act of 1986, Pub. L. No. 99-514, § 806, 100 Stat. 2363 (1986), codified at I.R.C. § 441(i) (1994). As noted earlier, however, many loan-outs fall outside the scope of these rules. See note 47 and accompanying text. For those entities, a § 269A analysis could still be triggered by the selection of a loan-out's taxable year.

161. Prop. Treas. Reg. § 1.269A-1(b)(6), 48 Fed. Reg. 13,438 (1983). For taxable years beginning before January 1, 1984, the list of "tainted" tax benefits also included certain contributions to, and benefits under, a qualified retirement plan, since larger contributions were permitted to corporate retirement plans than to Keogh plans before 1984. *Id.* But see 128 Cong. Rec. 22403 (Aug. 19, 1982) (comments of Senator Dole) (suggesting that retirement plans should not be considered in the § 269A analysis before the effective date of parity under TEFRA). The TEFRA Conference report indicates that § 269A only applies where a taxpayer achieves "significant" tax benefits through incorporation, but does not define "significant." Conference Committee, Report on the Tax Equity and Fiscal Responsibility Act of 1982, H.R. 4961, H.R. Rep. No. 760, 97th Cong., 2d Sess. 633 (1982).

162. See note 144 and accompanying text.

tors. Yet many—if not most—service-providers who *could* work as partners or sole proprietors would also have the option of choosing to work as someone's employee. As employees of another party, they might have access to at least some of the benefits that a loan-out could provide, although the benefits would not necessarily be customized to their needs. Their decision to incorporate could therefore be characterized as motivated not primarily by tax concerns, but by the desire to find the employer that provides the best possible benefits package. If such an "optimal" employer does not already exist in the marketplace, through incorporation the taxpayer can create such an employer. Thus, in many cases it would be difficult to say with certainty that an incorporation was primarily tax motivated rather than market motivated, even where comparable tax benefits are unavailable to sole proprietors and partners.¹⁶³

For these reasons, it seems likely that Section 269A will discourage the use of loan-outs. The only appellate court that has even mentioned Section 269A in this context gave it a cold reception. In *Sargent v. Commissioner*,¹⁶⁴ a case involving loan-outs formed by professional hockey players, the Eighth Circuit Court of Appeals stated in dicta that Section 269A was inapplicable because the "PSCs were established for a legitimate purpose, and [the athletes] had bona fide employment contracts with their respective PSCs."¹⁶⁵ However, the only asserted motives for forming the loan-outs in *Sargent* were: (1) to gain increased bargaining power; and (2) to place money into a pension plan. The first of these motives seems utterly irrelevant, especially since the opinion does not explain how incorporation would

163. If, as the proposed regulation implies, the very existence of tax benefits establishes that tax avoidance was the principal purpose of incorporation, then § 269A can be applied to virtually any controlled service corporation formed in a way that maximizes tax benefits to an individual employee-owner, as long as the corporation provides "substantially all" of its services to a single party during the relevant testing period (whatever that period is determined to be). The proposed regulation does not, however, indicate the weight to be afforded this "evidence." Surely the receipt of some federal tax benefits should not give rise to a conclusive presumption that the principal purpose of forming the corporation is tax avoidance. Any other interpretation of the proposed regulations seems inconsistent with both the language and the legislative history of § 269A.

164. 929 F.2d 1252 (8th Cir. 1991).

165. *Id.* at 1260 n.17. The *Sargent* court's comments on § 269A are dicta, because all of the taxable years at issue in *Sargent* (1978-82) preceded § 269A's January 1, 1983, effective date. Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), Pub. L. No. 97-248, § 250(a), 96 Stat. 324 (1982), codified at I.R.C. § 269(A) (1994); *Sargent v. Commissioner*, 93 Tax Ct. 572, 583 n.10 (1989).

increase the athletes' bargaining power.¹⁶⁶ The pension plan rationale is also unpersuasive, not only because it reflects the same level of tax motivation as the benefits enumerated in the proposed regulations,¹⁶⁷ but also because the players would have been covered by the National Hockey League Players Pension Plan had they not established their separate corporate plans.¹⁶⁸ The appellate court's acceptance of these motives suggests that it would find virtually any nontax motive sufficient to avoid Section 269A.

In summary, the purpose and intended scope of Section 269A are anything but clear. Because of the wide array of nontax purposes a taxpayer may assert, the proviso that the corporation provide substantially all services for only one other entity, and the statute's failure to define "substantially all" or to specify the testing period, Section 269A has not, in practice, given the government any powers not already exercisable under Section 269, Section 482, or the assignment of income doctrine. It appears doubtful that Section 269A has any "teeth" at all in discouraging loan-outs.¹⁶⁹

B. Challenges Invoking the Employee/Independent Contractor Analysis

In the wake of its numerous failures to persuade courts to disregard professional corporations under the doctrines discussed

166. See also *Leavell*, 1995 U.S. Tax Ct. LEXIS at *83 n.4 (Laro, J., dissenting) (noting that government accepted athlete's contention that incorporation was for primary purpose of enabling him to be a free agent). *Leavell* is the only other published opinion discussing the application of § 269A to loan-outs.

167. The proposed § 269A regulation had been promulgated eight years before the court issued this opinion. Notice of Proposed Rulemaking, 48 Fed. Reg. 13,438 (1983). Under the proposed regulation, the retirement contributions would not by themselves cause the players' corporations to be disregarded. Prop. Treas. Reg. § 1.269A-1(d)(2)(i), 48 Fed. Reg. 13,438-39 (1983) (generally barring application of § 269A to contributions to retirement plans of corporations formed before September 3, 1982). Yet that does not mean that the drafters of the regulation would have characterized them as nontax motives sufficient to "save" a corporation from § 269A if that section were otherwise applicable.

168. It is not clear whether the players established their corporate plans instead of, or in addition to, the league plan, but the loan-outs were not required to contribute to the league plan. *Sargent*, 929 F.2d at 1255, 93 Tax Ct. at 576-77. See note 30 (discussing the relationship between loan-out plans and multi-employer plans).

169. See Moore, *The Filmed Entertainment Industry* ¶ 1002.01 at 1652 (cited in note 59) (indicating that § 269A has not substantially deterred the use of loan-outs). As a tool for reallocating income between a loan-out and its shareholder-employee(s), § 482 appears to be superior to § 269A because, among other things, it is not circumscribed by the requirements that substantially all of the loan-out's services be provided to only one entity and that the corporate form be adopted for the principal purpose of avoiding federal income tax. Indeed, in *Keller* the court applied § 482 to reallocate a portion of the corporation's income to its employee-owner for the purpose of satisfying the arm's length standard. *Keller*, 77 Tax Ct. at 1027.

earlier, the Service has contended that most of the cases it lost under these doctrines involved service providers who did not fit the traditional "employee" mold—self-employed physicians, for example.¹⁷⁰ Therefore, it has turned its attention to incorporated service providers who perform services traditionally associated with employee status, and has sought to recharacterize loan-out arrangements as direct employment contracts in which the borrowing entity is the employer. This approach is especially harsh for taxpayers—and dubious in principle—because it allows the government to disregard the separate existence of a corporation without ever finding that it lacks a business purpose, that the parties have disregarded the corporate form, or that the transactions between the corporation and its principal employee fail to comport with arm's length standards.

1. Background

Even before it began to apply this analysis to loan-out corporations, the government had a long-standing interest in reclassifying independent contractors as employees,¹⁷¹ and it has intensified its efforts since the mid-1980s.¹⁷² In recent audits of the entertainment industry, for example, the Service frequently has challenged studios' characterization of various workers as independent contractors.¹⁷³ It

170. Gen. Couns. Mem. 39,553 (Sept. 3, 1986).

171. See, for example, Rev. Rul. 57-155, 1957-1 Cum. Bull. 333 (classifying actress and narrator as employees of film company).

172. See James J. Jurinski, *Independent Contractors: Tax and Business Planning* iii, §§ 1.10 to 1-1.30, 1-3.10 to 1-3.30 (Callaghan, 1993) (identifying reclassification as "one of the critical tax issues of the 1990s"); Ani Hadjian, *Hiring Temps Full-Time May Get the IRS on Your Tail*, *Fortune* 34 (Jan. 24, 1994) (reporting that the Service has been targeting companies that misclassify contingent workers, especially in temp-intensive industries); *IRS Plans to Step Up Audits of Independent Contractors, Says Neill, Mullenholz and Shaw*, 90 *Tax Notes Today* 164-67 (Aug. 8, 1990) (stating that consultants and others providing services as independent contractors would be the targets of increased audits in 1991).

173. During 1992, the Service initiated a Market Segment Specialization Program to focus on auditing the entertainment industry. See Husband, 9 *Ent. L. & Fin.* at 3 (cited in note 13); Diane Phelps, *A Closer Look at New IRS Policies*, 106 *Billboard* 4, 4 (April 9, 1994); Schuyler M. Moore, *How IRS Audits Affect Industry*, 8 *Ent. L. & Fin.* 1, 1 (1992); Robert Marich, *Hollywood on IRS Hit List: New Entertainment Industry Unit to Focus on Wealthy, Self-Employed*, *Hollywood Reporter* 1, 37 (Sept. 25, 1992). As part of this effort, the Service recently has issued new guidelines on worker reclassification in the film industry. See *IRS Market Segment Program Guidelines on Classification of Workers in Television Commercial Production and Professional Video Communications Industries*, reprinted in 92 *Daily Tax Rep. (BNA)* d60 (May 16, 1994) ("*Market Segment Program Guidelines*") (seeking to make accurate and consistent determinations of employee status by studying the market segment factors and the factors demonstrating the requisite control); Bob Geiger, *IRS Working Out Tax Deal With Film Production Industry*, *Minneapolis Star Tribune* 2D (Jan. 24, 1994) (observing that after years of

has announced its intent to pursue this issue in other industries as well, with special emphasis on small businesses and on industries in which workers tend to be employed on a temporary basis, such as publishing, telecommunications, advertising, software, and construction.¹⁷⁴

The government's preference for characterizing workers as employees rather than independent contractors has several sources: (1) the administrative convenience of collecting taxes through withholding; (2) the larger tax revenues generated by treating workers as employees; and (3) the relatively low level of tax compliance by independent contractors.¹⁷⁵ Indeed, in recent years, virtually all of the Service's efforts to collect employment taxes have focused on reclassifying workers rather than on discouraging underreporting by independent contractors,¹⁷⁶ even though the estimated revenue losses from noncompliance dwarf those from misclassification.¹⁷⁷

controversy regarding classification of entertainment industry workers, new audit guidelines represent negotiated compromise between government and industry positions). The Service confirms that worker classification is one of the most difficult issues facing its film industry task force. Rebert Marich, *Producer Wins Free-Lance Case*, *Hollywood Reporter* 4 (Feb. 18, 1994).

174. Report by the Committee on Government Operations, H.R. Rep. No. 102-1060 102d Cong., 2d Sess. 19 (Nov. 2, 1992) (noting the emphasis on classification issues in the Employment Tax Examination Program ("ETEP")); *Employee Misclassification Will Get More Scrutiny in All Audits, IRS Counsel Says*, 111 *Daily Tax Rep.* (BNA) d13 (June 11, 1993) (stating that misclassification will be an issue even when not the main focus of the audit); Jurinski, *Independent Contractors* § 1-3.30 (cited in note 172). The Service is currently developing employee/independent contractor classification guidelines for 50 different industries. See, for example, *Employment Tax Ruling in Final Stages of Development, IRS Official Says*, 151 *Daily Tax Rep.* (BNA), d10 (Aug. 9, 1993) (reporting that the Service is developing guidelines to determine the employment status of therapists and food service employees); *IRS Official Says Market Segment Guidelines Do Not Constitute Rulings*, 95 *Daily Tax Rep.* (BNA) d23 (May 19, 1994) (stating that the guidelines are intended to give taxpayers a sense of the common law factors the Service will use to classify a worker).

175. H.R. Rep. No. 102-1060 at 3-4. According to the House Committee on Government Operations, the trivial \$50 penalty imposed on a payor that fails to file a Form 1099 reporting payments for services provided by an unincorporated independent contractor, and the difficulty the Service has experienced in matching the payor's reported payments with the recipients' income tax returns, together account for this low level of compliance. *Id.* at 4. Note that if an independent contractor is incorporated, the payor is not required to report the payment at all. *Treas. Reg.* § 1.6041-3 (1994). Wisely, even if belatedly, the Treasury is considering eliminating this exemption. *Joint Committee on Taxation Staff Description of Miscellaneous Revenue Proposals Scheduled for Hearings Sept. 8, 21 and 23 Before House Ways and Means Select Revenue Measures Subcommittee*, 181 *Daily Tax Rep.* (BNA) d70 (Sept. 21, 1993).

