

are engaged in the same general line of business when: (1) the two businesses are similar (but not necessarily identical); and (2) after the two corporations are combined, the combination permits the parent corporation to make better use of its existing business-related resources.

Applying this test, the court noted that Castle's acquisition of Hy-Alloy allowed Castle to make better use of its existing distribution system to service a new, closely related market. Furthermore, Castle helped Hy-Alloy with financing by direct loans and the sponsorship of an industrial revenue bond. The court observed that this was "a classic case of a larger parent purchasing a smaller subsidiary to better utilize its existing resources, and to capitalize on the synergy between the two corporations." 36 CA4th at 1808.

► **COMMENT:** A determination that a taxpayer is engaged in a unitary business will not necessarily have adverse income tax consequences. A corporation engaged in business in California may seek to be classified as unitary with an affiliated corporation outside California if the affiliated corporation has incurred a loss. By filing a combined report, the California corporation may thereby reduce its California income tax. By broadening the scope of the same-line-of-business standard, *Castle* may ease the way for corporations seeking to establish unitary status.

FEDERAL TAXATION



MARILYN BARRETT
Los Angeles

Loan-Out Corporations

Ninth Circuit rides to the rescue as the IRS continues its assault on loan-out corporations.

Idaho Ambucare Ctr., Inc. v U.S. (9th Cir 1995) 57 F3d 752

Years ago, "loan-out" corporations enjoyed many benefits unavailable to individuals, including higher deductible limits for pension plan contributions, income

deferral opportunities through use of a fiscal year, and a greater number of deductible fringe benefits, such as medical insurance. Under a loan-out arrangement, a worker ("shareholder-employee") enters into an exclusive, long-term agreement with the worker's wholly owned corporation to provide services to the corporation, as the corporation designates. Generally, the ultimate recipient of the shareholder-employee's services contracts with and pays all compensation to the loan-out corporation. In turn, the loan-out corporation pays compensation to its shareholder-employee under the employment agreement and generally zeros out its income through such compensation payments, contributions to qualified pension plans, payment of other benefits for the shareholder-employee, and payment of business-related expenses.

Over the years, this form of entity became clearly disfavored by both the IRS and Congress. Congress has enacted a number of provisions that minimize and limit the tax advantages of loan-out corporations. For example, Congress generally equalized the benefits derived from retirement plans maintained by self-employed persons and by corporations, limited the ability to defer income through the use of a different fiscal year for the corporation, and imposed the highest marginal corporate tax rate on loan-out corporations to prevent minimization of overall taxes through the combined use of the graduated rate schedules available to individuals and corporate taxpayers.

Nevertheless, loan-out corporations can still be advantageous, particularly when the service provider would otherwise be classified as an "employee" of the ultimate recipient of the services. For example, an employee cannot deduct unreimbursed business expenses for alternative minimum tax purposes. A loan-out corporation is not subject to this limitation. In addition, an employee cannot maintain a qualified retirement plan, other than a very limited IRA, even if his or her employer does not provide one. A loan-out corporation is not subject to this limitation. Also, a loan-out corporation is able to deduct more fringe benefits than an individual. Because of these continuing advantages, loan-out corporations remain popular for many individuals, particularly in the entertainment industry, where major studios routinely treat individuals as employees unless they provide services through a loan-out corporation. Business expenses incurred by entertainers (agent commissions, attorney and accounting fees, and the like) can be substantial, and imposition of the alternative minimum tax onerous.

The IRS has mounted an unrelenting assault against loan-out corporations through the years by asserting a variety of theories designed to eliminate the tax advantages of this arrangement. For example, the IRS has argued that the separate identity of loan-out corporations should be disregarded because they are sham corpora-

tions, or corporations formed for the principal purpose of tax avoidance in contravention of IRC §269A, a provision enacted by Congress in 1982 that allows the IRS to reallocate income from a personal service corporation to its individual owner if substantially all of the services are performed for one other entity and the principal purpose for forming the corporation was to avoid or evade federal income tax. The IRS has also asserted that income of the loan-out corporation should be reallocated to its shareholder-employee under general assignment-of-income principles, and IRC §482 (allocation of income and deductions among taxpayers) and IRC §269 (disallowance of tax benefits of acquired corporations). To date, the IRS has not experienced great success with these arguments. In recent years, however, the IRS has more successfully argued that the income should be reallocated to the shareholder-employee by application of the common-law definition of employer and employee. This article will discuss three cases that so far have considered application of the common-law employer/employee definition in the context of loan-out corporations.

