from the THOUGHTFUL TAX ADVISOR

Good News (for a Change) For Professional Corporations: The *Keller* and *Foglesong III* Cases

By HOWARD L. SANGER and BRUCE GIVNER

According to the authors, two recent decisions by the Tax Court, *Daniel F. Keller* and *Frederick Foglesong*, herald an increased use of the professional corporation as a device for tax planning.

Left—Howard L. Sanger
Right—Bruce Givner

Howard L. Sanger is a tax partner in the Palm Springs office of the law firm of Flame, Sanger, Grayson & Ginsburg. Bruce Givner is a tax partner in the Los Angeles office of the same firm.

I. *Background*

The last two years have been difficult ones for professional corporations. Each development seemed to be another nail in the coffin of what has become the most widely used device for tax planning for professionals.

In *Foglesong v. Commissioner*,[1] the Seventh Circuit Court of Appeals reversed the Tax Court and remanded the case for consideration of several theories presented by the Commissioner in support of his determination that income was taxable to the 98% shareholder of a personal service corporation instead of to the corporation. Although this case involved a sales representative of steel tubing manufacturers, the implication for professional corporations was all too clear.

In enacting Internal Revenue Code Section 414(m),[2] Congress sought to limit the attractiveness of pension plans for professional corporations involved in partnerships. This was a direct result of, and attempt to overturn, the pro-taxpayer results achieved by the physicians in *Lloyd*

[1] 80-1 USTC ¶ 9399, 621 F. 2d 865, rev'g and rem'g CCH Dec. 34,024(M), 35 TCM 1309 (1976).
[2] P. L. 96-605, Sec. 201(a).

M. Garland, M. D.,[3] and *Thomas Kiddie, M. D., Inc.*[4]

In the September 1981 issue of the *Journal of Taxation*, there was an article entitled "The Court of Claims holding on a legal PC's reasonable compensation: problems remain," by Stanton D. Rosenbaum, one of the attorneys of the firm subject to the unfortunate decision. The case was the first decision on the IRS challenge to the reasonableness of salaries paid to attorney-shareholders, and it did not resolve the question of whether all of the income of the corporation can be paid out as compensation.

Finally, in the October 1981 issue of TAXES—*The Tax Magazine*, there was an article entitled "Avoiding Personal Holding Company Income for Professional Corporations: "Is It Really So Simple?" by Robert F. Wood. The title of the article tells the whole story and casts a chill over an area of professional incorporation that was thought safe.

II. *The* Keller *Case*

On October 29, 1981, *Daniel F. Keller*,[5] appeared. The taxpayer was a pathologist who had incorporated his practice separately from the practice of his 11 pathologist partners to gain the benefit of, among other items, his own pension plans.

First, the Court concluded favorably to the Commissioner an issue that had previously been unclear: whether the Commissioner may allocate income between a shareholder and the shareholder's wholly owned corporation under Internal Revenue Code Section 482. The Court then held that the standard under Section 482 is whether the total compensation, including employee benefits, paid to the taxpayer or contributed on his behalf by the corporation was essentially equivalent to that which he would have received absent incorporation. Using that "arm's-length" standard, the Court was satisfied that the aggregate compensation paid to or on behalf of the taxpayer was "substantially approximate" to the net amount of partnership income that the taxpayer received prior to incorporation and would have received absent incorporation.

Second, the Court concluded that the Commissioner's reliance on the doctrines of "lack of business purpose" and "substance over form" was misplaced. The Court used language that gives courage to all professional corporations:

> The policy favoring the recognition of corporations as entities independent of their shareholders requires that we not ignore the corporate form so long as the corporation actually conducts business.

III. *The Foglesong III Case*

On November 16, 1981, *Frederick H. Foglesong*,[6] was handed down. The taxpayer was a sales representative for steel tubing manufacturers who had incorporated in order to funnel dividends to his children through the issuance of preferred stock.