176. H.R. Rep. No. 102-1060 at 1. Section 530 of the Revenue Act of 1978 somewhat abated the risk of retroactive reclassification. Pub. L. No. 95-600, § 530, 92 Stat. 2763 (1978), as amended by Pub. L. No. 96-541, 94 Stat. 3204 (1980), Pub. L. No. 97-248, 96 Stat. 324 (1982), Pub. L. No. 99-514, 100 Stat. 2085 (1986). Section 530, a provision that was never codified, was originally enacted as a temporary measure until Congress replaced the old common law test of employee status with something more practical, Senate Committee on Finance, Report on the Revenue Act of 1978, H.R. 13511, S. Rep. No. 95-1263, 95th Cong., 2d Sess. 209-10 (1978), reprinted in 1978-3 Cum. Bull. 315, 507-08, but was extended indefinitely by § 269(c) of TEFRA, 1982-2 Cum. Bull. 462, 536, and is expected to continue in force until Congress replaces the

Reclassification challenges, when successful, can be costly for both parties. When the service provider is retroactively recharacterized as an employee, the party deemed to be the employer must withhold and pay to the government the worker's wage-based income tax obligations as well as the employee's portion of social security taxes, must pay the unemployment tax and the employer's share of social security taxes, and may also be liable for substantial

common law test. Section 530 relief is available only if the taxpayer had a reasonable basis for treating its workers as independent contractors. Revenue Act of 1978, § 530(a)(1), 92 Stat. at 2885. See also Rev. Proc. 85-18, 1985-1 Cum. Bull. 518 (setting forth guidelines for implementing § 530). A reasonable basis will be difficult to show when an examination of the 20 common law factors on which the Service relies indicates employee status. See Rev. Rul. 87-41, 1987-1 Cum. Bull. 296. See also note 190 (discussing the 20 factor test). Under the safe harbor provisions of § 530, however, a taxpayer can prevail by showing reasonable reliance on case law, rulings, a prior audit, or "long-standing recognized practice of a significant segment of the industry in which such individual was engaged." Revenue Act of 1978, § 530(a)(2)(c), 92 Stat. at 2886. In addition, although § 530 does not define "reasonable basis", the legislative history indicates that Congress intended that the standard be "liberally construed in favor of taxpayers." House Committee on Ways and Means, Controversies Involving the Employment Status of Certain Individuals for Purposes of the Employment Taxes, U.R. 14159, H.R. Rep. No. 95-1748, 95th Cong., 2d Sess. 631-32 (1978); Rev. Proc. 85-18, 1985-1 Cum. Bull. 518, § 3.01[c]. In *Critical Care Register Nursing, Inc. v. U.S.*, 776 F. Supp. 1025 (E.D. Pa. 1991), the district court held that a taxpayer may use the government's 20-factor test to establish a reasonable basis for treating a worker as an independent contractor. *Id.* at 1028.

Section 530 relief, however, is unavailable if the taxpayer has treated that worker—or another worker in a "substantially similar . . . position"—as an employee in the past. Revenue Act of 1978, § 530 (a)(2)(B), 92 Stat. at 2885; Rev. Proc. 85-18, 1985-1 Cum. Bull. 518. In addition, because of perceived abuses, Congress amended § 530 in 1986, making the relief provision inapplicable to certain technical workers such as engineers, designers, draftsmen, computer programmers, and systems analysts. Revenue Act of 1978, § 530(d), as amended by the Tax Reform Act of 1986, § 1706, Pub. L. No. 99-514, 100 Stat. 2085, 2781 (1986).

When § 530 applies, the Service may not retroactively reclassify workers as employees. However, § 530 applies only for purposes of implementing social security tax ("FICA"), unemployment tax ("FUTA"), and income tax withholding. Thus, it does not prevent reclassification for other purposes, such as reduction of the worker's business expense deductions, disqualification of the worker's or the employer's retirement plan, and certain other tax-favored employee benefits. H.R. Rep. No. 102-1060 at 14; Rev. Proc. 85-18, 1985-1 Cum. Bull. 518, § 3.08; Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, H.R. Doc. No. 3838, 99th Cong., 2d Sess. 1343 (Jt. Comm. Print 1987).

Section 530 not only limits the Service's authority to recharacterize on an audit, but also prevents the Service from issuing regulations and revenue rulings giving interpretive guidance on the characterization issue. Revenue Act of 1978, § 530(b), 92 Stat. at 2886 (as amended by § 269(c) of TEFRA, 96 Stat. at 552). This prohibition has been criticized, and its repeal may be imminent. See H.R. Rep. No. 102-1060 at 14. The Service will issue private rulings on the prior status of workers, as employees or independent contractors, for purposes of §§ 3121, 3306, and 3401, but it will not issue rulings as to prospective status. Rev. Proc. 95-3, 1995-1 Int. Rev. Bull. 85, § 3.01 (43).

177. H.R. Rep. No. 102-1060 at 19 (reporting revenue losses of \$2 billion from misclassification, versus \$20 billion from underreporting by self-employed individuals alone—not including partnerships, corporations, or persons who fail to file Schedule C).

interest and penalties.¹⁷⁸ Retroactive reclassification of workers can also cause an employer's fringe benefit and retirement plans to violate the nondiscrimination rules imposed on such plans, thereby resulting in the loss of their tax-favored status.¹⁷⁹

Reclassification can also be costly to the person recharacterized as an employee. As discussed earlier, employee status per se (apart from any tax-favored fringe benefits provided by the employer) is generally not advantageous from a tax perspective. Without independent contractor status, the worker will no longer be able to deduct one hundred percent of her ordinary and necessary business expenses or customize a retirement plan, and cannot deduct twenty-five percent any portion of her health insurance premiums.¹⁸⁰ If the worker has more than one employer during the year, excessive social security taxes may be withheld. Although the worker must pay a self-employment tax if classified as an independent contractor,¹⁸¹ that cost often can be shifted to the service recipient through higher fees to the same extent that an employer shifts payroll costs to customers. The situation is even worse if the reclassified worker was incorporated. In

178. See generally I.R.C. §§ 6601, 6621, 6651(a)(1)-(2), 6651(f), 6656(b)(1), 6663, 6672, 6721(d) (1994). Section 3509 of the Code mitigates the retroactive assessment of income withholding taxes and the employee's share of FICA taxes where the failure to withhold is unintentional. I.R.C. § 3509 (1994). However, it offers no relief with respect to FUTA taxes, the employer's share of FICA taxes, or underpayment interest and penalties. *Id.*; Prop. Treas. Reg. § 31.3509-1(d)(6), 51 Fed. Reg. 619, 626 (1986).

179. I.R.C. § 401(a)(3)(A) (1954); H.R. Rep. No. 102-1060 at 14 (cited in note 174). See, for example, *Burnetta v. Commissioner*, 68 Tax Ct. 387 (1977) (disqualifying corporations' retirement plans for failure to include workers provided by payroll service corporation). In the entertainment industry, where many workers belong to guilds that provide multi-employer pension plans, some guild agreements specify that the party who is the "borrower" in a loan-out transaction must contribute a specified percentage of the loan-out's compensation to the guild's pension fund. See, for example, Directors Guild of America Basic Agreement of 1990, Sec. 12-105; Screen Actors Guild Codified Basic Agreement of 1989 for Independent Producers, Sec. 32K; Writers Guild of America Theatrical and Television Basic Agreement—1992 Extension, Arts. 3.A.(3) and 17.B.(1). This arrangement will insulate the pension fund from losing tax-favored status if the worker's loan-out is disregarded and the worker is reclassified as the borrower's common law employee.

There are, however, other potential consequences of reclassification. If proposals to provide universal health care coverage result in employer mandates and if the tax classification of a worker also dictates the worker's classification for health insurance purposes, misclassification will cause additional problems. See *Treasury Defends S Corporation Tax Change in Clinton Health Reform Plan*, 84 Daily Tax Rep. (BNA) d5 (May 4, 1994) (reporting intent of the Clinton administration to use one set of worker classification guidelines for both health care and employment tax purposes). Reclassification of a worker may also trigger an employer's obligation to pay worker's compensation insurance premiums under state law, though the federal tax classification of a worker would not necessarily dictate this characterization under state law.

180. Employee status could also jeopardize the home office deduction for some workers. See note 12.

181. An independent contractor pays a self-employment tax equivalent to both halves of FICA, I.R.C. §§ 1401-02 (1994), but does not pay any FUTA.

that case, the reclassification effectively disregards the worker's loan-out corporation so that the worker can no longer use the corporation to defer taxes or to generate deductions for one hundred percent of the cost of health insurance and medical care. Disregard of the corporation also adversely affects other tax-favored insurance benefits, business expense deductions, and the availability of a customized retirement plan.¹⁸²

The government's aggressive posture on worker recharacterization may actually have triggered an increase in the use of loan-outs. Consumers of services may actively encourage workers to operate through loan-outs, believing that the loan-out will make reclassification less likely.¹⁸³ As a result, the government is likely to respond by stepping up its scrutiny of loan-outs.¹⁸⁴

2. The Common Law Test of Employee Status

The uncertainty surrounding employee status arises from the absence of a clear definition of "employee" in the relevant portions of the Code. For purposes of FICA and FUTA, workers generally are classified as employees if they would be so classified "under the usual common law rules applicable in determining the employer-employee relationship."¹⁸⁵ The government and the courts also have applied the

182. See text accompanying notes 10-50. See also H.R. Rep. No. 102-1060 at 4 (cited in note 174).

183. See, for example, Priv. Ltr. Rul. 9350002 (Sept. 2, 1993) (involving the owner of veterinary clinic who asked staff veterinarians to incorporate in order to avoid employee classification). The House Committee on Government Operations has predicted that its proposal to increase enforcement against independent contractors will lead to greater use of the corporate form by independent contractors because payments to corporations are generally exempt from Form 1099 reporting requirements. It recommends repealing this exemption with respect to payments for services, expressing concern that "the pressure on the 20 factor classification rules cannot be relieved unless this major loophole is closed." H.R. Rep. No. 102-1060 at 15-16. To improve the matching of payments with payee tax returns, the Committee also recommends that service consumers be required to contact the Service to verify the taxpayer identification number of each independent contractor they utilize, and that independent contractors who supply faulty taxpayer identification numbers to payors be subject to backup withholding. *Id.* at 17-18.

184. The entertainment industry has reported increased Service scrutiny of loan-outs. See, for example, Seigel, *Arizona Republic* at E1 (cited in note 13); Moore, 8 *Ent. L. & Fin.* at 1 (cited in note 173). The Service itself actively publicizes its efforts. See, for example, Reish and Ferenczy, *Retirement Plan Tips for Talent Guild Members*, 10 *Ent. L. & Fin.* 5 (cited in note 30); Marich, *Hollywood Reporter* at 19 (cited in note 5); Robert Marich, *IRS Cracks Whip on H'wood as Audits Soar*, *Hollywood Reporter* 1, 32 (Dec. 17, 1992).

185. I.R.C. §§ 3121(d)(2), 3306(i) (1994). The FUTA and withholding provisions of the Code define the term "employer." I.R.C. § 3306(a) (1994) (FUTA); I.R.C. § 3401(d) (1994) (prescribing income tax withholding rules). Although the FICA provisions do not define "employer," the

common law test to classify workers for purposes of Code provisions that do not define "employee."¹⁸⁶

By far the most important factor in the government's version of the common law analysis is the degree of control exercised by the party receiving the worker's services.¹⁸⁷ The Treasury Regulations focus on whether "the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished."¹⁸⁸

The regulations indicate that individuals who market their services to the public at large generally will be viewed as independent contractors: "Generally, physicians, lawyers, dentists, veterinarians, contractors, subcontractors, public stenographers, auctioneers and

Supreme Court has held that the definition for FICA purposes should not be narrower than that for withholding purposes. *Otte v. U.S.*, 419 U.S. 43, 51 (1974). Both the FUTA and withholding definitions of "employer" are essentially circular; a FUTA employer is one who employs others or pays "wages," I.R.C. § 3306(a) (1994), and an employer for withholding purposes is the person for whom another performs services as an "employee," unless the recipient of services does not control the payment of wages, in which case the wage payor is the employer, I.R.C. § 3401(d) (1994). "Wages" are defined unhelpfully as "remuneration for employment." I.R.C. §§ 3121(a) (FICA), 3306(b) (FUTA) (1994). See also I.R.C. § 3401(a) (withholding) (similar language). Until § 530 of the Revenue Act of 1978 is amended or repealed, the Treasury is prohibited from clarifying these rules through Revenue Rulings or regulations. Revenue Act of 1978, Pub. L. No. 95-600, § 530(c), 92 Stat. 2763, 2885, codified at 26 U.S.C. § 3401 (1988) (as amended by § 269(c) of the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324, 552, codified at I.R.C. § 3401 (1994)).

