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## Incorporation of Pro Athletes: Skating on Thin Ice?

George A. Vausher

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# INCORPORATION OF PRO ATHLETES: SKATING ON THIN ICE?

## I. INTRODUCTION

A fashionable practice among many professionals, including entertainers and athletes, is to create personal service corporations<sup>1</sup> in order to obtain various tax and pension related benefits.<sup>2</sup> The Internal Revenue Service (IRS) has often attacked the validity of these personal service corporations, contending that income should be treated as earned by the individual-shareholders, not the corporation.<sup>3</sup> Over the years, the IRS attacked the validity of personal service corporations on various grounds including the sham corporation doctrine,<sup>4</sup> the assignment of income doctrine,<sup>5</sup> and the constructive receipt doctrine.<sup>6</sup> The IRS has had mixed success with these now established doctrines.<sup>7</sup>

In 1989, the IRS undertook a special litigation project to take on several members of the Minnesota North Stars hockey team, who had incorporated themselves in order to obtain various tax and pension related benefits.<sup>8</sup> The lead case, *Sargent v. Commissioner*,<sup>9</sup> involved Gary Sargent, a professional hockey player and taxpayer residing in Burnsville,

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1. The Internal Revenue Code provides a specific definition of personal service corporations depending on the issue in question. Section 269A defines a personal service corporation as "a corporation the principal activity of which is the performance of personal services and such services are substantially performed by the employee-owners." 26 U.S.C. § 269A(b)(1) (1993). Compare 26 U.S.C. § 444(f) (1993) (personal service corporations defined for purposes of choosing tax year end) with 26 U.S.C. § 448(d)(2) (1993) (personal service corporations defined for purposes of cash basis accounting method).

2. Even after 1986 tax reforms, many professionals still prefer to operate as corporations in order to take advantage of more favorable terms for deducting business expenses, net operating loss, or medical expenses. See CCH TAX TRANSACTIONS LIBRARY, THE FILMED ENTERTAINMENT INDUSTRY § 1002 (1993). Generally, prior to 1986, corporations were subject to a lower tax rate than individuals. Prior to 1979, corporations had more flexibility in establishing qualified pension plans such as defined benefit plans. See Frank V. Battle, Jr., *The Use of Corporations by Persons Who Perform Services to Gain Tax Advantages*, 57 TAXES 797 (1979).

3. When the IRS reallocated income from the corporation to the individual-shareholder, the result was a hefty assessment, since the individuals were usually taxed at higher brackets than corporations. Battle, *supra* note 2, at 802.

4. *Id.*

5. *Id.* at 803.

6. Rev. Rul. 60-31, 1960-1 C.B. 174.

7. Battle, *supra* note 2, at 802.

8. *Sargent v. Commissioner*, 93 T.C. 572, 573 (1989), *rev'd*, 929 F.2d 1252 (8th Cir. 1991).

9. *Id.* at 573.

Minnesota. Sargent formed a wholly owned corporation, Chiefy-Cat,<sup>10</sup> with which he contracted to establish himself as president and sole director.<sup>11</sup> The contract specified terms of employment and compensation.<sup>12</sup> Subsequently, Sargent caused Chiefy-Cat to enter into a contract with the Minnesota North Stars.<sup>13</sup> This contract specified that Chiefy-Cat would provide the services of Sargent to the North Stars in return for compensation.<sup>14</sup>

The IRS argued that, despite these arrangements, Sargent was really an employee of the North Stars rather than Chiefy-Cat,<sup>15</sup> and therefore, any compensation paid by the North Stars to Chiefy-Cat was taxable income to Sargent.<sup>16</sup> Based on this view, the IRS assessed a deficiency of \$79,384, resulting from allocating as income to Sargent amounts paid to Chiefy-Cat.<sup>17</sup> The IRS based this contention on treasury regulations governing the status of employees as opposed to independent contractors for purposes of withholding of payroll taxes ("withholding regulations").<sup>18</sup> The majority of the United States Tax Court agreed with the IRS and held that Sargent was indeed an employee of the North Stars and not of Chiefy-Cat.<sup>19</sup> The tax court agreed with the IRS' assessment of \$79,384 and ordered Sargent to pay it.<sup>20</sup> Sargent appealed.<sup>21</sup>

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10. *Id.* at 574.

11. *Id.*

12. *Id.*

13. 93 T.C. at 574.

14. *Id.*

15. *Id.*

16. In other words, the IRS' position is that Sargent by providing his service to the North Stars was really an employee of the North Stars, and, therefore, Sargent could not by virtue of his contractual maneuvering allocate income paid for his services to Chiefy-Cat. 93 T.C. at 578.

17. The deficiency was the result of requiring Sargent to pay taxes at the rates applicable to individuals on funds paid by the North Stars to Sargent's corporation, Chiefy-Cat, and not paid out from Chiefy-Cat to Sargent as compensation. Interest and penalties are also included in the IRS' computation. 93 T.C. at 573.

18. According to the treasury regulations, individuals who work as "employees" for an employer are subject to withholding of income taxes. That is, if an employer hires an individual to do work, and if that individual is classified as an "employee" according to factors specified in the regulations, then the employer must withhold social security, federal income taxes, and state income taxes from the employee's pay. On the other hand, if an employer hires an individual to work as an "independent contractor" (for example, hiring a lawyer to file a specific claim) then the employer need not withhold income taxes. Treas. Reg. § 31.3121(d)-1(c)(2) (1980).

19. 93 T.C. at 583.

