Utility of Personal Service Corporations for Athletes

Bret M. Kanis
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I. INTRODUCTION

Professional sports are no longer just entertainment; they have become an extremely lucrative business industry. As a result, athletes' salaries are increasing at astronomical rates. Athletes' off-the-field activities, which include product endorsements and other commercial ventures, are often just as, if not more, lucrative, as their salaries from their on-the-field activities. As this increase in income causes greater tax liability, athletes, agents, and accountants are all looking for tax shelters to reduce taxable income. The "personal service corporation" is one tax avoidance method that has proven effective.

Personal service corporations were once a common method for reducing athletes' tax liabilities. However, recent legislation limiting the

1. The term "professional sports" includes professional team sports, such as football and baseball, as well as professional individual sports, such as tennis and golf. The 1993 average salary for a Major League Baseball player was $1,074,097. Player-by-Player Inventory of Team Payrolls, USA TODAY, Oct. 29, 1993, at 4C. The 1993 average salary for a National Football League player was $645,000. Larry Weisman, Salary Cap Has Players Spooked, USA TODAY, Nov. 24, 1993, at 8C. The 1993-94 average salary for a National Hockey League Player was over $500,000. Dave Sell, NHL on The Rise, But How High Can It Go? New Teams Prospering, Salaries Up, But Uncertain Labor Situation, Fan Base Weigh Heavily, WASH. POST, Jan. 23, 1994, at D14. An athlete must make in excess of six million dollars per year to be one of the 40 highest-paid athletes. Randall Lane & Warren Midgett, The Super 40, FORBES, Dec. 20, 1993, at 94.

2. As a result of the first year of free agency in the National Football League, the average salary increased by 34%, from $481,000 in 1992 to $645,000 in 1993. Weisman, supra note 1, at 8C.

3. Lane & Midgett, supra note 1, at 94, 98. Product endorsements and commercial ventures accounted for 41% of the total income of the 40 highest-paid athletes. Id. at 94.

4. A "tax shelter" is a "transaction by which a taxpayer reduces his or her tax liability by engaging in activities that provide deductions or tax credits ... to 'shelter' the taxpayer's other income." BLACK'S LAW DICTIONARY 485 (3d ed. 1991); see also D. DALE BANDY ET AL., PRENTICE HALL'S FEDERAL TAXATION 1992 F17 (John L. Kramer & Lawrence C. Phillips eds., 1992) (defining a "tax shelter" as a passive activity that usually lacks economic substance and reduces a taxpayer's tax liability from other business activities by creating deductions or credits).


6. Richard E. Halperin, Use of Loan-Out Corporations Has Been Limited, But Advantages Remain, J. TAX'N, Aug. 1986, at 74. There are cases from as early as 1966 involving the incorporation of an athlete's services. See, e.g., Patterson v. Commissioner, 25 T.C.M. (CCH) 1230 (1966) (discussing the incorporation of the services of Floyd Patterson, a professional boxer), aff'd, 22 A.F.T.R.2d (P-H) P 5810 (2d Cir. 1968). The bulk of the litigation, however, arose from events that took place in the 1970's. Sargent v. Commissioner, 929 F.2d 1252 (8th Cir. 1991) (discussing the 1978
utility of these corporations as a tax avoidance technique has decreased the popularity of such corporations. Despite this legislation, athletes should still consider utilizing a personal service corporation, as benefits to incorporating athletes' services still exist.

This Comment discusses the general utility of personal service corporations for athletes. Section II of this Comment describes the personal service corporation and its formation. Section III specifically discusses the formation of personal service corporations by athletes. Section IV sets forth the advantages of personal service corporations. Section V discusses the disadvantages of personal service corporations in light of recent legislation and attacks by the Commissioner of the Internal Revenue Service. Finally, this Comment argues that personal service corporations are still useful and should be considered by professional athletes.

II. PERSONAL SERVICE CORPORATIONS

The Internal Revenue Code utilizes a variety of definitions for personal service corporations. For example, § 269A defines a personal service corporation as a corporation whose principal activity is the rendering of personal services by an employee who owns at least 10% of the corporation's stock. Most personal service corporations involve

formation of personal service corporations by two professional hockey players, Gary Sargent and Steve Christoff); Johnson v. United States, 698 F.2d 372 (9th Cir. 1982) (discussing the formation of a personal service corporation in 1974 by Charles Johnson, a professional basketball player); Kenyatta Corp. v. Commissioner, 86 T.C. 171 (1986) (discussing the formation of a personal service corporation in 1973 by a former professional basketball player, Bill Russell), aff'd, 812 F.2d 577 (9th Cir. 1987).


8. See infra notes 13-21 and accompanying text.
9. See infra notes 22-31 and accompanying text.
10. See infra notes 32-130 and accompanying text.
11. See infra notes 131-235 and accompanying text.
12. See infra notes 236-62 and accompanying text.
13. I.R.C. § 269A(b)(1)-(2) (West 1994); see also I.R.C. § 441(i)(2) (West 1994) (defining a personal service corporation for purposes of determining a corporation's taxable year); I.R.C. § 448(d)(2) (West 1994) (defining a personal service corporation
only one employee who is the sole shareholder of the company and who provides personal services on behalf of the corporation. To form a personal service corporation, the applicable state law requirements must be met. In addition, a personal service corporation should follow all other necessary procedures for organizing a corporation. To reap the benefits of incorporation, the corporation must be considered a separate legal and tax entity. This occurs as long as the corporation performs some meaningful business function.