186. Those Code provisions that use the term "employee" without defining it include: (1) the income tax withholding rules, I.R.C. § 3401 (1994), see, for example, *Lanigan Storage & Van Co. v. United States*, 389 F.2d 337, 338 (6th Cir. 1968); (2) the 2% floor on miscellaneous itemized deductions (including unreimbursed employee expenses under I.R.C. § 67), see, for example, *Lewis v. Commissioner*, 66 Tax Ct. Mem. Dec. (CCH) 1830, 1832 (1993); *Johnson v. Commissioner*, 66 Tax Ct. Mem. Dec. (CCH) 1323, 1325 (1993); and (3) the rules regarding whether a particular worker must be counted as an employee in determining whether the employer's retirement plan satisfies the requirements of the Code, see, for example, *Monroe v. Commissioner*, 38 Tax Ct. Mem. Dec. (CCH) 466, 469 (1979); *Pugh v. Commissioner*, 49 Tax Ct. Mem. Dec. (CCH) 748, 750-51 (1985); *Herman v. Commissioner*, 52 Tax Ct. Mem. Dec. (CCH) 1194, 1196 (1986); *Reece v. Commissioner*, 63 Tax Ct. Mem. Dec. (CCH) 3129, 3131 (1992); *Bilenas v. Commissioner*, 47 Tax Ct. Mem. Dec. (CCH) 217, 219 (1983); *Pulver v. Commissioner*, 44 Tax Ct. Mem. Dec. (CCH) 644, 648 (1982); *Neely v. Commissioner*, 37 Tax Ct. Mem. Dec. (CCH) 128, 130 (1978); *Professional & Executive Leasing, Inc. v. Commissioner*, 862 F.2d 751, 754 (9th Cir. 1988) (holding that the taxpayer's control over the workers was not sufficient to establish an employment relationship even under the lower standards applicable to professionals).

187. Rev. Rul. 87-41, 1987-1 Cum. Bull. 296; Rev. Rul. 75-41, 1975-1 Cum. Bull. 352.

188. Treas. Reg. § 31.3121(d)-1(c)(2) (1994) (FICA), Treas. Reg. § 31.3306(i)-1(b) (1994) (FUTA), 31.3401(c)-1 (income tax withholding) (1994). See, for example, Rev. Rul. 57-145, 1957-1 Cum. Bull. 332 (concluding that a corporation exercised the control necessary to establish an employment relationship); Rev. Rul. 68-396, 1968-2 Cum. Bull. 436 (focusing on the right to control and actual control in establishing the employment relationship).

others who follow an independent trade, business, or profession, in which they offer their services to the public, are not employees.”¹⁸⁹

Although control is the most important factor, the Service normally considers twenty indicia derived from common law in determining a worker's status.¹⁹⁰ Courts occasionally consider other factors as well.¹⁹¹ Both the Department of the Treasury and the General Accounting Office have conceded, however, that this multi-factor test is “too vague to be administered on a consistent basis.”¹⁹²

189. Treas. Reg. § 31.3401(c)-1(c) (1994) (income tax withholding). See also Treas. Regs. §§ 31.3121(d)-1(c)(2) (1994) (FICA), 31.3306(i)-1 (1994) (FUTA) (using virtually identical language). Accord, Rev. Rul. 87-41, 1987-1 Cum. Bull. 296, 298 (noting that individuals who follow an independent trade are generally not considered employees). In addition, corporate officers, except for those who perform minimal services and receive no compensation, generally are considered employees of their corporations for FICA purposes. I.R.C. § 3121(d)(1) (1994); Treas. Reg. § 31.3121(d)-1(b) (1994).

190. Specifically, the following factors indicate employee status: (1) the payor provides detailed instructions on how the work is to be done; (2) the payor provides training; (3) workers and the work materials are integrated with the payor rather than functioning independently; (4) the services are rendered personally; (5) the payor (rather than the worker) hires, supervises, and pays the worker's assistants; (6) the relationship between payor and worker is relatively permanent; (7) the payor sets the workers' hours; (8) the payor requires the workers to work a minimum number of hours per day or week, or to work “full-time”; (9) the payor requires the workers to work on the payor's premises and the workers may have access to the payor's support facilities and personnel; (10) the payor requires the workers to perform services in a given sequence; (11) the payor requires the workers to furnish progress or similar reports; (12) workers are paid hourly, monthly, or weekly; (13) the payor pays the workers' business and/or travel expenses; (14) the payor furnishes equipment and materials; (15) the workers do not make a significant investment in equipment and materials; (16) the payor bears the risk of economic loss and carries any necessary insurance; (17) the workers work exclusively for the payor; (18) the workers do not offer services to the public through advertising or other means; (19) the payor has the right to discharge or discipline the workers at any time; and (20) the workers have the right to terminate the relationship without incurring liability. Rev. Rul. 87-41, 1987-1 Cum. Bull. 296, 298-99. The list is not exhaustive, *Breaux and Daigle, Inc. v. U.S.*, 900 F.2d 49, 51 (5th Cir. 1990), and the weight given to each factor depends in part on the nature of the work and the context in which it is performed. For additional commentary on each factor, see Daniel L. Morgan and Yale F. Goldberg, *Employees and Independent Contractors*, Tax Transactions Library (CCH) 455-59 (June 1990).

191. The judicially adopted factors include: (1) the skill required for the work, *Bartels v. Birmingham*, 332 U.S. 126, 130 (1947); *Enochs v. Williams Packing & Navigation Co.*, 370 U.S. 1, 3-4; (2) the intent of the parties, *McCormick v. U.S.*, 531 F.2d 554, 560-61 (Ct. Cl. 1976); (3) the custom of the industry, *Bonney Motor Express, Inc. v. U.S.*, 206 F. Supp. 22, 26 (E.D. Va. 1962); (4) the labels used by the parties, *Rayhill v. U.S.*, 364 F.2d 347, 355-57 (Ct. Cl. 1966); and (5) the provision of employee benefits, *Lewis*, 66 Tax Ct. Mem. Dec. (CCH) at 1834. The Restatement (Second) of Agency § 220(2) (1958), lists other factors that a court or the Service might consider. See *Nationwide Mutual Ins. Co. v. Darden*, 112 S. Ct. 1344, 1348 (1992) (applying multi-factor test to determine whether someone is an employee under ERISA).

192. H.R. Rep. No. 102-1060 at 2, 4 (cited in note 174). Not surprisingly, the subjective nature of this analysis has produced a 40% appeals rate for worker classification determinations made by examining agents. *Id.* at 20. Because payors are not required to notify workers of the significance of being classified as an independent contractor, some workers may assume mistakenly that social security or unemployment taxes are being paid on their behalf. See *id.* at 7, 18

The Service has begun to address the vagueness problem by issuing nonbinding industry-specific guidelines. With respect to certain segments of the film industry, for example, the Service recently has attempted to clarify its approach to worker classification. The newly issued guidelines,¹⁹³ which lack the force of law,¹⁹⁴ adhere to the "control" test and the twenty factor analysis, and do not purport to treat incorporated workers differently from other workers. The film industry guidelines do not reflect any softening of the government's position on worker classification. Rather, they illustrate specific applications of the control-oriented common law analysis, and they indicate the weight to be given to each of the twenty indicia in specific factual contexts. In a rather confusing passage that suggests a tightening of the classification standards, the guidelines indicate that while guild members will *conclusively* be deemed to be employees if they do *not* use loan-outs, the consequences of using a loan-out are beyond the scope of the guidelines.¹⁹⁵

For tax purposes it is not clear why the existence of control sufficient to create a common law employment relationship should dictate tax consequences different from those that would exist in an independent contractor relationship.¹⁹⁶ The common law test used by

(recommending that service consumers be required to supply each worker with a standardized explanation of their classification and its ramifications).

193. *Market Segment Program Guidelines*, 92 Daily Tax Rep. (BNA) at d60 (cited in note 173).

194. Therefore, according to Service officials, these guidelines do not constitute "rulings," and thus do not violate the prohibition of § 530 of the Revenue Act of 1978. See *Employment Taxes, IRS Official Says Market Segment Guidelines Do Not Constitute Rulings*, 95 Daily Tax Rep. (BNA), d23 (May 19, 1994); *Internal Revenue Service Market Segment Program Guidelines on Classification of Workers in Television Commercial Production and Professional Video Communications Industries*, 92 Daily Tax Rep. (BNA), d2 (May 16, 1994).

195. *Market Segment Program Guidelines* at § IV.A.3 (cited in note 173).

196. *Stover Bedding Co. v. Industrial Commission*, 99 Utah 423, 107 P.2d 1027, 1029 (1940) and *Breaux and Daigle, Inc. v. United States*, 89-2 U.S.T.C. ¶ 9536, 89601-03 (E.D. La. 1989), aff'd 900 F.2d 49 (5th Cir. 1990), discuss the development of the control test in the FICA and FUTA contexts.

In the context of social legislation the Supreme Court has on occasion strayed from strict adherence to the common law definition of the employment relationship in favor of a test that focuses on "economic reality" in light of the purpose of the legislation at issue. The Supreme Court broadly interpreted the common law test in the FICA context in *United States v. Silk*, 331 U.S. 704, 713 (1947), when it ruled that employee status for FICA purposes should be determined under the same rules applied to the National Labor Relations Act in *NLRB v. Hearst Publications*, 322 U.S. 111 (1944), which held that the definition of "employee" "was a federal problem to be construed in the light of the mischief to be corrected and the end to be attained." *Silk*, 331 U.S. at 713 (quoting *Hearst*, 322 U.S. at 124). In the context of federal labor laws, where the goal was to remedy inequality of bargaining power, *Hearst* had held that "employee" "included workers who were such as a matter of economic reality." *Silk*, 322 U.S. at 713. Accordingly, *Hearst* rejected a test employing the "technical concepts pertinent to an employer's legal responsibility to third persons for acts of his servants"—that is, the power to control the worker's service-related activities. *Id.* (quoting *Hearst*, 322 U.S. at 129). The *Silk* Court identi-

the courts and the Service was developed in tort law as a means of determining when the doctrine of respondeat superior should apply.¹⁹⁷ In that context, it makes sense to apply a test that focuses on control, since it places liability on the party who was in the best position to prevent the injury. The common law test also has been applied in copyright law to determine whether a copyright belongs to the party who contracted to pay for a creative effort or to the party who performed the creative activity under that contract.¹⁹⁸ In that context as well, the emphasis on control appears to bear a reasonable relationship to the public policy being served, since the greater the control exercised by the supervisor, the less likely it is that the supervised party made a substantial creative contribution.

In the tax context, the control test arguably serves two legitimate purposes: (1) making enforcement of the tax laws easier for the government by allowing collection of taxes through payroll

fied the purpose of collecting FICA and FUTA taxes on the wages of employees as "the protection of [the] beneficiaries from some of the hardships of existence," notably "the insecurities of modern life, particularly old age and unemployment." *Id.* at 710-11.

Only one week after its *Silk* decision, the Supreme Court in *Bartels v. Birmingham*, 332 U.S. 126, held that for FICA purposes the members of a band were employees of their band leader rather than of the dance hall that engaged the band. 322 U.S. at 132. The bands in question were "name" bands built around their band leaders rather than groups formed by the dance hall operator. As such, the bands performed limited engagements for numerous dance halls under a separate contract for each engagement. The standard contract adopted by the American Federation of Musicians, however, purported to give the dance hall operator "complete control" over the band members, apparently in order to make the band members common law employees of the dance hall operator and, thus, shift the social security tax obligation from the band leader to the dance hall operator. *Id.* at 128-29. *Bartels* established that taxpayers could not contractually create a "control" relationship that would conclusively establish an employment arrangement. *Id.* at 130-32 (citing *Silk*, 331 U.S. at 704 (discussing the importance of factors other than control)).

After *Silk* and *Bartels*, however, Congress expressed concern that the "economic reality" test would overwhelm the common law standards and broaden the reach of FICA beyond Congress's intent, see H.R.J. Res. 296, Pub. L. No. 642, 80th Cong., 2d Sess. (1948), in 62 Stat. 438 (resolving to maintain the status quo with respect to certain employment taxes and social security benefits); Veto of Social Security Benefits, 2 U.S. Code Cong. Serv. 2501, 2502 (1948) (statement of President Truman on vetoing the joint resolution); *United States v. Thorson*, 282 F.2d 157, 159-60 (1st Cir. 1960) (explaining the congressional action); and the Court has since returned to the principle that when a statute is silent on the definition of "employee" the common law standards should prevail. *Darden*, 112 S. Ct. at 1348-49 (construing § 3(6) of ERISA); *Community for Creative Nonviolence v. Reid*, 490 U.S. 730, 738-51 (1989) (construing § 101 of the Copyright Act).