Although the decision was against the taxpayer and appears, at first glance, to be inconsistent with the pro-taxpayer result in *Keller*, a more careful reading indicates that the taxpayer lost on a fact situation that will almost never arise in the typical professional corporation context. Since $30,000 of what would otherwise have been income to the taxpayer was diverted to his children, he did not receive an amount in compensation and plan contributions that was substantially equivalent to what he would have received absent the incorporation.

In fact, the Court concluded its opinion with more comforting language:

> . . . [I]t is not our intention to discourage the use of the corporate form for personal service businesses where one of the purposes of the incorporation is to take advantage of certain intended Federal tax law benefits, i. e., medical reimbursement plans, death benefits, and retirement plans . . . . Clearly Congress has intended such a use of the corporate form, and it would therefore be inappropriate for us to adopt a rule to the contrary . . . .

IV. *Conclusion*

Fear of an IRS attack on the validity of professional corporations should be somewhat assuaged by these two cases. Since we now know, through experience, that the impact of Section 414(m) on pension plans can be minimal with proper analysis, these cases herald an increased use of the professional corporation as a device for tax planning.

Obviously, there are still rules to be observed and cautions to be given. For example, the six-judge dissent in *Keller* may give the IRS inspiration to continue the attack.

However, it is to be hoped that with the change in Administrations from former President Carter's emphasis on curbing abusive tax shelters

[4] CCH Dec. 36,876, 73 TC 5 (1979).
[5] CCH Dec. 35,076, 69 TC 1055 (1978).
[5] CCH Dec. 38,401, 77 TC —, No. 70.
[6] CCH Dec. 38,423, 77 TC —, No. 74, on remand from CA-7, *Foglesong v. Commissioner*, note 1, supra.

to President Reagan's emphasis on dealing with tax protesters, the IRS will focus on more economically rewarding avenues of taxpayer activity than professional corporations. ●

Treasury

The Treasury Department intends to recommend legislation to amend rules relating to the computation of original issue discount on bonds and other evidences of indebtedness issued at a discount. The Department believes that present rules deeming discount to be earned in equal installments over the life of an obligation permit overstatement of the issuers' interest deduction in the early years of such obligations. It suggests a new rule that would alter the timing of interest deductions without affecting the aggregate amount of deductions available for original issue discount.

Under the Treasury's proposal, discount on bonds and other obligations issued after May 3, 1982, would be considered earned in a geometric progression over the life of a bond, with the compounding of accrued interest taken into consideration. Bonds issued after the effective date pursuant to a written, binding agreement predating the new rule's applicability would be excepted from the amended computation.

Internal Revenue Service

On April 19, 1982, IRS Commissioner Egger told the House Ways and Means Subcommittee on Select Revenue Measures that the IRS will use research and compliance projects to combat the overstatement of expenses and deductions by individuals engaged in direct sales of consumer goods out of the home. It appears to the IRS that the primary motivation for these business activities is the creation of losses to offset wages or income from other sources.

The IRS is dealing with this problem through the identification and examination of selected individual income tax returns, which indicate that such items as family meals and vacation, compensation to minor children, and expenses for pet dogs as "security devices" are but a few of the means by which direct sales businesses manipulate tax liability.

New Assignments

Appointments have recently been made to four of the key executive positions created by the IRS reorganization. As associate commissioner for operation, Donald E. Bergherm will serve with the associate commissioners for policy and management and for data processing in planning and coordinating agency-wide activities and advising the Commissioner on operating programs. His responsibility will extend to policy matters affecting all enforcement and compliance operations, and he will direct the activities of the new assistant commissioners for collection, criminal investigation, and examination and those of the existing assistant commissioner for employee plans and exempt organizations.

Percy P. Woodard, Jr., will be responsible for developing and supervising the execution of nationwide tax return examination programs as the new assistant commissioner for examination. The new assistant commissioner for criminal investigation, Richard C. Wassenaar, will direct the enforcement of criminal tax statutes, including nationwide programs for investigating suspected violations and recommending prosecution. Finally, Larry G. Westfall has been named as the assistant commissioner for collection, directing national programs for the collection of overdue taxes, investigation of nonfilers, and prevention of deliquent returns and accounts.