Eighth Circuit Saves Hockey Players From IRS Body Check

The IRS first successfully attacked loan-out corporations in *Gary A. Sargent* (1989) 93 TC 572, using the common-law employer/employee definition. Sargent and Christoff entered into employment contracts with their loan-out corporations, Chiefy-Cat, Inc. and RIF Enterprises, Inc., respectively, under which they agreed to provide services as hockey players and consultants. Chiefy-Cat and RIF then entered into agreements with the Northstar Hockey Partnership (club) under which they agreed to provide the services of Sargent and Christoff as hockey players for the Minnesota North Stars hockey team. Sargent and Christoff each individually guaranteed the performance of all obligations of their respective loan-out corporations. Under the agreements between Chiefy-Cat and RIF and the club, (1) the club had the right to sell, transfer, assign, or loan out the services of Sargent and Christoff; (2) Sargent and Christoff could not engage in any other athletic sport, make public appearances, enter into sponsorships or similar activities related to the services performed for the club without the club's consent; (3) the club provided Sargent and Christoff with uniforms and equipment; and (4) the club set the schedule of games, determined which players would play in each game, what strategy would be used, and when training would take place. The IRS sought to disallow pension plan deductions taken by Chiefy-Cat and RIF for their contributions to qualified pension plans set up for the benefit of Sargent and Christoff, respectively, and further sought

to tax Sargent and Christoff on the entire amount paid by the club to Chiefy-Cat and RIF.

The Tax Court agreed with the IRS and held that Sargent and Christoff were employees of the club instead of their respective loan-out corporations. The Tax Court found that the "team," and not their loan-out corporations, exercised the requisite control under the common-law test for establishing employee status, and compensation paid to Chiefy-Cat and RIF by the club was allocable to Sargent and Christoff. Notably, the Tax Court stated (93 TC at 579):

[T]he nature of team sports is a critical element which must be taken into account in determining the existence of an employer-employee relationship in accordance with common law principles. Coaching, even in respect of professionals, involves instruction and direction on fundamental techniques, game tactics, and strategy. Coaches and managers determine when, if, and how long a player will play and in what position. . . . Coaches scrutinize and direct a player in even the smallest details, in order to achieve a slight edge over the opposition.

Sargent and Christoff appealed the Tax Court's decision and the Eighth Circuit reversed in *Sargent v Commissioner* (8th Cir 1991) 929 F2d 1252. The Eighth Circuit rejected the Tax Court's "team" concept, concluding that casting the test for the legitimacy of a loan-out corporation in terms of whether a "team" is the service recipient is an arbitrary and specious approach. The court cited several cases, including the Tax Court's decision in *Charles Johnson* (1982) 78 TC 882, aff'd (9th Cir 1984) 734 F2d 20 (unpublished opinion), as establishing the test that must be met for a loan-out corporation to be deemed the true controller of the service provider: (1) the service provider must be an employee of the loan-out corporation, whom the corporation has the right to direct or control in some meaningful sense; and (2) there must exist between the loan-out corporation and the service recipient a contract or similar indicium recognizing the loan-out corporation's controlling position. 929 F2d at 1256.

The Eighth Circuit held that the bona fide, arm's-length contracts between the club and Chiefy-Cat and RIF provided the requisite control for Sargent and Christoff to be considered employees of their loan-out corporations. The Eighth Circuit sardonically noted that the Tax Court's decision in *Sargent* was inconsistent with that same court's decision in *Jo Ann Pflug*, TC Memo 1989-615, a case the Tax Court decided only one day after it rendered its *Sargent* decision. In *Pflug*, the Tax Court held that an actress who entered into an exclusive personal services contract with her husband's loan-out corporation was an employee of the loan-out corporation, even though it in turn lent her services to 20th Century Fox and even though, according to the Eighth Circuit, "[t]here can be little question that Ms. Pflug was part of a team under more stringent produc-

tion controls than those placed on either Sargent or Christoff by the club." 929 F2d at 1257.