197. See, for example, *Lifetime Siding, Inc. v. United States*, 359 F.2d 657, 660 (2d Cir. 1966) (upholding a jury instruction providing that "the test to be used in determining the status . . . is the common law one applicable in tort actions").

198. If there is an employment relationship, the copyright belongs to the employer unless the parties agree to the contrary in writing. 17 U.S.C. §§ 101, 201(b) (1988 & Supp. 1993). See *Community for Creative Nonviolence*, 490 U.S. at 737 (applying statute where payor commissioned a sculpture).

withholding rather than by relying on self-reporting by independent contractors; and (2) protecting workers who may be unaware that their employers are treating them as independent contractors and thus depriving them of future government benefits such as Social Security and unemployment compensation (and possibly, in the future, health care benefits).¹⁹⁹ Although the first rationale—ease of enforcement—merits some consideration, the inequities it imposes on the affected taxpayers and the availability of alternative remedies such as improving enforcement of the payor's reporting requirements render it unpersuasive.²⁰⁰ As for the paternalistic rationale, it is inappropriate in the case of workers who make an informed choice to operate as independent contractors.²⁰¹ One way to demonstrate such an informed choice, of course, is to incorporate.²⁰²

3. Applying the Common Law Test to Loan-Outs

As discussed in Part III.A, the government litigated the earliest of the employee loan-out cases without resorting to the employee/independent contractor analysis at all. Instead, it employed the various doctrines described earlier—assignment of income, sham incorporation, and, in later years, Section 482—which allow recharacterization of a loan-out arrangement whenever the conduct of the parties is inconsistent with their treatment of the transaction for tax purposes. Under appropriate circumstances, these same doctrines allow the government to disregard corporations formed by individuals who predominantly provide their services not to one recipient but

199. See American Tax Policy Institute, *Independent Contractors* at I-6 to I-7 (cited in note 172); H.R. Rep. No. 102-1060 at 21 (cited in note 174) (noting that workers who are not independent need the protection that employment status provides); House Subcommittee on Public Assistance and Unemployment Compensation of the Committee on Ways and Means, U.S. House of Representatives, *Federal-State Unemployment Compensation System*, WMCP 100-39, 100th Cong., 2d Sess. 33-34 (Comm. Print, 1988) (study of the federal-state unemployment system prepared by the Congressional Research Service of the Library of Congress).

200. See H.R. Rep. No. 102-1060 at 22-26 (urging enforcing payor reporting requirements as a remedy preferable to worker reclassification in most cases). See also note 183 (discussing inadequate reporting rules).

201. The Committee on Government Operations voiced similar policy arguments in its report recommending that the Service be permitted to publish guidance on the distinction between employees and independent contractors. H.R. Rep. 102-1060 at 21-22.

202. The Service will not issue prespective rulings on whether, under common law rules, a loan-out corporation or the borrowing entity is the "employer" of a loaned worker where the period of the "loan" is more than temporary (equal to or greater than one year), or the loan-out corporation hires employees of the borrower and assigns them back to the borrower. Rev. Proc. 95-3, 1995-1 Cum. Bull 447, 452-53, § 3.02(8). Even when a ruling is available, this route will be impractical for many taxpayers entering into short-term services contracts, and will only remove the uncertainty rather than address the merits of the government's approach.

instead to the public at large. Thus, until the mid-1980s, the government treated loan-outs no differently from so-called "professional corporations."

In none of these early cases did the government attempt to use the worker reclassification approach. Such an approach probably would have failed in *Fox*,²⁰³ since the syndicate probably lacked sufficient control over the cartoonist to be considered his employer.²⁰⁴ In *Laughton*,²⁰⁵ however, the actor could have been recharacterized as an employee of the studio that "borrowed" his services if the studio exercised the degree of control that typifies the studio-actor relationship. And in *Johnson*²⁰⁶ the control analysis would have reclassified Johnson as an employee of his basketball team.

The *Fox*, *Laughton*, and *Johnson* cases predated the government's intense interest in worker classification. As the following cases illustrate, since the mid-1980s the government has embraced worker reclassification as its preferred response to the proliferation of loan-outs. This approach allows it to disregard loan-out corporations even when all appropriate formalities have been observed, the shareholder-employee's relationship with the corporation satisfies arm's length standards, and all relevant contracts clearly reflect the role of the corporation as principal rather than agent.²⁰⁷

203. 37 Bd. Tax App. 271 (1938); see notes 97-101 and accompanying text.

204. The "control" test probably also would have failed in *Patterson*, 25 Tax Ct. Mem. Dec. (CCH) 1230, since an individual competitor such as a boxer traditionally would not be considered an employee. Arguably, a boxer whose professional activities were dictated almost entirely by a single promoter or manager might be considered an employee.

205. 40 Bd. Tax App. 101 (1939), remanded, 113 F.2d 103 (9th Cir. 1940). See notes 102-15 and accompanying text.

206. 78 Tax Ct. 882 (1982), aff'd, 698 F.2d 372 (9th Cir. 1982). See notes 116-21 and accompanying text.

207. *Jones v. Commissioner*, 64 Tax Ct. 1066 (1975), was a precursor of this line of cases. Despite the judge's degree of control over the reporter, the government did not contend that the reporter was an employee of the court. Under the common law analysis, a sufficient number of factors other than "control" might have pointed to independent contractor status. For example, the court might have found that the reporter supplied his own materials, set his own hours for review and transcription, worked in an office space not supplied by the court, performed reporting services for other parties, or received neither training nor detailed instructions from the court.

a. Professional & Executive Leasing, Inc. v. Commissioner

*Professional & Executive Leasing, Inc. v. Commissioner*²⁰⁸ opened the door to applying worker classification analysis to loan-outs by finding that doctrine applicable to determining not only whether a particular worker is someone's employee, but also the identity of the employer where the worker's status is conceded. A corporation ("PEL") had been formed for the purpose of leasing the services of various physicians, dentists, veterinarians, accountants, and business and legal professionals.²⁰⁹ Notably, almost all of the workers held an ownership interest in the entity to which they were leased, and no worker was ever leased to an entity in which another worker held an ownership interest.²¹⁰

The Commissioner contended that PEL's pension and profit sharing plans did not qualify under Section 401(a) of the Code,²¹¹ because numerous individuals covered by the plans were not "employees" of the corporation for tax purposes. Applying the common law concepts outlined in the income tax regulations,²¹² the Tax Court agreed.²¹³ Although it conceded that no single factor was controlling, the court nonetheless described as "fundamental" the question of "whether the person for whom the work is performed has the right to control the activities of the individuals whose status is in issue, not only as to results but also as to the means and method to be used for accomplishing the result."²¹⁴ Although it recognized that the case law developing these principles addressed the question of whether a particular individual was an employee or an independent contractor, the Tax Court found it to be equally applicable in identifying the employer of an acknowledged employee.²¹⁵

The Tax Court found that several of the common law indicia suggested that PEL's workers were employees of the service recipi-

208. 89 Tax Ct. 225 (1987), aff'd, 862 F.2d 751 (9th Cir. 1988).

209. Id. at 227. It thus differed from the more typical loan-out, which has a single employee-owner.

210. Id. at 233-34.

211. To qualify under § 401(a), an employer's retirement plan must be maintained exclusively for the benefit of employees. I.R.C. § 401(a) (1994).

212. Treas. Reg. § 31.3121(d)-1(c)(2) (1980).

213. Specifically, the Tax Court considered the following factors:

(1) The degree of control exercised over the details of the work; (2) investment in the work facilities; (3) opportunity for profit or loss; (4) whether the type of work is part of the principal's regular business; (5) right to discharge; (6) permanency of the relationship; and (7) the relationship the parties think they are creating.

Professional & Executive Leasing, 89 Tax Ct. at 232 (citations omitted).

214. Id. at 232-33 (quoting *Packard v. Commissioner*, 63 Tax Ct. 621, 629 (1975)).

215. Id. at 232 (citing *Bartels*, 332 U.S. at 132).

ents, and that the existence of these factors outweighed the existence of an employment contract between the personnel and PEL.²¹⁶ The Tax Court found that the transactions in question “lack[ed] objective economic substance and [were] not controlling for tax purposes,”²¹⁷ and concluded that PEL’s role was really that of bookkeeper and payroll agent rather than employer.²¹⁸ The court found that PEL exercised “minimal, if any, control over the workers”—it had never reassigned a worker, and “it strain[ed] credulity to believe that a worker would comply with an assignment to a recipient [entity] in which he had no [ownership] interest.”²¹⁹ In determining that the personnel in question were not employed by PEL, the Tax Court acknowledged that it was heavily influenced by the fact that the workers had an ownership interest in the recipient for which they provided services.²²⁰ PEL’s purported employees, therefore, were either self-employed or employed by the entity to which they were assigned; the Tax Court, however, did not resolve this uncertainty.²²¹

On appeal, the Ninth Circuit agreed with the Tax Court and the income tax regulations that the “right to control . . . not only as to the result . . . but also as to the details and means by which that result is accomplished” was the most fundamental test.²²² The appellate court observed that, in the case of professionals such as physicians, a lesser degree of control need be found to establish an employment relationship,²²³ but it agreed with the Tax Court’s conclusion that the

216. The court found that: (1) PEL did not control the details of the professionals’ work performance, and, in fact was unqualified to do so; (2) the service recipients, and not PEL, owned PEL’s work facilities; (3) all profit or loss from the leased person’s efforts remained with that person, with PEL receiving only a fixed fee from the service recipient; and (4) PEL’s right to discharge workers, like its right to reassign them, was illusory in light of their equity interests in the recipients to which they were assigned. *Professional & Executive Leasing*, 89 Tax Ct. at 233-34.

217. *Id.* at 235.

218. *Id.* at 234. In that respect, PEL resembled the foreign corporations in the Lend-A-Star rulings. See Part III.C.

219. *Id.* at 233-34.

220. *Id.* at 233. Although the record indicated that some of the leased personnel may not have had ownership interests in the entities to which they were assigned, the Tax Court did not find that fact dispositive.

221. See *id.* at 235 (holding that the workers in question were not employees).

222. *Professional & Executive Leasing*, 862 F.2d at 753 (quoting Treas. Reg. § 31.3121(d)-1(c)(2) (1980)). See also *Professional & Executive Leasing*, 862 F.2d at 753 (citing *Silk*, 331 U.S. at 714-16) (discussing common law factors).

223. *Professional & Executive Leasing*, 862 F.2d at 753 (citing *James v. Commissioner*, 25 Tax Ct. 1296, 1301 (1956) (physicians); Rev. Rul. 57-21, 1957-1 Cum. Bull. 317 (physicians)). See also *Professional & Executive Leasing*, 89 Tax Ct. at 232 n.11 (noting that under Treas. Reg. § 31.3401(c)-1(c), professionals who incorporate “may be regarded as employees of such entities”).

taxpayer in this case had failed to establish even this lesser degree of control.²²⁴

Because of the leased workers' ownership of the lessee entities, *Professional & Executive Leasing* did not test the Tax Court's willingness to respect "plain vanilla" loan-out arrangements such as those commonly used in the entertainment industry. The "control" analysis undertaken by both the Tax Court and the appellate court was influenced so heavily by the ownership factor that it is impossible to determine how the case would have been decided absent that fact.²²⁵

It is instructive to contrast *Professional & Executive Leasing* with the garden variety "temporary" personnel agency, which the Service routinely treats as the employer of its workers even though the borrowing entity closely supervises and controls the workers' daily tasks, and even though the workers are usually free to accept or reject an assignment.²²⁶ In this context, the government's application of the "control" test has been somewhat capricious. Although the Service usually takes the position that temporary agencies, rather than their clients, are the employers of the temporary workers they provide to clients, many of these rulings conflict with the notion that detailed, daily "control" is the critical factor in worker classification. Indeed, in defense of its position on temporary agencies the government occasionally has found itself arguing against its own "control" analysis. In *Critical Care Register Nursing v. United States*,²²⁷ for example, the government tried without success to persuade a jury (and subsequently a judge) to overlook the control factor; the jury found that because the temporary agency had no right to control the temporary nurses it provided, the nurses were employees of the client hospitals rather than the agency. Similarly, in a private ruling involving temporary clerical workers, the Service dismissed the high degree of

224. *Professional & Executive Leasing*, 862 F.2d at 754.

225. If the proposed "leased owner" regulations had been in effect during the tax years at issue in *Professional & Executive Leasing*, the court might have reached the same result without undertaking the control analysis. See note 31.