20. *Id.* at 573, 583.

21. *Sargent v. Commissioner*, 929 F.2d 1252 (8th Cir. 1991).

Characterizing the issue as "one of first impression," the Eighth Circuit Court of Appeals reversed.<sup>22</sup> The court of appeals held that the tax court's adoption of the withholding regulations as the new standard was an unwarranted deviation from the established approaches for analyzing the validity of personal service corporations.<sup>23</sup> The court of appeals then applied tax court precedents to the facts and concluded that Sargent was indeed an employee of Chiefy-Cat rather than the North Stars,<sup>24</sup> and that amounts paid by the North Stars to Chiefy-Cat were not taxable directly to Sargent.<sup>25</sup>

But the puck did not stop there. Shortly after the court of appeals reversed, the IRS issued an angry Action on Decision<sup>26</sup> criticizing the court of appeals for rejecting its new arguments.<sup>27</sup> The IRS promised to raise the issue again in all other circuits.<sup>28</sup>

Is the IRS skating on thin ice? This Note will examine the arguments that the IRS has traditionally used to attack personal service corporations in the context of "incorporated talent" cases. This Note will then compare the analysis applied by the tax court in *Sargent* with the analysis applied by the court of appeals. Finally, this Note will examine the weight of the arguments in favor of adopting the IRS' new approach and will conclude with recommendations for practitioners who wish to advise their clients regarding incorporating their talents.<sup>29</sup>

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22. *Id.* at 1253.

23. *Id.* at 1256.

24. *Id.*

25. *Id.* at 1258.

26. An Action on Decision is a statement by the IRS in which the Service describes whether it intends to conduct further litigation respecting the same issues. See *Sargent v. Commissioner*, 929 F.2d 1252 (8th Cir. 1991), *action on decision*, 1991-022 (Oct. 22, 1991).

27. *Id.*

28. *Id.*

29. Burton W. Kanter & Sheldon I. Banoff, *Incorporation of Pro Athletes—Is IRS a Bad Sport?*, 77 J. TAX'N 254 (1992).

## II. ATTACKING PERSONAL SERVICE CORPORATIONS

### A. *The Traditional Approaches*

IRS attacks on personal service corporations have traditionally been based on "form-over-substance" type grounds.<sup>30</sup> This section discusses the most important of these grounds.<sup>31</sup>

#### 1. Sham Corporations

The most "drastic" approach to personal service corporations is to disregard the corporate entity as a sham,<sup>32</sup> on the theory that its only purpose is tax avoidance, and attribute taxable income directly to the shareholder-employee.<sup>33</sup> The Supreme Court in *Moline Properties v. Commissioner*<sup>34</sup> addressed the issue of disregarding a corporation under the sham corporation test. There, the Court held that a corporation constitutes an entity for tax purposes if it was organized for a legitimate business purpose or if it engaged in substantial business activities, regardless of the motive for its creation.<sup>35</sup>

The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be 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 [a] business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity.<sup>36</sup>

In *Sargent*, Chiefy-Cat was organized for the purpose of permitting Sargent to take advantage of the lower tax rates available to corporations and to permit Sargent to set up a corporate pension plan.<sup>37</sup> Chiefy-Cat

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30. BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* § 2.07 (5th ed. 1987).

31. *Id.* at 2-22.

32. *Id.*

33. *Id.*

34. 319 U.S. 436 (1943).

35. *Id.* at 438-39.

36. *Id.* (footnotes omitted).

37. *Sargent v. Commissioner*, 93 T.C. 572, 574 (1989).

was also set up for negotiations and dealings with the North Stars<sup>38</sup> and perhaps future negotiations with other clubs.<sup>39</sup> The IRS conceded that these were sufficient business objectives to prevent application of the sham corporation doctrine.<sup>40</sup>

## 2. Agent or Alter Ego

In some cases, the IRS has successfully argued that the personal service corporation is a mere "agent" of the individual shareholder who is the true owner of income, and therefore, income paid to the agent-corporation is really income that is taxable to the individual-shareholder.<sup>41</sup> This argument is based on the principle that a corporation, like an individual, may act as an agent or nominee for another person without becoming taxable on income collected by it on behalf of its principal.<sup>42</sup> Thus, if a corporation is a mere agent or an alter ego for its shareholder, serving no other functions and engaging in no significant business activity, its separate taxable identity may be disregarded.<sup>43</sup> The IRS succeeded with this argument in several important cases.<sup>44</sup>

In *Sargent*, the IRS did not contend that Chiefy-Cat was a mere agent of Sargent. The IRS was probably impressed by the fact that Chiefy-Cat operated in its own name and that its actions did not directly bind Sargent.<sup>45</sup>

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38. *Id.*

39. *Id.*

40. *Id.* at 578.

41. See generally BITTKER & EUSTICE, *supra* note 30, § 2.10.

42. *Id.*

43. *Id.*

44. *Factor v. Commissioner*, 281 F.2d 100, 130 (9th Cir. 1960), *cert. denied*, 364 U.S. 933 (1961) (shareholder taxed on income of his corporation under agency theory); *Johansson v. United States*, 336 F.2d 809, 814 (5th Cir. 1964) (corporate income taxed directly to shareholder who earned it); see generally BITTKER & EUSTICE, *supra* note 30, § 2.10.

45. *Sargent v. Commissioner*, 93 T.C. 572, 578 (1989); see generally BITTKER & EUSTICE, *supra* note 30, § 2.10.