The Eighth Circuit also refused to invoke the assignment-of-income doctrine of IRC §§269A and 482. The court concluded that Chiefy-Cat and RIF had been formed for valid business reasons and not principally for the purpose of avoiding income tax. The Eighth Circuit stated that the corporate form of entity must generally be respected, even though tax benefits accrue from such form, such as the pension plan deductions taken by Chiefy-Cat and RIF. The court illustrated this point by noting that the IRS had not questioned the legitimacy of Chiefy-Cat and RIF's corporate business activities. In addition, both Chiefy-Cat and RIF had properly withheld and paid all employment and income taxes from salaries paid to Sargent and Christoff, respectively; maintained and paid benefits to pension plans for Sargent and Christoff; filed all employment and corporate tax returns; and paid all taxes required. 929 F2d at 1259.

►**COMMENT:** In an Action on Decision dated October 22, 1991 (CC-1991-022), the IRS stated that it will not follow the holding in *Sargent* in other circuits, and IRS representatives have informally indicated that the IRS intends to pursue its *Sargent* theory aggressively in the other circuits.

Tax Court Blocks Basketball Player's Loan-Out Attempt

The IRS scored another victory using the common-law employee definition in *Allen Leavell* (1995) 104 TC 140. Leavell, a basketball player, formed Allen Leavell, Inc. (Leavell, Inc.), a personal service corporation that executed a Uniform Player Contract (a form prescribed by the NBA) with the Houston Rockets. The Rockets also required Leavell to sign a "Personal Guarantee by Player," in which he agreed to be bound by the terms and conditions set forth in the Uniform Player Contract. The IRS sought to reallocate income from Leavell, Inc., to Leavell individually under the theory it had espoused in *Sargent*, namely, that the Rockets, and not Leavell, Inc., exercised such control over the manner in which Leavell performed his services that the Rockets club was his true employer.

The Tax Court held in favor of the IRS. The court listed the numerous ways in which the Rockets controlled the manner in which Leavell performed his services. For example, the contract required the player to attend each training camp; play the scheduled games during the season; play all scheduled exhibition games during and before the season; when invited, play in the All-Star games and attend every event associated with those games; play in the playoff games; report at the time and place fixed by the Rockets in good physical condition; keep in good physical condition; give his best

services and loyalty to the Rockets; agree to give immediate notice of any injury suffered by him and submit to a medical examination and treatment by a physician designated by the Rockets; play only for the Rockets or its assignees; observe and comply at all times with all requirements of the Rockets respecting conduct of its team and players; be neatly and fully attired in public and always conduct himself according to the highest standards of honesty, morality, fair play, and sportsmanship, on and off the court; not engage in sports endangering his health or safety; not engage in any game or exhibition game of basketball or other sport without the Rockets' written consent; engage in promotional activities at the request of the Rockets and refrain from engaging in such activities without its consent; and conform his personal conduct to standards of good citizenship, good moral character, and good sportsmanship.

The Tax Court concluded that the contractual requirements evidenced that the Rockets maintained such control over Leavell that, under the common-law test of employee status, he was properly characterized as an employee of the Rockets, not Leavell, Inc., and the compensation paid to Leavell, Inc., was properly reallocated to him individually. The court specifically stated that it did not reach this holding because of any "team-sports doctrine," which the Eighth Circuit rejected in *Sargent*, but based its decision instead on the degree of control exercised.

Judge Swift issued an opinion concurring in the result only. He opined that the analysis should be controlled by the test established in the Tax Court's earlier opinion in *Charles Johnson* (1982) 78 TC 882. Judge Swift concluded that the *Johnson* test was not satisfied in this case, because there were irregularities in the way in which the Uniform Player Contract had been executed by Leavell, Inc., and there was no contract between Leavell individually and Leavell, Inc. In addition, the Rockets had required Leavell to sign the personal guaranty. Judge Swift further noted that Congress enacted IRC §269A to allow the IRS to reallocate income from a personal service corporation to its individual owner in situations like this, and suggested that the IRS should use this statutory provision instead of theories like the common-law employee definition.

►**COMMENT:** IRS representatives have indicated that Judge Swift's admonishment about IRC §269A is currently under review. *Allen Leavell* was appealable to the Fifth Circuit, but no appeal was filed.