226. See, for example, Rev. Rul. 75-41, 1975-1 Cum. Bull. 323 (ruling that a corporation supplying medical support staff to outside parties was the workers' employer for tax purposes); Rev. Rul. 70-630, 1970-2 Cum. Bull. 229 (conceding that temporary sales clerks were employees of the temporary agency rather than of the retail stores to which they were assigned); Priv. Ltr. Rul. 8945021 (Aug. 14, 1989) (advising that temporary pharmacists were employees of lending entity); Priv. Ltr. Rul. 9311001 (Oct. 8, 1992) (ruling that temporary clerical workers were employees of lending entity). In contrast, in *Burnetta*, 68 Tax Ct. 387, the Service successfully argued that medical support staff were employees of the physicians' corporations rather than of the staffing corporation that issued their paychecks. *Id.* at 398. However, the staffing entity was not a typical temporary agency because, among other things, it had no employment contracts with its workers granting it the right to terminate them. *Id.*

227. 776 F. Supp. 1025 (E.D. Pa. 1991), nonacq. 94 T.N.T. 154-20 (Aug. 8, 1994).

control exercised by the borrower by finding it "reasonable to infer that any direction or control exercised over the worker by the client had flown from the firm's contractual relationship with the client and was, in effect, exercised with the firm's consent."²²⁸ Specifically, "[a]lthough the right to fix the working hours or to terminate the worker's services were ostensibly the right of the client, they resulted from the firm's relationship with the client."²²⁹ Other rulings have readily found this kind of "implied consent" by conventional temporary agencies.²³⁰

Thus, in most of the temporary agency cases, the Service has used the "implied consent" rationale to argue that the agency retains the *right* to control the workers' daily job performances even though it may not actually exercise that control except by retaining the right to terminate. The income tax regulations, which emphasize the "right to control" rather than the actual exercise of that control, support this "implied consent" interpretation.²³¹ The government also acknowledges that the entity's right to control the worker is sufficiently "real" when the corporation's owner-employee is a physician, dentist, or other professional providing services to the public at large. In contrast, the government apparently does not view a loan-out corporation's power to terminate or replace its owner-employee as sufficiently "real" to be respected for tax purposes. Yet a physician's loan-out is no more likely to "fire" the physician than an actor's loan-out is to "fire" the actor. In spite of this apparent inconsistency, the government has made it clear that it still views a loan-out's control over a worker as questionable whenever the worker's services are subject primarily to the detailed direction of the service recipient.²³²

228. Priv. Ltr. Rul. 8745043 (Aug. 12, 1987).

229. *Id.*

230. See, for example, Priv. Ltr. Rul. 8052112 (Oct. 3, 1980) (advising agency that its lack of supervision over nurses "does not negate [its] right to control [them]").

231. Treas. Reg. §§ 31.3121(d)-1(c)(2) (1980), 31.3306(i)-1, 31.3401(c)-1(b) (1994).

232. The Chief Counsel's office has endorsed the view of one commentator that:

[T]he benchmark should be whether, prior to incorporation, the service person is recognized as already being in an existing trade or business under common-law principles, or whether he is merely an employee. An employee should not be permitted to incorporate; such would be an attempt to create a business enterprise where none has existed historically, and, moreover, where it has no commercial significance. Moreover, the employee might then be obtaining for himself corporate benefits that Congress arguably intended to be available only to corporate enterprises. On the other hand, where one has been in a free standing trade or business individually, then he is merely changing his form of operations, and he should be permitted to utilize the benefits of his change in business enterprise by obtaining the benefits (and disadvantages) of operation in the corporate form.

b. Pflug v. Commissioner

In *Pflug v. Commissioner*,²³³ the government unsuccessfully challenged actress JoAnn Pflug's contention that she received her performing income as an employee of her husband's wholly-owned loan-out corporation rather than as a self-employed independent contractor doing business with the loan-out.²³⁴ *Pflug* has subsequently been cited as authority for respecting the separate tax identity of loan-outs.²³⁵ A close examination of that decision, however, suggests that its precedential value is weak, at best.

Pflug and her husband, game show host Charles Woolery, formed a loan-out (Charwool Productions, Inc.), with Woolery as sole shareholder and president, and Pflug as vice president. Any party seeking to obtain the services of Pflug or Woolery was required to enter a contract for those services with Charwool. Charwool then "loaned" the employee named in the contract, collected the agreed upon compensation, and reported this amount, net of the corporation's expenses (including salaries), as corporate income. The parties contracting with Charwool did not withhold any employment taxes on the amounts they paid to Charwool.²³⁶

In exchange for providing her services to Charwool on an exclusive basis, Pflug received both direct and indirect compensation from Charwool.²³⁷ In each of the taxable years preceding 1982, Charwool treated these disbursements as Pflug's salary, and withheld employment taxes on these amounts.²³⁸ For 1982, however, Charwool calculated Pflug's compensation as a percentage of the corporation's net income based on the proportion of gross revenues attributable to the lending of Pflug's services, and Charwool did not withhold any employment taxes on Pflug's compensation, treating Pflug, in effect,

Gen. Couns. Mem. 39,553 (Sept. 3, 1986) (quoting Sheldon I. Banoff, *Reducing the Income Tax Burden of Professional Persons by Use of Corporations, Joint Ventures, Subpartnerships and Trusts*, 58 Taxes 968, 984 (1980)).

233. 58 Tax Ct. Mem. Dec. (CCH) 685 (1989).

234. As an independent contractor, Pflug would have been obligated to pay the self-employment tax under I.R.C. §§ 1401 et seq. (1994). *Pflug*, 58 Tax Ct. Mem. Dec. (CCH) at 687. In contrast, because Pflug was Charwool's employee, Charwool was required to withhold employment taxes on her behalf. *Id.* at 688.

235. *Sargent*, 929 F.2d at 1257.

236. *Id.*

237. *Id.* Pflug and Charwool never executed a written employment contract; the only evidence of their contract was Pflug's oral testimony and the conduct of the parties during the years at issue. *Id.* at 688.

238. *Id.*

as an unincorporated independent contractor under contract to Charwool.²³⁹

The Tax Court focused on whether Pflug was liable for self-employment taxes—that is, whether her relationship with Charwool was that of employee or unincorporated independent contractor. Relying on the common law rules, the court concluded that Pflug's relationship to Charwool was that of employee rather than independent contractor, chiefly because "Charwool had the right to exercise dominion and control over [her] activities. . . ."²⁴⁰ Yet the court's conclusion (indeed, the very way it framed the issue) simply begs the question of whether Charwool was the real party in interest in its contracts with third parties for the lending of Pflug's services. In other words, the court simply assumed that Pflug received her compensation from Charwool. The court never addressed the possibility that Charwool was simply acting as Pflug's booking and collection agent, or even as a mere assignee of her income. The Tax Court may have been correct in concluding that Pflug was acting as someone's employee rather than as a sole proprietor, but that did not answer the question of whose employee she was.²⁴¹

c. Sargent v. Commissioner

The logical gap left by *Pflug* was obscured two years later, when the Court of Appeals for the Eighth Circuit cited *Pflug* as authority for recognizing an entertainer's loan-out as a separate taxable entity in the context of reversing the Tax Court's decision in *Sargent v. Commissioner*.²⁴²

i. The Tax Court Decision

Each hockey player in *Sargent* formed a loan-out corporation after initially playing for his team as an individual employee. As noted earlier, the ostensible purpose of each incorporation was to enjoy "increased bargaining power and the possibility of placing

239. Id. at 686-87.

240. Id. at 688.

241. See *Herman v. Commissioner*, 52 Tax Ct. Mem. Dec. (CCH) 1194, 1196 (1986) (finding it unnecessary to decide whether worker was employed by "lending" entity or "borrowing" entity, in concluding that worker was not an independent contractor and, therefore, not entitled to establish a Keogh plan).

242. 93 Tax Ct. 572 (1989), rev'd, 929 F.2d 1252 (8th Cir. 1991). The Tax Court issued its decision in *Sargent* one day before it issued its decision in *Pflug*.

money into a pension plan.”²⁴³ Each loan-out agreed to provide the services of its employee to the hockey club in exchange for specified compensation payable to the loan-out. Each player entered a contract with his loan-out agreeing to provide athletic and consulting services exclusively to the loan-out, and agreeing to abide by its instructions.²⁴⁴ Each petitioner was the sole shareholder, sole director, and president of his loan-out, and each entered into a separate agreement with the hockey club personally guaranteeing the loan-out’s obligations.²⁴⁵

Each loan-out set up a pension fund for its athlete-employee, and in each case the Service issued a letter declaring the fund to be a qualified pension plan.²⁴⁶ During the years in question, the hockey club paid to the loan-outs the amounts that it otherwise would have placed in the National Hockey League Players’ Pension Plan on the petitioners’ behalf. Although the club did not require either of the loan-outs to contribute these same amounts to the pension plan of its employee-owner, each loan-out not only paid a salary to its employee, but also contributed a substantial sum to the employee’s pension plan.²⁴⁷ The Service argued that the amount paid to each loan-out by the hockey club was taxable directly to the loan-out’s employee-owner,²⁴⁸ because under the common law control test the players were employees of the club rather than of their loan-outs.²⁴⁹

The Tax Court agreed with the government. The court distinguished *Fox* and *Laughton*—as well as several cases in which physicians’ professional corporations were respected for tax purposes²⁵⁰—on the grounds that in each of those cases the court had either made a factual finding, or simply assumed, that “the taxpayers were employees of their personal service corporations.”²⁵¹ In *Sargent*, by contrast, the court determined that the requisite employment relationship between the players and their corporations was lacking, and the case presented “a classic situation for the application of the

243. *Id.* at 574-75. See notes 164-68 and accompanying text.

244. *Sargent*, 93 Tax Ct. at 574-75. One loan-out withheld all required payroll taxes from the petitioners’ salaries. The record, however, was unclear with respect to the other loan-out. *Id.* at 574, 575 n.3.

245. *Id.* at 574-76.

246. *Id.* at 574, 576.

247. In each case, the total of the employee’s salary plus the pension contribution was slightly less than the amounts paid by the hockey club to the loan-out. *Id.* at 575-76.

248. *Id.* at 573.

249. *Id.* at 578-79.

250. *Keller*, 77 Tax Ct. at 1024; *Pacella*, 78 Tax Ct. at 618, 622; *Haag*, 88 Tax Ct. at 611, 615.

251. *Sargent*, 93 Tax Ct. at 582. The court also noted that the *Johnson* court had assumed, without deciding, that an employment relationship existed between the athlete and the corporation. *Id.* See notes 119-21 and accompanying text.

assignment of income doctrine articulated in *Lucas v. Earl*.²⁵² Therefore, it treated all sums paid to the loan-outs as sums paid directly to the athlete-employees.

The Tax Court acknowledged that it was relying on cases that addressed “whether an individual is an employee or an independent contractor rather than, as is the case herein, who is the employer of a conceded employee.” Nonetheless, the court cited *Professional & Executive Leasing* for the proposition that these cases could also provide “guidance in determining who is the employer.”²⁵³ The most fundamental aspect of this analysis, in the court’s view, was the “control” test.²⁵⁴

Applying this standard, the court concluded that the hockey club, rather than the corporation, exercised the requisite control through its coaches and managers. In reaching that conclusion, the court observed that “the nature of team sports is a critical element which must be taken into account” in applying the common law control test. In team sports, unlike individual sports, the court observed, “[c]oaches scrutinize and direct a player in even the smallest details,”²⁵⁵ so that “the nature of the team sport of hockey involves a high level of control over player activity by coaches and managers.”²⁵⁶ Therefore, because they performed their services as part of a “team,” the individual hockey players could not be employees of their loan-outs.²⁵⁷

The entire Tax Court reviewed Judge Tannenwald’s majority opinion in *Sargent*, with twelve judges agreeing and six dissenting.²⁵⁸ The dissenting judges argued that the corporate form and the designation of the loan-out as the principal in the contract with the hockey club could be disregarded only if the corporation were a sham.²⁵⁹ Rejecting the majority’s application of the “control” test, Judge Wells suggested that the tax law should respect the authority of a corporation to enter into a contract that grants a third party the right to control the work related activities of the “loaned” employee. In other words, as in the case of a garden-variety temporary personnel agency,

252. *Sargent*, 93 Tax Ct. at 583.

253. *Id.* at 578.

254. *Id.*

255. *Id.* at 580.

256. *Id.*

257. *Id.* at 579-80.

258. *Id.* at 584, 589.