### 3. Actual Earner

A fundamental principle in tax law is that "income must be taxed to him who earned it."<sup>46</sup> In the context of personal service corporations, this principle has given rise to the so-called "actual earner" test.<sup>47</sup> Under the "actual earner" test, the issue is whether the shareholder-employee is the "actual earner" of income so that income paid to the corporation by a third party should be treated as income that is taxable directly to the individual.<sup>48</sup>

In *Sargent*, the "actual earner" of the compensation paid by the North Stars was, in the view of the tax court, Sargent himself.<sup>49</sup> According to the tax court, Sargent was the "actual earner" because it was Sargent who actually played for the North Stars.<sup>50</sup> It was Sargent who attended the practice sessions.<sup>51</sup> It was Sargent who had to abide by the orders of the coaches and the management of the North Stars.<sup>52</sup>

Yet, one can argue that the "actual earner" in *Sargent* was really Chiefy-Cat, since it was Chiefy-Cat who was "working" for the North Stars using Sargent as its employee.<sup>53</sup> After all, it was Chiefy-Cat that owned the contracts pursuant to which the North Stars were receiving the services

46. *Commissioner v. Culbertson*, 337 U.S. 733, 739-40 (1949). This principle was established by the Supreme Court in the landmark case of *Lucas v. Earl*, 281 U.S. 111 (1930). There, Mr. Earl, a corporate officer and a practicing attorney, entered into an agreement with his spouse under which the parties agreed that all future fees earned by Mr. Earl were joint property of both spouses. Mr. Earl argued that only one-half of his salary and fees was taxable to him because the other half belonged to his spouse by virtue of their agreement. Thus, the issue presented to the Court was whether a taxpayer who anticipates earned income may assign part or all of that earned income to another taxpayer by the use of a contract. The Court held that the taxpayer could not assign this income. The Court reasoned that Congress intended to tax income to "the man who earned it." Justice Holmes stated:

There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us and we think that no distinction can be taken according to the motives leading to that arrangement by which the fruits are attributed to a different tree from that on which they grew.

*Id.* at 114-15.

47. *Johnson v. Commissioner*, 78 T.C. 882, 891 (1982).

48. *Id.*

49. *Sargent v. Commissioner*, 93 T.C. 572, 581, 583 (1989).

50. *Id.*

51. *Id.*

52. *Id.*

53. *See Sargent v. Commissioner*, 929 F.2d 1252, 1259 (8th Cir. 1991).

of Sargent.<sup>54</sup> The court of appeals appeared to argue this construction when it said that the "actual earner" of income cannot be determined "by merely pointing to the one actually turning the spade or dribbling the ball."<sup>55</sup>

#### 4. The Control Test

The ultimate question under the "actual earner" test is who earned the income?<sup>56</sup> In the choice between an individual and a corporation, the answer is difficult.<sup>57</sup> The corporation is more than a passive donee of income and often plays a substantial role in the earning process by providing capital and resources.<sup>58</sup> Thus, the true earner of corporate income cannot be determined by merely pointing to the one actually doing the work or "dribbling the ball."<sup>59</sup> After noting these problems with the "actual earner" test, the United States Tax Court, in *Johnson v. Commissioner*,<sup>60</sup> formulated what is now referred to as the "control test."<sup>61</sup>

Under the "control test," the issue is whether the corporation or its shareholder was the one "in control" of earned income.<sup>62</sup> The "control test" has two elements. First, the person who performed the work must be "an employee of the corporation whom the corporation has the right to direct or control in some meaningful sense."<sup>63</sup> Second, "a contract or similar indicia recognizing the corporation's controlling position" must exist between the corporation and the third party benefiting from the work of the employee.<sup>64</sup>

Under the first element of the "control test," the issue is whether a valid employer-employee relationship exists between the individual-shareholder and the personal service corporation.<sup>65</sup> In determining whether the required employer-employee relationship exists, the court considers whether a valid employment contract exists between the

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54. *Id.* at 1255.

55. *Id.* at 1259.

56. *Johnson v. Commissioner*, 78 T.C. 882, 891 (1982).

57. *Id.*

58. BITTKER & EUSTICE, *supra* note 30, § 2.07.

59. *Id.*

60. *Johnson*, 78 T.C. 882, 891 (1982).

61. *Id.*

62. *Id.*

63. *Id.*

64. *Id.*

65. *Johnson*, 78 T.C. at 891.



individual-shareholder and the corporation.<sup>66</sup> In *Sargent*, the relationship of Chiefy-Cat and Sargent was governed by an employment contract.<sup>67</sup> Although the purpose of the contract was to establish Sargent as an employee of Chiefy-Cat, the tax court did not find this contract dispositive in its decision as to whether Sargent was an employee of Chiefy-Cat.<sup>68</sup> On the other hand, the court of appeals found that this employment contract was sufficient to prove that Sargent was an employee of Chiefy-Cat, thus satisfying the first element of the "control test."<sup>69</sup>

Under the second element of the "control test," the issue is whether a contract or similar indicia recognizing the corporation's controlling position exists between the personal service corporation and third parties benefiting from the services of the shareholder-employee.<sup>70</sup> In *Sargent*, the tax court's view was that the contract between Chiefy-Cat and the North Stars was not sufficient to show that the North Stars recognized Chiefy-Cat's position as the employer of Sargent.<sup>71</sup> The court of appeals, on the other hand, found that the contract was sufficient to show that the North Stars viewed Chiefy-Cat as the employer of Sargent and the entity in control.<sup>72</sup> The court of appeals reasoned that the North Stars' reliance on Chiefy-Cat as a separate entity from Sargent distinguished the case from *Johnson*.<sup>73</sup> In *Johnson*, the San Francisco Warriors refused to contract

66. *Sargent v. Commissioner*, 929 F.2d 1252, 1257 (8th Cir. 1991).