Ninth Circuit Rules in Favor of Taxpayer

As California tax practitioners pondered the continued viability of loan-out corporations in light of *Leavell* and the IRS's apparent determination to continue attacking loan-out corporations on the employer control the-

ory, the Ninth Circuit rendered its decision in *Idaho Ambucare*. The court considered whether Dr. Crepps, who provided administrative services to Idaho Ambucare Center, Inc. (Ambucare) through William F. Crepps, M.D., P.A. (Crepps, P.A.), his loan-out corporation, was an employee of Ambucare or of Crepps, P.A. Dr. Crepps was a shareholder and a member of the board of directors of Ambucare. Crepps, P.A. entered into a management contract with Ambucare under which Ambucare agreed to pay Crepps, P.A., \$2500 per month to provide management services. The management contract expressly stated that Dr. Crepps was an independent contractor and was not entitled to employee benefits. The contract was effective for three years and could be terminated by either party on 90 days' notice. Dr. Crepps did not have a written employment agreement with Crepps, P.A. As administrator, Dr. Crepps managed the Ambucare facility, oversaw its finances, hired employees, and supervised the scheduling of surgeries. Ambucare did not make the periodic payments to Crepps, P.A., as called for under the management contract. Instead, when Dr. Crepps resigned, Ambucare paid Crepps, P.A., \$59,000 in one lump sum, from which it did not withhold employment taxes. The IRS assessed the employment taxes against Ambucare on the ground that Dr. Crepps was its employee. Ambucare paid the taxes and filed a claim for refund. The district court ruled in Ambucare's favor and the IRS appealed.

In reviewing whether Dr. Crepps was an employee of Ambucare or of Crepps, P.A., the Ninth Circuit applied the same two-prong test used by the Eighth Circuit in *Sargent* and earlier created by the Tax Court in *Johnson*, to evaluate whether Dr. Crepps was an employee of Crepps, P.A., *i.e.*, that (1) the loan-out corporation must have the right to direct or control in some meaningful sense the activities of the service provider; and (2) there must exist between the loan-out corporation and the entity using the services a contract or similar indicium that recognizes the loan-out corporation's controlling position.

The Ninth Circuit first noted that no documentary evidence existed that demonstrated that Dr. Crepps was an employee of Crepps, P.A. or that Crepps, P.A., had the right to control his activities. Citing the Tax Court's decision in *Pflug*, however, the Ninth Circuit concluded that the lack of a written agreement between the two was not fatal to the assertion that Crepps, P.A. controlled Dr. Crepps. The court further noted that Dr. Crepps testified that he was employed full time by the loan-out corporation and was never employed elsewhere during that time. On the other hand, the IRS offered no evidence to the contrary other than its legal argument. Based on the evidence available, the Ninth Circuit concluded that it "can be said" that Crepps, P.A., controlled Dr. Crepps. 57 F3d at 755.

With respect to the second factor, the Ninth Circuit said it needed to look no further than the express language of the management agreement between Crepps, P.A., and Ambucare, which clearly indicated the controlling position of Crepps, P.A.

The IRS sought to negate the validity of the management contract between Ambucare and Crepps, P.A., on the ground that Crepps, P.A.'s articles of incorporation stated that it was formed to practice the specialty of anesthesiology, but did not refer to provision of administrative services. The IRS argued that Idaho law made it illegal for a corporation to engage in any activity other than that for which it was formed. Because Crepps, P.A., was not formed to provide administrative services, the IRS argued that the management contract violated Idaho law and was invalid. The Ninth Circuit swiftly dispensed with this argument, concluding that the provision of administrative services was incidental to Dr. Crepps' services as an anesthesiologist. 57 F3d at 755 n3. The Ninth Circuit held that Dr. Crepps was an employee of Crepps, P.A., not Ambucare, and that Ambucare was not liable for employment taxes on payments it made to Crepps, P.A.

►**COMMENT:** *Ambucare* indicates that the loan-out corporate form of entity is alive and well in the Ninth Circuit, as long as the test laid out by the Tax Court in *Johnson* is satisfied. In view of the persistent assault by the IRS against loan-out corporations, and its success in *Leavell*, however, it is doubtful that the battle is yet over.

Ambucare upheld the separate identity of Dr. Crepps' loan-out corporation despite Dr. Crepps' lax observance of corporate formalities. Significantly, Dr. Crepps and Crepps, P.A., did not have a written employment contract, and Ambucare and Crepps, P.A., did not comply with their contract during its operation (for example, Ambucare did not make the monthly payments called for under this contract). Practitioners should not take the Ninth Circuit's permissiveness in this case as justification for not strictly observing corporate formalities. The Ninth Circuit's willingness to respect the separate identity of Crepps, P.A., notwithstanding the parties' failures in documentation and practice, appears to be largely due to the failure of the IRS to submit any contrary evidence, a failure that will likely be cured in future cases. ❖