259. *Id.* at 586-87 (Wells, J., dissenting). Judge Wells considered the majority’s opinion to be inconsistent with the decisions in *Haag*, *Johnson*, and *Keller*. *Id.* at 586.

such a contract should not divest the corporation of its status as employer:²⁶⁰

The logical outgrowth of the majority's unique analysis is that only "traditional" independent contractors (i.e., those over whom service-recipients do not exercise control) can avail themselves of PSCs while traditional employees cannot. Such a rule, while perhaps appealing from the standpoint of predictability, finds no meaningful support in our precedent.²⁶¹

The dissent asserted that treating the players as common law employees of their team was the same as "disregarding the existence of the PSC's entirely."²⁶²

ii. The Eighth Circuit Reversal

On appeal, the Eighth Circuit's majority opinion accepted the analysis of Judge Wells' dissent and rejected Judge Tannenwald's version of the control test. The Eighth Circuit relied on the concept of "implied consent" as applied in the temporary agency rulings and expressed in the income tax regulations: "[I]t is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he has the right to do so."²⁶³ Concluding that it would be "arbitrary" to apply different standards depending on whether the worker "is or is not a member of a superficially defined 'team,'" the court found it irrelevant that the party consuming the services (the hockey club) expected its service-providers to function as a "team."²⁶⁴ The appellate court applied the two-part analysis used by the Tax Court in *Johnson* and concluded that both parts of the test were satisfied: (1) the athletes were employees of their loan-outs because the latter had the right of control (whether or not exercised); and (2) each loan-out had validly contracted with the owner of the hockey club to provide the personal services of the loan-out's employee.²⁶⁵ In *Johnson*, the Eighth Circuit noted, the Tax Court was apparently untroubled by the fact that the taxpayer was a member of a "team."²⁶⁶

260. *Id.* at 588.

261. *Id.*

262. *Id.*

263. Treas. Reg. § 31.3121(d)-1(c)(2) (1980) (FICA), quoted in *Sargent*, 929 F.2d at 1256. See also Treas. Reg. §§ 31.3401(c)-1(b) (FUTA), 31.3306(i)-1(b) (1994) (income tax withholding).

264. *Sargent*, 929 F.2d at 1256.

265. *Id.* at 1256-58.

266. *Id.* at 1257.

The Eighth Circuit majority also found inconsistencies between the Tax Court's almost simultaneous decisions in *Sargent* and *Pflug*. In the appellate court's view, *Pflug* held "that Ms. Pflug was an employee of Charwool, and not an employee of 20th Century Fox Studios."²⁶⁷ As discussed earlier, however,²⁶⁸ the Tax Court's opinion in *Pflug* includes no such holding, because the question before the court had nothing to do with Pflug's relationship to the studio; it concerned only her relationship to Charwool.

Having interpreted *Pflug* as the Tax Court's validation of loan-outs, however, the court of appeals in *Sargent* declared itself "perplexed to find that [the] same contractual arrangements which were dispositive of the issue of 'control' in *Pflug* were summarily discarded" by the Tax Court in *Sargent*.²⁶⁹ The majority also suggested that Pflug's activities as a cast member working with a technical and production staff in a television series made her as much a "team" member as the hockey players in *Sargent*, since ultimate creative control over her work product rested with the studio.²⁷⁰ Finding "ample Tax Court precedent which upholds the sanctity of contractual relations between taxpayers and their respective personal service corporations," the *Sargent* majority found that the assignment of income concerns articulated in *Lucas v. Earl* are not implicated, where the taxpayer conducts her income-earning activity through a bona fide corporation.²⁷¹

The government responded to the *Sargent* reversal with a prompt nonacquiescence, and has continued to litigate the loan-out

267. Id.

268. See notes 233-41 and accompanying text.

269. *Sargent*, 929 F.2d at 1257.

270. Id.

271. Id. at 1257-59 (citing *Moline Properties*, 319 U.S. at 438-39). Dissenting, Judge Arnold agreed with the Tax Court majority, finding that "[t]he idea that the coach issued orders to [the hockey players] in their capacity as corporate officers, which orders they then relayed to themselves as corporate employees, is fanciful." Id. at 1261 (Arnold, C.J., dissenting). This idea, of course, is no more "fanciful" than the idea that a corporation has a separate existence as a legal and taxpaying entity. As Justice Holmes observed:

[I]t leads nowhere to call a corporation a fiction. If it is a fiction it is a fiction created by law with intent that it should be acted on as if true. The corporation is a person and its ownership is a nonconductor that makes it impossible to attribute an interest in its property to its members.

Klein v. Bd. of Supervisors, 282 U.S. 19, 24 (1930), quoted in *Foglesong*, 621 F.2d at 868 and *Keller*, 77 Tax Ct. at 1031 n.20. If the property of a bona fide corporation cannot be attributed to its members, the services provided by that corporation should not be so attributed either. Indeed, the logical consequence of Judge Arnold's position would be that, for tax purposes, a corporation could never act as the employer of its controlling shareholder.

question outside the Eighth Circuit²⁷² and to enforce its position in administrative proceedings. In two recent private letter rulings, for example, the Service reclassified a physician and several veterinarians as employees of the clinics where they practiced, notwithstanding the fact that each of these workers had incorporated, and the corporations had executed all appropriate contracts.²⁷³ The Service's latest reclassification efforts suggest that the analysis of loan-outs has reached a critical juncture. If taxpayers expect other circuits to adopt the Eighth Circuit's analysis, the use of loan-outs may increase, especially in light of the government's intensified scrutiny of taxpayers asserting independent contractor status.²⁷⁴

As noted earlier, the Treasury can assert two policy reasons in support of its worker reclassification efforts: ease of enforcement and

272. The nonacquiescence states:

We disagree with both the manner in which the Eighth Circuit employed the regulation provision as well as its conclusion that the PSC's controlled the taxpayers. Further, it is our view that the Eighth Circuit improperly employed a form over substance analysis to the set of facts at issue herein by relying on the mere existence of the taxpayers' contracts with their respective PSC's, rather than the control imposed directly upon the taxpayers by the team's coaching staff and management.

. . . The manner in which the taxpayers rendered their services to the team, subject to the coach's and club's control is, in our opinion, the determinative factor in resolving the question of by whom the taxpayers were actually employed.

. . . [T]he Service will continue to litigate this issue based upon the rationale espoused in this case by the Tax Court and will continue to defend the issue in all circuits except the Eighth Circuit.

1991 AOD LEXIS 42, Action on Decision CC-1991-022 (Oct. 22, 1991). The Service noted that it would not seek Supreme Court review in *Sargent* because no other circuit had addressed the issue yet. *Id.* It reiterated its nonacquiescence in the recently promulgated *Market Segment Program Guidelines*, 92 Daily Tax Rep. (BNA) at d60 (cited in note 173).

The Service prevailed in its most recent effort to disregard an athlete's loan-out, in *Leavell v. Commissioner*, 1995 U.S. Tax Ct. LEXIS 8, 104 T.C. No. 6 (Jan. 30, 1995), in which the Tax Court declined to follow the Eighth Circuit's *Sargent* decision. If it continues to litigate these issues, the government will also have to address additional questions *Sargent* left unresolved. First, assuming the corporate entity is disregarded, what will happen to the corporate pension plan if, as in *Sargent*, the Service has declared it to be a qualified plan and the corporation has already made substantial contributions, because a plan can only be tax qualified if it is maintained for the sole benefit of employees? I.R.C. § 401(a)(2) (1994). Second, how can the government's position in *Sargent* be reconciled with I.R.C. § 3401(d)(1), which provides that the party controlling wage payments (on *Sargent's* facts, the loan-out) is the employer for withholding tax purposes, a rule that the courts have extended to FICA and FUTA? Third, can the government's position be squared with the rule that, for FICA purposes, corporate officers (such as the hockey player in *Sargent*) are employees of their corporations without regard to the common law standards? I.R.C. § 3121 (d)(1) (1994). See generally Morgan and Goldberg, *Employees and Independent Contractors* at ¶¶ 105.02, 108, 114, 614 (cited in note 190) (raising these questions).

273. Priv. Ltr. Rul. 9219020 (Feb. 6, 1992) (physician); Priv. Ltr. Rul. 9350002 (Sept. 3, 1993) (veterinarians).

274. See, for example, Priv. Ltr. Rul. 9350002 (Sept. 2, 1993) (involving an owner of an animal health clinic who cited reliance on *Sargent* as a "reasonable basis" for treating incorporated workers as independent contractors).

protection of workers.²⁷⁵ Whatever the merits of these arguments with respect to unincorporated workers, they are not persuasive in the case of workers who have incorporated in order to achieve independent contractor status. Paternalistic concerns seem particularly inappropriate with respect to workers sophisticated enough to incorporate, respect the corporate formalities, and file a corporate tax return. The compliance rationale is only marginally more persuasive. Withholding provides greater assurance that FICA, and income taxes will be paid, and if withholding is to take place at all, someone must be identified as the withholding agent. Reclassifying workers as employees thus makes enforcement somewhat easier. However, the worker who incorporates creates her own withholding agent. The very existence of a loan-out corporation requires the filing of various documents under state law, as well as a federal income tax return. Thus, when a worker incorporates, withholding will take place with respect to the worker's salary from the loan-out. The government's enforcement burden is therefore only somewhat greater than when that worker is treated as an employee of the service recipient, because the number of potential withholding agents is greater. Against this enforcement burden must be weighed the adverse consequences to the taxpayer who, in effect, is not "allowed" to incorporate—that is, the loss of some deductions, inability to use a fiscal year, and diminished (or lost) access to tax-qualified retirement, insurance, medical, or other fringe benefit plans designed to meet her needs. Congress has made clear that the tax advantages of such benefits should be available to corporations and those persons they employ. Any exceptions to the favorable treatment Congress has provided should have a sound basis in policy, and should be identified by Congress and clearly delineated in the Code. By focusing on the extent to which a corporation chooses to grant its clients the power to direct the work-related activities of the corporation's employees, a business judgment that is not relevant to whether that corporation and the employment relationship exist in fact, the government's reliance on the "control" test improperly attempts to circumvent the Code provisions.

C. Foreign Loan-Outs: The Lend-A-Star Rulings

The government's position in *Sargent* roughly parallels its position with respect to foreign loan-outs formed by nonresidents,

275. See notes 175-77 and accompanying text.

although the standards it has articulated for foreign loan-outs appear to be even more stringent. Because foreign loan-outs present special tax avoidance problems unique to the international context, the government's position in these cases may rest on a stronger foundation than in the domestic context.

*Johansson v. United States*²⁷⁶ illustrates the special problems presented by foreign loan-outs. In that case, a Swedish boxer who fought several matches in the United States formed a loan-out in Switzerland and claimed Swiss residence for himself in order to invoke a tax treaty exemption applicable to Swiss residents employed by Swiss entities.²⁷⁷ The taxpayer had entered an employment contract with a newly formed Swiss corporation²⁷⁸ of which he was the "sole employee and sole source of revenue."²⁷⁹ Although the Fifth Circuit conceded that the taxpayer's arrangement fit within the literal terms of the treaty exemption, it employed a "substance over form" analysis to conclude that disregarding such a formalistic employment relationship would not "seriously encumber[]" the policy behind the treaty exemption—assuring foreign enterprises "that they may freely send their agents and employees into the other contracting state without thereby subjecting those employees to the latter's taxes."²⁸⁰

After its victory in *Johansson*, the Service published a series of Revenue Rulings, popularly known as the Lend-A-Star rulings, indicating that, in most circumstances, it would disregard foreign loan-outs utilized by treaty country residents who perform entertainment services in the United States, regardless of whether the applicable treaty contained an artistes and athletes clause.²⁸¹ The loan-out would, in effect, be treated as an agent of the entertainer, rather than vice versa. The examples provided in these rulings indicate that the Service will treat a loan-out as the principal (that is, the employer) if all of the following conditions are satisfied: (1) the artist does not own

276. 336 F.2d 809 (5th Cir. 1964).

277. *Id.* at 812.

278. *Id.* at 813. The employment contract preceded the formation of the corporation by two weeks. *Id.* at 813 n.4.

279. *Id.* at 813. Although the taxpayer was not a director, and the court's opinion did not indicate whether he was a shareholder, evidently his employment contract entitled him to receive 70% of the corporation's gross income, plus expenses and a pension. *Id.* The opinion also notes that he "conducted his affairs largely independent of [the corporation's] sole director or its stockholders." *Id.*

280. *Id.* at 814. The court also held that the boxer was not a Swiss resident, *id.* at 812-13, but advanced its loan-out analysis as an independent rationale. *Id.* at 813.