67. *Id.* at 1255.

68. *Sargent v. Commissioner*, 93 T.C. 572, 580 (1989).

69. 929 F.2d at 1258. An example of how the "control test" is applied by the tax court is provided by the case of *Pflug v. Commissioner*, 58 T.C.M. 685 (1989). There, JoAnn Pflug, a professional actress, entered into an exclusive employment contract with her husband's corporation, Charwool Productions. *Id.* at 686. Subsequently, Charwool entered into a contract with 20th Century Fox Studios, wherein Charwool agreed to provide the services of JoAnn Pflug for the "Fall Guy" television series. *Id.* The issue in the case was whether JoAnn Pflug was an employee of Charwool as opposed to an employee of 20th Century Fox. *Id.* at 687. The tax court found the contracts between the respective parties to be dispositive and stated that "[t]he fundamental question is whether Charwool had the right to exercise dominion and control over the activities of [Pflug]." On the facts, the court there found that Charwool had the requisite right to control Pflug. *Id.* at 688.

70. *Johnson*, 78 T.C. at 891.

71. 93 T.C. at 583.

72. 929 F.2d at 1258.

73. *Id.* In *Johnson v. Commissioner*, 78 T.C. 882 (1982), the facts involved Charles Johnson, a professional basketball player residing in Oakland, California. *Id.* at 883. Charles Johnson began playing in the National Basketball Association ("NBA") in the fall of 1972. In September of 1972, he signed an NBA Uniform Player contract with the San Francisco Warriors. The contract obligated him to play basketball for the Warriors for one year. *Id.* Johnson then signed new contracts with the Warriors each year. Johnson's attorney attempted to have the Warriors contract with Johnson's corporation rather than Johnson himself. However, the Warriors were

with Charles Johnson's corporation.<sup>74</sup> The Warriors insisted that Johnson personally sign the contract.<sup>75</sup> In *Sargent*, however, the North Stars viewed Chiefy-Cat as an acceptable entity with whom the North Stars were able to contract for Gary Sargent's services.<sup>76</sup> The court of appeals called this type of reasoning the "contracts theory."<sup>77</sup>

The "contracts theory" stands for the principle that, in determining the person in "control," the court should look at the contracts between the personal service corporation and third parties. In its Action on Decision, the IRS called this "contract theory" a "form-over-substance" approach.<sup>78</sup> In the IRS' view, determining who is in control is a question of hard facts, not a question of contracts.<sup>79</sup> Here, the IRS would argue that the one in control was none other than Sargent.<sup>80</sup>

### 5. Constructive Receipt

A related line of cases deals with the doctrine of constructive receipt.<sup>81</sup> Under the doctrine of constructive receipt, a taxpayer is required to recognize income from the sale of personal services in the taxable year

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adamant about having the NBA Uniform Player contract signed by the players, and thus, the Warriors rejected the proposed licensing contract between the Warriors and Johnson's personal service corporation. *Id.* at 884.

In applying the "control test," the tax court held that the income paid by the Warriors is taxable income to Johnson and not to Johnson's personal service corporation. 78 T.C. at 893. The tax court reasoned that Johnson's corporation did not meet the requirements of the "control test." *Id.* The first element of the "control test" is that the employee must be controlled by his personal service corporation. *Id.* at 891. The tax court found that this test is met by virtue of the contract between Johnson and his corporation. *Id.* at 893. The second element of the "control test" is that the corporation, not the employee, must be in control of the relationship between the corporation and the third party. *Id.* at 891. The tax court found that this second element was not met, since the Warriors had expressly refused to contract with Johnson's corporation and purposefully contracted with Johnson himself. 78 T.C. at 893. Therefore, the court concluded that Johnson's corporation was not the entity in control of the income paid by the Warriors. *Id.*

74. *Johnson*, 78 T.C. at 893.

75. *Id.*

76. 929 F.2d at 1258.

77. *Id.*

78. *Sargent v. Commissioner*, 929 F.2d 1252 (8th Cir. 1991), *action on decision*, 1991-022 (Oct. 22, 1991).

79. *Id.*

80. 93 T.C. at 583.

81. See generally BORIS I. BITTKER, FEDERAL INCOME TAXATION OF INDIVIDUALS § 36.2 (1988).

in which he actually or constructively received payment for such services.<sup>82</sup> The doctrine is best explained in the Treasury Regulations:<sup>83</sup>

Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.<sup>84</sup>

Thus, under the constructive receipt test, the issue is whether income earned by the corporation is subject to substantial limitations or restrictions so that it is not income that should be taxed directly to the corporation's controlling shareholder.<sup>85</sup> In determining if the receipt of income is subject to substantial limitations or restrictions, the court considers several factors such as: (1) whether the funds were available to the shareholder so that he could draw upon them at his will; (2) whether the corporation was ready and able to pay him; (3) whether the right of the shareholder to receive the income was not restricted by contract or other methods; and (4) whether the failure to receive income resulted from the shareholder's own choice.<sup>86</sup>

Applying the constructive receipt doctrine to the facts of *Sargent* tends to show that funds paid to Chiefy-Cat were not constructively received by Sargent. The relationship between Chiefy-Cat and Sargent was not a casual relationship but was governed by contract.<sup>87</sup> According to the terms of the contract, Sargent received a certain amount of compensation for his services, no more and no less.<sup>88</sup> Chiefy-Cat did not maintain substantial amounts of cash on its books so that Sargent could draw upon corporate cash at his pleasure.<sup>89</sup> The corporation appears to have carefully

82. 26 U.S.C. § 451(a) (1993) (generally requires taxpayers to report income in the "taxable year in which received by the taxpayer"); Treas. Reg. § 1.451-2(a) (as amended in 1979) (requires the taxpayer to report income in the year in which the income is "constructively received").