281. See, for example, Rev. Rul. 74-330, 1974-2 Cum. Bull. 278; Rev. Rul. 74-331, 1974-2 Cum. Bull. 282. These Revenue Rulings have been incorporated in the Treasury Regulations. See Treas. Reg. § 1.1441-4(a)(1) (1960). See also Rev. Rul. 75-503, 1975-2 Cum. Bull. 352 (applying Rev. Rul. 74-330 to a foreign boxer's arrangement with his manager).

stock in, or otherwise exercise control over, the loan-out; (2) the artist receives only a fixed salary not measured by profits; (3) the artist has a continuing work relationship with the loan-out; (4) the artist cannot veto the terms of any contract the loan-out negotiates, and does not restrict the loan-out's use of his services; (5) the loan-out furnishes the tools and "place of performance," and has the right to control the details of the artist's performance; (6) the loan-out assumes the financial risk of the artist's performance; and (7) the artist's services are part of the "regular business" of the corporation.²⁸² The rulings imply that *all* of these conditions must be satisfied. The typical loan-out clearly would not satisfy all of these tests.²⁸³

The Lend-A-Star rulings, while directed at foreign loan-outs used by nonresident entertainers, are based on familiar principles often applied to domestic loan-outs: the sham incorporation and assignment of income doctrines, the arm's length standard of Section 482, and the common law indicia of an employment relationship. In the domestic context, however, the government has never required a taxpayer to establish that *all* of the common law factors indicate independent contractor status. Thus, the Lend-A-Star rulings appear to demand a higher level of scrutiny than has been applied to domestic loan-outs.²⁸⁴ Still, nothing in the rulings themselves would appear to preclude such a broader application.²⁸⁵

Considerations unique to international taxation may justify the Lend-A-Star rulings. As discussed in Part II.B.4,²⁸⁶ some foreign individuals employed by foreign loan-outs can escape United States taxation altogether under treaty provisions that exempt nonresident

282. 1974-2 Cum. Bull. at 280-82, 285. These requirements track some of the key indicia of independent contractor status under the common law test. See, for example, Rev. Rul. 87-41, 1987-1 Cum. Bull. 296; Rev. Rul. 75-41, 1975-1 Cum. Bull. 323. See also note 190 and accompanying text.

283. See generally Stiglitz and Lawson, *Tax Planning for Entertainers, Artists and Athletes* at 71-72 (cited in note 59). These authors also suggest that Treas. Regs. § 31.3401(a)(6)-(l)(e), 1.1441-6(c) and 1.1441-4(b) are inconsistent with the Lend-A-Star rulings. *Id.* at 72.

284. To the extent that the standard imposed on foreign loan-outs is more demanding than that imposed on domestic loan-outs, the Lend-a-Star rulings may violate treaty nondiscrimination requirements. See, for example, 1992 OECD Model Income Tax Treaty, Art. 24 (cited in note 61). However, because the higher level of scrutiny is designed to prevent the foreign worker from completely avoiding a tax liability to which a domestic corporation or individual ordinarily would be subject, the difference in treatment may be sufficiently justified to be compatible with United States treaty obligations. See generally Michael J. McIntyre, *The International Income Tax Rules of the United States* § 2/E1 (Butterworth Legal, 1991).

285. See Stiglitz and Lawson, *Tax Planning for Entertainers, Artists and Athletes* at 36-37 (cited in note 59).

286. See notes 63-67 and accompanying text.

alien employees of foreign employers. In addition, nonresident aliens such as the taxpayer in *Johansson* have often incorporated in a country other than their country of residence or citizenship solely to take advantage of a favorable tax treaty between the United States and the country of incorporation. Both of these scenarios arise because of provisions contained in tax treaties rather than in the Code. Thus, disregarding loan-outs designed to capitalize on favorable treaties can preserve the intent of Congress when broadly drafted treaty provisions threaten to undermine that intent.²⁸⁷

These special considerations have no bearing on domestic loan-out corporations. Yet even after the *Sargent* reversal the government continues to apply substance over form arguments similar to those of the Lend-A-Star rulings whenever it believes that a properly formed domestic corporation should be treated as an agent of its controlling shareholder. As discussed in Part IV, in most cases, a thorough agency analysis dictates the opposite conclusion.

IV. THE *BOLLINGER* APPROACH

A sounder approach to the loan-out problem is to recognize the separate taxpayer status of a properly formed loan-out, and apply agency principles to determine whether the individual or the corporation is the principal in any given transaction. A substantial line of authority addresses whether purported agency relationships between related taxpayers should be respected for tax purposes. Under the agency approach, loan-out transactions can be scrutinized, and recast where necessary, without disregarding the existence of a properly formed corporation.

The seminal tax case addressing corporate agency is *Moline Properties, Inc. v. Commissioner*,²⁸⁸ in which the Commissioner, contending that the corporation was a mere agent for the shareholder, sought to tax a corporation's capital gains to its sole shareholder. The

287. By ignoring the separate existence of an artist's or athlete's loan-out, and/or denying treaty benefits to certain treaty-country corporations that: (1) are beneficially owned by third-country residents; (2) zero out their taxable income by making deductible payments to third-country residents; or (3) are formed principally to obtain treaty benefits, the specific anti-treaty-shopping provisions in newer treaties address these abuses more directly. See, for example, U.S. Model Income Tax Treaty, Art. 16 (restricting treaty benefits available to an entity resident in a contracting state but owned by residents of another state); United Kingdom, Art. 16 (similar) (cited in note 61). See generally H. David Rosenbloom, *Tax Treaty Abuse: Policies and Issues*, 15 L. & Pol. Intl. Bus. 763 (1983). See also note 66 (discussing anti-treaty shopping rules).

288. 319 U.S. 436 (1943).

Supreme Court rejected the agency characterization: "There was no actual contract of agency, nor the usual incidents of an agency relationship. Surely the mere fact of the existence of a corporation with one or several stockholders, regardless of the corporation's business activities, does not make the corporation the agent of its stockholders."²⁸⁹ The Court added that "the question of agency or not depends on the same legal issues as does the question of identity" between shareholder and corporation.²⁹⁰ On that question, as noted earlier,²⁹¹ the Court held that "so long as th[e] purpose [of incorporating] is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity."²⁹²

One fact that distinguished *Moline* from the typical loan-out arrangement was the *Moline* shareholder's "neghible" exercise of control over the corporation.²⁹³ Control, however, was clearly present several years later in *National Carbide Corporation v. Commissioner*,²⁹⁴ in which three wholly owned subsidiaries of a corporation agreed to operate their plants as "agents" for their parent and to pay virtually all of their profits, except nominal sums that each subsidiary reported as income, to the parent. The Supreme Court refused to hold that the mere existence of a control relationship proved that the controlled entities were agents of the shareholder. Instead, the Court held that the subsidiaries were taxable on their profits, and treated the agreement to pay their profits to the parent as an anticipatory assignment of income.²⁹⁵ The Court acknowledged that it was possible for a controlled subsidiary to be a "true" agent of its parent, and set forth four indicia and two requirements for finding an agency relationship under such circumstances:

[1] Whether the corporation operates in the name and for the account of the principal, [2] binds the principal by its actions, [3] transmits money received to the principal, and [4] whether receipt of income is attributable to the services of employees of the principal and to assets belonging to the principal

289. Id. at 440.

290. Id. at 440-41.

291. See notes 92-94 and accompanying text.

292. *Moline Properties*, 319 U.S. at 439.

293. Id. at 440.

294. 336 U.S. 422 (1949).

295. Id. at 434-36. The Court concluded that no agency relationship existed where the subsidiaries represented themselves to their customers as the principals in the transaction, attempted to shield the parent from service of process, and used thousands of their own employees and millions of dollars of their own assets in their operations. Id. at 425, 434, 438, 438 n.21.

are some of the relevant considerations in determining whether a true agency exists. [5] If the corporation is a true agent, its relations with its principal must not be dependent upon the fact that it is owned by the principal, if such is the case. [6] Its business purpose must be the carrying on of the normal duties of an agent.²⁹⁶

With its 1988 decision in *Commissioner v. Bollinger*,²⁹⁷ the Supreme Court clarified the meaning of the fifth *National Carbide* factor, thereby making it possible for taxpayers to predict with greater accuracy when a corporation would be treated as an agent of its controlling shareholders. In *Bollinger*, each of several real estate partnerships formed a corporation to hold title to the partnership's real property for the sole purpose of borrowing funds at rates higher than the state's usury law permitted for noncorporate buyers. When the partnership reported the income and losses from the property on its tax return, the Commissioner reallocated these amounts to the nominee corporation, treating it not as the partnership's agent but as the true owner of the property. The Commissioner contended that the corporation lacked agency status because it did not satisfy the fifth and sixth *National Carbide* factors.

The Supreme Court rejected the Commissioner's characterization.²⁹⁸ With regard to the sixth factor, the Court concluded that the nominee's business purpose was "the carrying on of the normal duties of an agent," because the partnership represented itself as the principal to all parties involved with the loans:²⁹⁹ "The lenders, contractors, managers, employees, and tenants—all who had contact with the development—knew that the corporation was merely the agent of the partnership, if they knew of the existence of the corporation at all."³⁰⁰

296. *Id.* at 437 (citations omitted). Subsequent cases have indicated that only the fifth and sixth of these factors are mandatory. *Bollinger*, 485 U.S. at 340, 346-47 (referring to *National Carbide* as establishing four "indicia" and two "requirements"); *Roccaforte v. Commissioner*, 708 F.2d 986, 989 (5th Cir. 1983) (holding that the first four conditions in *National Carbide* are only "relevant considerations" and that only the last two are mandatory and absolute); *Ourisman v. Commissioner*, 760 F.2d 541, 547-48 (4th Cir. 1985) (same); *First Chicago Corp. v. Commissioner*, 96 Tax Ct. 421, 447 n.17 (1991) (same).

297. 485 U.S. 340 (1988).

298. The Supreme Court granted certiorari in order to resolve a circuit split over the tax status of corporate nominees. *Id.* at 341. Compare *George v. Commissioner*, 803 F.2d 144, 148 (5th Cir. 1986) (stating that the existence of agency is not based on ownership) with *Frink v. Commissioner*, 798 F.2d 106, 109-10 (4th Cir. 1986) (considering ownership as a factor in finding that an agency relationship existed).

299. 485 U.S. at 347. This finding of fact is somewhat difficult to accept, because, under state law, the partnership would not have been able to borrow funds at the high interest rate the lender charged the corporation. The implication is that the lender knew that the true borrower was the partnership, and was willing to cooperate with the partnership in misleading the state authorities.

300. *Id.* at 345.

As to the fifth *National Carbide* factor—the requirement that the nominee’s “relations with its principal not be dependent upon the fact that it is owned by the principal”—the Court found that the meaning of this test was “at the risk of understatement, not entirely clear.”³⁰¹ In an observation that seems particularly pertinent to the “control” question in the loan-out context, the Court noted that: “Ultimately, the relations between a corporate agent and its owner-principal are *always* dependent upon the fact of ownership, in that the owner can cause the relations to be altered or terminated at any time.”³⁰²

Rather than conclude that “all subsidiary-parent agencies [are] invalid for tax purposes, a position which the *National Carbide* opinion specifically disavowed,”³⁰³ the *Bollinger* Court interpreted the fifth factor as simply a restatement of the concern that “the separate-entity doctrine of *Moline* not be subverted.”³⁰⁴ In effect, the *Bollinger* Court interpreted the fifth factor as an expression of concern that the Commissioner not be whipsawed by a standard that would give shareholders free rein to wait until *after* the occurrence of taxable events to assert agent or principal status retroactively, depending on which status would lower their tax liability.³⁰⁵

The *Bollinger* Court agreed that it was reasonable to require, as a condition of recognizing the corporation as a genuine agent, “unequivocal evidence of genuineness in the corporation-shareholder context, in order to prevent evasion of *Moline*,” but it refused to hold that a taxpayer could meet this requirement only by showing an arm’s length relationship between the corporation and its shareholders, including the payment of an agency fee.³⁰⁶ Instead, the Court held:

It seems to us that the genuineness of the agency relationship is adequately assured, and tax-avoiding manipulation adequately avoided, when the fact that the corporation is acting as agent for its shareholders with respect to a particular asset is set forth in a written agreement at the time that asset is

301. *Id.* at 348-49.

302. *Id.* at 349.

303. *Id.*

304. *Id.* See also *First Chicago Corp.*, 96 Tax Ct. at 447-48 (stating that the “decision and rationale in *Bollinger* is an attempt at balancing a concern for the viability of the concept in *Moline* with situations where tax consequences should flow through a corporation which is acting as a ‘genuine agent’”).

305. *Bollinger*, 485 U.S. at 345-46. See also *Greenberg v. Commissioner*, 56 Tax Ct. Mem. Dec. (CCH) 1030, 1032 (1989) (stating that *Moline Properties* would be undermined if shareholders could wait until the end of the year and choose whether to claim agent or owner status).