83. Treas. Reg. § 1.451-2(a) (as amended in 1979).

84. *Id.*

85. *Id.*

86. Rev. Rul. 60-31, 1960-1 C.B. 174.

87. *Sargent v. Commissioner*, 93 T.C. 572, 574 (1989).

88. *Id.*

89. *Id.*

managed its cash.<sup>90</sup> The cash that came in from the North Stars was paid either to Sargent as salary or as legitimate corporate expenses such as payroll taxes and contributions to the pension plan.<sup>91</sup>

## 6. Allocation of Income

Even if the personal service corporation's status as a separate taxable entity is honored and the assignment of income doctrine is inapplicable, the IRS may be able to reallocate part of the corporation's income to its controlling shareholder-employee under section 482 of the Internal Revenue Code.<sup>92</sup> This provision permits gross income (as well as deductions and credits) to be reallocated between or among two or more related organizations, if it is necessary to prevent evasion of taxes or to reflect clearly the income of any such organizations.<sup>93</sup>

Thus, under the reallocation of income approach, the issue is whether part of the corporation's income should be reallocated to its shareholder in order to prevent the evasion of taxes or to clearly reflect the income of the shareholder.<sup>94</sup> In applying section 482, the court must determine whether the arrangement between the personal service corporation and its controlling shareholder-employee is comparable to an arm's length transaction between two independent parties.<sup>95</sup> This standard is satisfied if the shareholder-employee's compensation reasonably reflects the value of his services.<sup>96</sup>

In *Sargent*, Chiefy-Cat's income from the North Stars was \$450,000 over the four years in question.<sup>97</sup> Chiefy-Cat paid Sargent a salary of \$345,000 and made contributions of \$100,416 to its pension plan.<sup>98</sup> The

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90. *Id.*

91. *Id.*

92. 26 U.S.C. § 482 (1993) provides:

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

93. *Id.*

94. *Id.*

95. BITTKER & EUSTICE, *supra* note 30, § 2.07.

96. *See* Hagg v. Commissioner, 88 T.C. 604 (1987).

97. *Sargent v. Commissioner*, 93 T.C. 572, 574 (1989).

98. *Id.* at 575.

entire compensation package to Sargent totaled \$445,416, or ninety-nine percent of the corporation's gross income. Therefore, section 482 reallocation provisions could not be applied to the benefit of the IRS.<sup>99</sup>

### *B. The Employer-Employee Tests*

Thus far, this Note has reviewed some of the important established doctrines for attacking personal service corporations. This Note will now review the grounds that were raised by the IRS and adopted by the tax court in *Sargent v. Commissioner*.

#### 1. The Withholding Regulations

A significant body of law deals with whether a person working for a corporate employer is an employee of that corporation, subject to income tax withholding, or a mere independent contractor, not subject to withholding.<sup>100</sup> This important issue is governed by section 3121 of the Internal Revenue Code and related treasury regulations ("withholding regulations").<sup>101</sup> Under the withholding regulations, the issue is whether the corporation exercised sufficient control over its shareholder-employee so that the shareholder may be considered a true employee of the corporation.<sup>102</sup> In determining the existence of an employer-employee relationship, the court considers several factors among which are: (1) whether the corporation has the right to control the details and means by which the work is accomplished;<sup>103</sup> (2) whether the corporation provides the instrumentalities and the facilities;<sup>104</sup> (3) whether the worker is classified as an employee under local workers' compensation and unemployment tax laws;<sup>105</sup> and (4) whether the relationship is long-term or short-term.<sup>106</sup>

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99. *Id.* at 587 n.2 (dissenting opinion comment about section 482 allocation).

100. *See* 26 U.S.C. § 3121 (1993); Treas. Reg. § 31.3121(d)-1(c)(2) (1980).

101. 26 U.S.C. § 3121 (1993) (provides one definition of an "employee" as, among others, "any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee").

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

103. *Id.*

104. *Id.*

105. *See* *Professional & Executive Leasing, Inc. v. Commissioner*, 862 F.2d 751 (9th Cir. 1988).

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

The first factor is the right of the corporation to control the details and means by which the work is performed.<sup>107</sup> This factor focuses on the extent to which the employer has discretion to decide on when and how long the worker must work and the specific means by which the worker will do his work.<sup>108</sup> In this regard, it is not necessary that the employer actually direct or control the manner and means of the work, only that the employer has the right to do so.<sup>109</sup> The extent of control necessary for a professional to qualify as an employee is less than that necessary for a nonprofessional.<sup>110</sup>

In *Sargent*, the tax court found that applying this first factor clearly indicates that Sargent was in fact an employee of the North Stars rather than an employee of Chiefy-Cat.<sup>111</sup> The tax court noted that Sargent was under the direct control and supervision of the coaches and managers of the North Stars.<sup>112</sup> Sargent was required to comply with club rules;<sup>113</sup> he went to practice when he was ordered to do so,<sup>114</sup> and he played when the coaches decided that he should play.<sup>115</sup>

Nonetheless, Sargent argued that his status was not that of a lowly employee but that of a highly skilled professional<sup>116</sup> and that he had substantial discretion to play according to his skill and experience.<sup>117</sup> The tax court was not impressed by this argument.<sup>118</sup> The tax court reasoned that Sargent, skilled as he was, was still part of a team of equally skilled persons.<sup>119</sup> Sargent could not use his skills except in the context of instructions provided by his coach.<sup>120</sup> The court of appeals, on the other hand, was more sympathetic to Sargent's argument,<sup>121</sup> reasoning that Sargent enjoyed a status similar to that of a hired professional.

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107. *Id.*

108. *Id.*

109. *Id.*

110. 862 F.2d at 753.

111. *Sargent v. Commissioner*, 93 T.C. 572, 583 (1989).

112. *Id.* at 579, 580.

113. *Id.*

114. *Id.*

115. *Id.*

116. 93 T.C. at 579, 580.

117. *Id.*

118. *Id.*

119. *Id.*

120. *Id.*

121. *Sargent v. Commissioner*, 929 F.2d 1252, 1256 (8th Cir. 1991).

The second factor is whether the corporation provides the instrumentalities and facilities.<sup>122</sup> In *Sargent*, the tax court noted that the North Stars provided the uniforms, the equipment, and the facilities.<sup>123</sup> This factor tends to indicate that *Sargent* was an employee of the North Stars.<sup>124</sup> The court of appeals did not address this factor.

The third factor is whether the worker is classified as an employee for purposes of workers' compensation and local payroll tax laws.<sup>125</sup> In *Sargent*, the tax court did not address this factor. However, in the statement of facts, the tax court noted that, for purposes of the National Hockey League's pension plan, *Sargent* was not classified as an employee of the North Stars.<sup>126</sup> Neither the tax court nor the court of appeals appears to have given this fact any weight.

The fourth factor is whether the relationship between the corporation and the worker is a long-term or short-term relationship.<sup>127</sup> Thus, the court can consider whether the employer has the right to discharge the worker after a certain task is completed or whether the corporation has the right to assign additional work to the worker after the task at hand is completed.<sup>128</sup> In *Sargent*, Chiefy-Cat's contract with the North Stars had a duration of one year,<sup>129</sup> renewable each year at the option of the parties.<sup>130</sup> Both the tax court and the appeals court ignored this factor.

## 2. The "Team Sports" Test

In an important article<sup>131</sup> addressing the issue of classifying employees and independent contractors, Professor Sheldon I. Banoff suggested that, rather than attempt an ad hoc balancing in every case, the courts should follow an "overall principle" that would increase predictabili-

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

123. 93 T.C. at 577.

124. *Id.*

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

126. 93 T.C. at 576.

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

128. *Id.*

129. 93 T.C. at 574.

130. *Id.*

131. Sheldon I. Banoff, *Reducing the Income Tax Burden of Professional Persons by Use of Corporations, Joint Ventures, Sub-partnerships, and Trusts*, 58 TAXES 968, 972 (1980). According to the dissent in the tax court's opinion, the theory presented by Professor Banoff "appears to have been adopted" by the IRS in *Sargent*. *Sargent v. Commissioner*, 93 T.C. 572, 588 n.4 (1989) (dissenting opinion).

ty and efficiency.<sup>132</sup> Professor Banoff suggested that the test for determining which personal service corporations ought to be respected 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.<sup>133</sup>

Thus, under Professor Banoff's approach, the issue is whether, prior to incorporation, the individual who performed the service is recognized as an employee or as an independent contractor operating a separate trade or business.<sup>134</sup> In making this determination in cases involving professional athletes, the court considers whether the individual who is a professional athlete has traditionally been required to sign contracts with sports clubs, creating an employer-employee relationship.<sup>135</sup> In *Sargent*, the tax court applied this test when it emphasized that hockey was a "team sport" and that Sargent was a member of a team.<sup>136</sup> The tax court appeared to reason that as long as the case involves the kind of sport that is tradition-

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132. Banoff, *supra* note 131, at 984, 985. According to Professor Banoff, the advantage of this approach is to formulate a general "principle which has predictive value for both taxpayers and the IRS." Under the proposed approach, the courts would have to apply a bright-line rule to distinguish cases in which the personal service corporation should be disregarded. *Id.* at 984.

It is important to note, however, that Professor Banoff never suggested that any court adopt this test. Professor Banoff espoused "legislative change" by Congress to "deal with this evil." This point was apparently missed by both the tax court and the appeals court in *Sargent*. See Burton W. Kanter & Sheldon I. Banoff, *Incorporation of Pro Athletes--Is IRS a Bad Sport?*, 77 J. TAX'N 254 (1992).

133. Banoff, *supra* note 131, at 984. For example, the athlete who traditionally has been required to sign contracts with a sports club (creating an employee relationship) could not incorporate his personal services as a ball player. On the other hand, athletes who compete independently (e.g., professional golfers) would not be deemed employees under common law concepts and could thus incorporate their professional activities. *Id.* at 985.

Taking this approach a step further, Professor Banoff suggested that a professional athlete can form a corporation to handle certain aspects of his business that are not related to his work with the athletic team. For example, an athlete could incorporate his tangential services (i.e., endorsements and personal appearance fees) as those constitute one or more separate trades or businesses and are not susceptible to employee status. *Id.* at 985.