306. *Bollinger*, 485 U.S. at 349.

acquired, the corporation functions as agent and not principal with respect to the asset for all purposes, and the corporation is held out as the agent and not principal in all dealings with third parties relating to the asset.³⁰⁷

The Supreme Court did not indicate whether the three tests were mandatory or merely illustrative of the kind of "unequivocal evidence" required to show that a corporation is acting as an agent of its controlling shareholder(s). Although treating the three tests as mandatory would provide certainty and eliminate some evidentiary problems, the requirement of a written agency agreement could also prevent the government from finding that a corporation acted as a shareholder's agent even when the overall facts and circumstances clearly indicate an agency relationship. It seems unlikely that the Supreme Court would allow taxpayers to avoid agency status by such formalistic inaction—that is, by declining to put their agency agreement in writing.³⁰⁸

Thus, if a written agency agreement were a prerequisite to agency status for a controlled corporation, taxpayers would have no difficulty ensuring that their loan-outs would be treated as principals. In contrast, if other forms of "unequivocal evidence" of the agency relationship are acceptable, then there surely will be instances in which a loan-out should be treated as an agent of its shareholder-employee because the overall conduct of the parties supports that characterization. Where the loan-out is not a sham entity and evidence of its agency role is lacking, however, the loan-out's status as the principal in a transaction should be respected (assuming, of course, that the shareholder-employee has respected all corporate formalities).³⁰⁹ The fact that both the loan-out and the employee-shareholder consistently respect the employment contract, and that the corporation is identified as the principal in contracts with third parties, as required by the *Johnson* court, should indicate that the employee-shareholder is acting as an agent of the corporation.

307. *Id.* at 349-50.

308. See *Advance Homes v. Commissioner*, 59 Tax Ct. Mem. Dec. (CCH) 906, 909 (1990) (holding that the tests are only illustrative and that written agency agreement is not required); *Charfoos v. Commissioner*, 62 Tax Ct. Mem. Dec. (CCH) 32, 39 n.4 (1991) (finding the three "tests" merely factors, not dispositive).

309. Compare *Charfoos*, 62 Tax Ct. Mem. Dec. (CCH) at 40 (rejecting taxpayer's claim of agency relationship where corporation incurred debt on its own behalf, entered contracts with third parties on its own behalf, and sold property in its own name, where the corporation's actions were not binding on the shareholder, where it was unclear whether the corporation remitted its gross receipts to the shareholder, where money the shareholder received was not attributable to shareholder's own assets, where the corporation did not carry out the normal duties of an agent, and where the corporation held itself out to third parties as the principal).

To be a principal under *National Carbide* and *Bollinger*, a corporation should not receive income from the use of assets that it lacks the legal authority to exploit.³¹⁰ The employee-shareholder, therefore, should transfer to the loan-out any assets (including intangibles) that may be essential to the entity's income-producing activity. The right to exploit the employee's services is one such asset; hence the importance of a valid employment contract. However, there are many other assets a loan-out might exploit. A performer, for example, should transfer her right of publicity, because it will typically have to be licensed to any third party that contracts for her services. A writer would have to transfer the copyright in any completed works that might be sold or licensed to third parties.³¹¹ Such transfers could take the form of capital contributions, loans, sales, leases, or licenses. In the case of any transfer other than a capital contribution, any payments the shareholder receives from the loan-out in exchange for such assets must reflect arm's length bargaining. To the extent those payments represent deductible interest, rents, or royalties, of course, the deductions will help to zero out the loan-out's income.

There may be situations where evidence of the loan-out's agency status is equivocal. In such cases, well-settled doctrines including, but not limited to, assignment of income, sham incorporation, and Section 482 should suffice to determine the true nature of the transaction. Thus, when a shareholder-employee treats the corporation simply as a source of personal funds, the corporation may be disregarded as a sham, or the withdrawn funds may be regarded as constructive dividends (subject to double taxation if the corporation has not elected S status). In addition, when a shareholder-employee signs one third party contract as an officer (that is, agent) of the loan-out and another as an individual, but directs the third party in each case to make all payments to the corporation, the assignment of income doctrine applies, and income earned under the contract the shareholder executed as an individual should be taxable to the

310. *National Carbide*, 336 U.S. at 437.

311. Copyright in works created while the writer was employed by the loan-out should vest in the corporation ab initio under the work-made-for-hire rules of copyright law. See note 198. However, it is possible that the copyright law might not respect every employment relationship that is respected for tax purposes. Thus, in order to ensure that the loan-out is the owner of the asset, the writer should execute a separate contract transferring any interest she might be deemed to have in those copyrights to the loan-out. Otherwise, income from use or disposition of the asset might be deemed to accrue directly to the writer. See *Fox*, 37 Bd. Tax App. at 272-73, 278 (by transferring copyrights in completed works to the loan-out, taxpayer gave loan-out the right to any earnings arising therefrom).

individual (who may then be deemed to have made a capital contribution or loan to the corporation), while income earned under the contract the shareholder executed as a representative of the loan-out should be taxable to the corporation. As these examples illustrate, in any case where the loan-out's agency status is unclear, the particular facts and circumstances should lend themselves to analysis under existing doctrines consistent with *Moline Properties*. As long as there exists a valid employment contract between the loan-out and its employee-owner, there should be no role for worker reclassification in the agency analysis.

If the government persists in defending the position it staked out in *Sargent*, it will run squarely into the *Bollinger* line of authority. Based on the facts presented in the *Sargent* opinions, the hockey players' loan-outs should have been treated as principals under *Bollinger*.³¹² The logical consequence of the government's position on loan-outs is that *Bollinger* would foreclose the taxpayers in *Sargent* from treating their corporations as agents, and *Sargent* would foreclose them from treating their corporations as principals. *Bollinger* expressed concern that taxpayers might whipsaw the government if agency status were not clearly defined. If the Service has its way, it will be the taxpayer who is whipsawed.³¹³

V. CONCLUSION

Worker reclassification arguments such as those advanced by the government in *Sargent* are an inappropriate response to the use of loan-out corporations by service providers seeking the economic and tax benefits of incorporation. In ruling for the government in *Sargent*, the Tax Court attempted to apply the common law test of employee status to a task for which it was not designed—identifying the

312. *Pflug* is a more difficult case, only because the opinion does not contain sufficient facts for an adequate agency analysis. It is quite possible, however, that on a more complete factual record the loan-out in that case would qualify as a principal under *Bollinger*.

313. In effect, the government would be able to choose when to treat a loan-out as an agent, but the taxpayer would have no choice. In its discussion of the Supreme Court's decision in *Higgins v. Smith*, 308 U.S. at 476, which used a "control" analysis to disallow losses incurred on a sale of property to the taxpayer's controlled corporation, the Ninth Circuit in *Laughton* observed:

It is arguable that the Higgins decision means that no matter what the particular 'tax event' may be, if it be more profitable to the tax collector to disregard the intervening corporate entity this must be done. However, it seems to us that if this were the intent of the court it would have said so and not spread its consideration of the cases over many pages of the opinion. . . .

Laughton, 113 F.2d at 104.

employer of a worker who is already conceded to be an employee. The Court applied this test without considering whether the public policy underlying the distinction had any relevance to the issue in the case. In doing so, the Tax Court endorsed the Treasury's "back-door" effort to disregard a properly formed corporation.

Respecting the separate taxpayer status of closely-held service corporations regardless of the nature of the services provided, and the number of parties receiving those services, would erase the inequity of the current dichotomy, which treats "traditional" professional practices as appropriate for incorporation. It would also simplify the worker classification problem by offering taxpayers a safe harbor guaranteeing them independent contractor status if they conduct their business in corporate form. This approach would provide certainty for taxpayers and would reduce the cost of conducting the audits and litigation engendered by worker reclassification.

The agency analysis proposed in this Article offers both the government and taxpayers a clearer roadmap than the employee/independent contractor analysis, and eliminates the conflict between the latter approach and the principles of *Moline Properties*. Moreover, the assignment of income doctrine, the sham incorporation doctrine, and Section 482 remain available to police any fraudulent transactions, as well as any transactions in which the corporation is a mere assignee or collector of funds derived from transactions in which it played no role at all. Historically, these doctrines have successfully identified the true earner of income in a wide variety of factual contexts. Where, as in *Sargent*, these doctrines have indicated that a loan-out is the true earner, the government's leap to the employee/independent contractor analysis represents an ill-conceived departure from settled principles of tax law.

A return to these sounder principles, of course, will require the government to respect the status of loan-outs that would be disregarded under the position articulated in the *Sargent* nonacquiescence. The government's major concern about abandoning the misclassification attack on loan-outs will no doubt be loss of revenues. However, losses due to noncompliance by independent contractors can and should be addressed by improving enforcement. For example, payors can be required to report payments made to incorporated independent contractors rather than only payments made to sole proprietors as under current law. In addition, any losses caused by the use of fiscal years by loan-outs can be mitigated if Congress expands the definition

of a PSC for purposes of Section 441 so that more corporations (not necessarily limited to loan-outs) will be forced onto calendar years.

Other lost revenues may arise from larger contributions to retirement plans, deduction of expenses at the corporate level rather than the individual level, and the use of tax-favored fringe benefit plans by employee-shareholders. However, these losses result directly from Congress's decision to treat corporate taxpayers (and, in some cases, sole proprietors) more favorably than employees. As long as this disparity exists, it is only rational for workers to operate in the corporate form if at all possible. It is well-settled that "[a]ny one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury."³¹⁴ Current law makes it relatively easy for workers in capital intensive businesses, and those in the traditional service professions who serve the public at large, to minimize their taxes by maximizing the benefits of incorporation. Any policy that denies comparable benefits to workers who render services exclusively to one or a few recipients bears a heavy burden of justification.³¹⁵

Congress has the power, of course, to end the benefits of loan-outs by enacting legislation comparable to the grantor trust rules,³¹⁶ which tax the grantor on income from property held in a trust if the grantor retains the power to reclaim title to that property. A similar rule could be designed for controlled corporations, whereby a corporation would be disregarded for some or all federal tax purposes if a single shareholder had a designated degree of control (for example, beneficial ownership of more than some specified percentage of the stock). Alternatively, the same effect would follow if a rule were adopted which required a corporation to have more than one owner in order to satisfy the tax definition of a corporation.³¹⁷ Either approach,

314. *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934), aff'd 293 U.S. 465 (1935).

315. For example, Congress's rationales for subjecting unreimbursed employee expenses to the 2% floor on miscellaneous itemized deductions suggest that the same treatment should be applied to sole proprietors and traditional professional corporations; in addition, several of those rationales could apply to corporations in general. See note 11.

316. I.R.C. § 676 (1994); but see *Vnuk v. Commissioner*, 621 F.2d 1318, 1320-21 (8th Cir. 1980) (applying grantor trust rules to impose tax on individual despite claim he was employee of the trust he created, but distinguishing several loan-out cases because those corporations had the legal right to direct workers' activities).

317. The Code itself does not define "corporation." Section 301.7701-2 of the Treasury Regulations sets forth the familiar definition. Although it requires the entity to have "associates," the regulation has not been interpreted as barring single-shareholder corporations. If Congress were to adopt a multiple-owner rule, provision would have to be made to prevent formalistic evasion of the rule—for example, by issuing a single share of stock to a second person. In addition, provision could be made for temporary and inadvertent loss of the second shareholder (for example, where one of only two shareholders dies and the second shareholder

of course, would eradicate the separate tax status of any corporation controlled by one individual or entity because it would apply regardless of the nature of the corporation's business activities. Thus, the rule would eliminate the separate taxpayer status of all wholly owned subsidiaries as well as one-person professional corporations formed by individual lawyers, physicians, and accountants, and individuals engaged in businesses traditionally viewed as independent—for example, plumbers, retailers, manufacturers, and consultants. If Congress were to apply such a rule only to traditionally nonself-employed workers—athletes, entertainers, nurses, truck drivers, and clerical workers, for example—the affected taxpayers would surely demand a justification for the distinction. Thus, any policy that would be advanced by disregarding loan-outs should be evaluated publicly in the appropriate policy-making forum. Until Congress takes action, it is overreaching for the Treasury itself to create such a distinction by a “back-door” method such as worker reclassification.

At the policy level, advocates of disregarding loan-outs while respecting other controlled corporations should bear a heavy burden of justification. That burden was not satisfied in the enactment of Section 269A, a hasty measure that ultimately proved ineffective. Its failure reflects the lack of deliberation and debate which accompanied its enactment. If Congress revisits the question of closely held service corporations, it should do so in a more considered and careful manner.

If there is any inequity or irrationality in the tax benefits currently enjoyed by loan-outs, it is not in the fact that taxpayers may achieve tax savings through the mere formalism of incorporating. Rather, it is in the fact that such formalism is *necessary* to achieve those tax savings. To restore rationality to the taxation of personal services, the answer is not to disregard a properly formed corporation but instead to change the tax laws that make this formalism necessary. The amount of business, medical, insurance, and retirement plan deductions available to a worker should not turn on how many different parties receive the worker's services in a given period of time. Although that is the effect of current law, it is not a rational tax policy. Until individual employees receive tax benefits comparable to those of independent contractors and corporations, courts and the government should respect the formalism of incorporating a service business and “lending” the employee to a third party as a rational response to these discriminatory features of the tax system.

inherits the decedent's shares). It is unlikely that Congress would enact such a multiple-owner test.