As another example, consider a professional tennis player who competes both on tour and who also competes as a team member on the team tennis circuit. Under the proposed rules, the athlete's personal service corporation would be recognized as the earner of income on the tour, but it would not be as to team tennis earnings because as a team member her services are more like those of an employee. *Id.* at 985.

134. Banoff, *supra* note 131, at 984.

135. *Id.*

136. *Sargent v. Commissioner*, 93 T.C. 572, 580 (1989).



ally operated as a team sport, the athletes who traditionally play as members of the team should not be permitted to form corporations.<sup>137</sup>

The court of appeals, in contrast, rejected this "team sports" analysis,<sup>138</sup> reasoning that the "team sports" analysis draws a kind of bright-line rule that is not justified.<sup>139</sup> The court of appeals, instead, adopted the "control test" described in *Johnson*.<sup>140</sup> Under the "control test," the determining factors are the contractual relationships between the athlete, his corporation, and the athletic team.<sup>141</sup> The court of appeals reasoned that the "team sports" test short-cuts this analysis of the contractual relationships and of the facts in each case by focusing instead on a single element, the "team sports" nature of the activity involved, which cannot be controlled by the parties.<sup>142</sup>

### III. CONTRASTING THE APPROACHES

In this section, this Note will first summarize the approaches adopted by the tax court and the court of appeals and compare the two approaches. Finally, this section will offer criticism of, and argument against, the tax court's approach.

#### A. *The Tax Court's Approach*

The approach espoused by the tax court can be summarized as follows: First, the court analyzes the relationships among the athlete, his personal service corporation, and the sports club that employs him.<sup>143</sup> The court analyzes their relationships by applying the factors described in the withholding regulations that distinguish an employee from an independent contractor.<sup>144</sup> The court applies these factors to determine if the athlete was in effect an employee of the sports club rather than an employee of the personal service corporation.<sup>145</sup> Second, the court analyzes the relationships of the parties prior to the time at which the

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137. *Id.*

138. *Sargent v. Commissioner*, 929 F.2d 1252, 1256 (8th Cir. 1991).

139. *Id.*

140. *Id.*

141. *Id.* at 1258.

142. *Id.* at 1256.

143. 93 T.C. at 578.

144. *Id.* at 578-79.

145. *Id.*

individual athlete formed his or her personal service corporation.<sup>146</sup> If prior to the time of incorporation the athlete was considered a mere employee of the sports club, then incorporation does not change his or her status as an employee.<sup>147</sup>

One can argue that this approach in effect creates a presumption<sup>148</sup> that an individual athlete who is working as an employee for a sports club cannot change his status from an employee to an independent contractor by the mere act of incorporating his talents.<sup>149</sup> To rebut this presumption, the athlete may argue the factors established by the withholding regulations.<sup>150</sup> The most important of these factors is the sports club's right to control the means by which the athlete's work is preformed.<sup>151</sup> Since almost all sports clubs control the conduct of their athletes to a material extent, it is hard to see how an athlete playing for a professional sports club can argue that he or she should be allowed to incorporate.<sup>152</sup>

### B. *The Court of Appeals' Approach*

To be contrasted with the tax court's view is the "traditional approach" adopted by the court of appeals. This approach requires the court to first examine the facts to determine whether the corporation was formed for a legitimate business purpose and is therefore not a mere "sham" or factious entity.<sup>153</sup> Once satisfied that the corporation was formed for a legitimate business purpose, the court then applies the "agency or alter ego" test to determine whether the personal service corporation is a mere agent of the individual shareholder.<sup>154</sup> If the corporation is not a factious entity or a mere agent of the individual shareholder, the court then applies the "actual earner" test, the "control" test, and the "constructive receipt" test to determine whether income should be reallocated (under the

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146. *Id.* at 579.

147. *Id.*

148. Banoff, *supra* note 131, at 984 ("overall principle").

149. *Id.*

150. *Id.*

151. 93 T.C. at 578.

152. *Id.* at 579-80.

153. 929 F.2d at 1259 (applying *Moline Properties v. Commissioner*, 319 U.S. 436, 438-39 (1943)).

154. *Jones v. Commissioner*, 640 F.2d 745 (5th Cir. 1981).

provisions of section 482) from the personal service corporation to the individual-shareholder in order to properly reflect income.<sup>155</sup>

### C. Comparing the Approaches

The traditional approach (revolving around the "control test") adopted by the court of appeals has several virtues. Unlike the tax court's approach, which in effect creates a presumption against the validity of the personal service corporation, the traditional approach begins with a presumption in favor of the validity of the personal service corporation.<sup>156</sup> Under the doctrine of *Moline Properties*, the personal service corporation, once formed for a legitimate business reason, is presumed to be a separate entity.<sup>157</sup>

Second, the traditional approach requires a more detailed analysis of the facts in each case. Specifically, the traditional approach requires the court to examine and understand the contractual relationships between the parties involved. The traditional approach is a "contract theory"<sup>158</sup> approach. Under the traditional approach, it is the contractual provisions between the parties that determine: (1) whether the corporation is a mere "agent" of the individual shareholder;<sup>159</sup> (2) whether the corporation or the individual is the "actual earner" of income;<sup>160</sup> (3) whether the corporation or the individual is the one in "control" of incoming funds;<sup>161</sup> and (4) whether the funds retained by the corporation are subject to "substantial limitations or restrictions" so that funds retained by the corporation are not "constructively received" by the individual owner.<sup>162</sup>

By adopting a presumption in favor of personal service corporations and a "contract theory" mode of analysis, the traditional approach, approved by the court of appeals in *Sargent*, provides an adequate framework for case-by-case analysis of personal service corporations.<sup>163</sup> In contrast, the tax court's approach, with its presumption against the validity of personal

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155. *Sargent v. Commissioner*, 929 F.2d 1252, 1260 (8th Cir. 1991) (discussion of section 482 of the Internal Revenue Code).

156. *Id.*

157. *Id.*

158. *Id.* at 1258.

159. *See Jones v. Commissioner*, 640 F.2d 745 (5th Cir. 1981).

160. *Johnson v. Commissioner*, 78 T.C. 882, 890 (1982).

161. *Id.*

162. *Treas. Reg.* § 1.451-2(a) (as amended in 1979).

163. *Banoff*, *supra* note 131, at 984.

service corporations, and with its emphasis on the employer's ability to control the means in which work is accomplished, provides a harsh rule that disregards the contractual relationships between the parties.<sup>164</sup>

#### D. *Attacking the IRS' Approach*

In its Action on Decision, the IRS severely criticized the court of appeals for refusing to follow the approach espoused by the tax court.<sup>165</sup> The IRS' argument is that, in adopting a "contract theory" of analysis, the court of appeals had applied a "form-over-substance" analysis.<sup>166</sup> The IRS favors the tax court's approach as the one that focuses on reality.<sup>167</sup> If the IRS should raise these issues again, as it promised it will, what argument would most likely convince the court not to follow the tax court's approach?

Counsel should argue that the issue of the validity of personal service corporations has been discussed extensively by the Supreme Court and the federal courts for almost a century.<sup>168</sup> The established lines of cases start with a presumption in favor of the validity of the personal service corporation<sup>169</sup> and then focus on the issue of how income should be allocated between the personal service corporation and its individual-shareholders.<sup>170</sup> The established cases require the court to consider the contracts between the parties involved, based on the theory that contracts between parties are not mere pieces of paper but reflect the understanding and reliance interests of the parties.<sup>171</sup>

The tax court's decision is an unwarranted aberration from the established rules.<sup>172</sup> First, the tax court's approach, in effect, creates a presumption against the validity of personal service corporations,<sup>173</sup> and therefore the tax court's approach conflicts with the doctrine of *Moline Properties*, under which a corporation formed for a legitimate business

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164. *Id.*

165. *Sargent v. Commissioner*, 929 F.2d 1252 (8th Cir. 1991), *action on decision*, 1991-022 (Oct. 22, 1991).

166. *Id.*

167. *Id.*

168. *Banoff*, *supra* note 131, at 984.

169. *Sargent v. Commissioner*, 929 F.2d 1252, 1259 (8th Cir. 1991).

170. *Id.* at 1260.

171. *Id.* at 1258.

172. *Sargent v. Commissioner*, 93 T.C. 572, 587 (1989) (dissenting opinion).

173. *Banoff*, *supra* note 131, at 984.

purpose should be treated as a separate taxable entity.<sup>174</sup> Second, the tax court's approach, by focusing on an employer-employee view of relationships, permits the court to ignore the contractual relationships between the parties intended to control their rights and liabilities.<sup>175</sup>

The tax court's approach instead requires the court to apply arbitrary factors stated in the withholding regulations, the most important being the degree to which the alleged employer has the right to control the means in which the work is performed.<sup>176</sup> When the courts ignore the contracts and apply these factors, the courts, in effect, deny the taxpayers their right to "structure their affairs."<sup>177</sup> At the same time, the courts create uncertainty as to the validity of these contracts.

Finally, counsel should point out that commentators who might agree with the tax court's view have suggested that any change in law in this area should be made by the legislature and not the courts.<sup>178</sup> Counsel should argue that because of its character as a bright-line rule, with wide-ranging effects, the question should be decided by the legislature and not the courts.<sup>179</sup>

#### IV. CONCLUSION

Even after the 1986 tax reforms, athletes and other professionals can enjoy substantial tax benefits by operating as personal service corporations.<sup>180</sup> In *Sargent*, the tax court adopted a standard for reviewing personal service corporations that places in doubt the validity of these corporations.<sup>181</sup> The tax court was reversed in the Eighth Circuit, but the IRS promised to raise the *Sargent* arguments again in all other circuits.<sup>182</sup> The approach espoused by the IRS, and adopted by the tax court in *Sargent*, puts in doubt the validity of personal service corporations in cases in which the shareholders are professional athletes who are normally employed by sports clubs or who participate in team sports.<sup>183</sup> The IRS

174. *Moline Properties v. Commissioner*, 319 U.S. 436 (1943).

175. *Commissioner v. First Sec. Bank of Utah*, 405 U.S. 394, 398-99 n.4 (1972).

176. 93 T.C. at 578.

177. 405 U.S. at 394, 398-99 n.4.

178. Banoff, *supra* note 131, at 984.

179. *Id.*

180. See CCH TAX TRANSACTIONS LIBRARY, THE FILMED ENTERTAINMENT INDUSTRY § 1002 (1993).

181. Kanter & Banoff, *supra* note 29, at 254.

182. *Id.*

183. *Id.*

was reversed once, but until the issue is settled by a higher court, athletes and others who incorporate their talents may find themselves skating on thin ice.<sup>184</sup>

*George A. Vausher\**

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184. *Id.*

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