Upon proper formation of the corporation, the corporation and the individual enter into a contract for the individual to perform specified services exclusively on behalf of the corporation. The corporation then contracts out the individual's services to third parties. The third parties pay the corporation a fee for the individual's services, and the corporation pays a portion to the individual as a salary.

14. John C. Weistart & Cym H. Lowell, The Law of Sports § 7.11 (1979). Depending upon the goals of the corporation, the athlete may be the majority shareholder of the corporation, rather than the sole shareholder. Id. Other shareholders might include the athlete's agent, manager, parents, or wife. Most personal service corporations are formed by individuals, such as doctors, lawyers, accountants, entertainers, and athletes who have a unique personal service to provide. Martha A. Van de Ven & Steven A. Kauffman, Merits of Incorporating the Athlete, 9 Tax Adviser 478, 478 (1978). Although personal service corporations may be formed by many different individuals, this Comment merely discusses personal service corporations in the context of specific utility to athletes.

15. Van de Ven & Kauffman, supra note 14, at 481. The state law requirements usually include the filing of organizational documents, such as the articles of incorporation and the payment of a filing fee. See id.

16. See id. The necessary procedures include applying for a state and federal identification number, holding organization meetings, keeping corporate minutes from such meetings, electing the board of directors, appointing officers, adopting the corporate by-laws and articles of incorporation, issuing stock, and establishing a corporate bank account. See id.

17. Id. at 481. For a discussion of the benefits of incorporating an athlete's services, see infra notes 155-173 and accompanying text.


19. Van de Ven & Kauffman, supra note 14, at 481. The Individual usually also sits on the board of directors, serves as an officer, and acts as a trustee for any corporate pension and profit-sharing plans. Id. at 478.

20. Id. Personal service corporations are often called "loan-out" corporations since the employment agreement between the corporation and the individual gives the corporation the right to loan-out the individual's services for a fee. Lawson & Stiglitz, supra note 7, at 3.

21. Shefsky, supra note 5, § 21.06(1). To avoid the personal holding company tax, the corporation usually pays the athlete a salary of all the money received by the
III. ATHLETE’S PERSONAL SERVICE CORPORATIONS

The formation of a personal service corporation by an athlete is similar structural and legal aspects as found in other personal service corporations. As with any personal service corporation, the athlete is either the majority or sole shareholder. The athlete must create the corporation in accordance with state law requirements. The athlete should serve as a member of the corporation’s board of directors, one of the corporation’s officers and one of the trustees of any corporate retirement plan. The other directors and officers of the corporation should consist of people who have a close relationship with the athlete and will act in the athlete’s best interest, such as the athlete’s agent, financial advisor, accountant, attorney, spouse, or parents.

An athlete creates a personal service corporation primarily to reduce the athlete’s tax liability. However, the corporation is not a separate entity for tax purposes unless it performs some valid business function. The corporation meets this requirement as long as it performs the normal, everyday business operations of typical corporations. For an athlete, everyday business operations include negotiating the employment agreement with the team, contributing to fringe benefit plans, entering into leases for practice facilities, purchasing necessary athletic equipment and supplies, and paying all normal business expenses and applicable taxes.

Upon the formation of the corporation, the athlete enters into an employment agreement promising to render services to the corporation or to any other person at the corporation’s direction. The corporation corporat...
then enters into an agreement with a team, tournament sponsor, advertiser, or any other party interested in the athlete's services. The contracting party pays the corporation for the athlete's services and, from these payments, the athlete receives a salary.

The formation and function of athletes' personal service corporations are similar to the personal service corporations formed by other individuals. However, athletes often face particular circumstances that affect the utility of forming a personal service corporation. In addition, some of the circumstances that are unique to athletes often affect the avoidance of attacks by the Internal Revenue Service.

**IV. ADVANTAGES OF PERSONAL SERVICE CORPORATIONS**

One of the primary reasons for establishing a personal service corporation is to reap the tax benefits associated with forming a corporation. Additionally, the individual may establish a corporate retirement plan, which the individual is either unable to implement, or is supplemental to any existing retirement plans. The corporation may also adopt corporate fringe benefit programs that are otherwise unavailable to employees or self-employed individuals.

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Footnotes:

30. See Champion, supra note 22, at 424.
31. If the professional athlete plays for a team, the corporation contracts with that team for the player's services. Van de Ven & Kauffman, supra note 14, at 478. The National Football League and Major League Baseball prohibit teams from contracting with personal service corporations. Leslie S. Klinger, Incorporating the Entertainer: Is It Still Valuable?, ENT. L. REP., Aug. 1986, at 3, 6 n.2. These athletes may still find it beneficial to incorporate their off-the-field services, such as product endorsements and personal appearances. Id. If the athlete participates in an individual sport, such as tennis, golf or boxing, the corporation enters into a contract with the sponsor of the tournament, race or event. Id.
32. See infra notes 152-53 and accompanying text. For a discussion of the tax benefits associated with forming a corporation, see infra notes 35-62 and accompanying text.
34. See infra notes 104-27 and accompanying text.
A. Tax Avoidance Techniques

One of the main reasons for incorporating an athlete's services is to minimize the athlete's tax liability.35 The personal service corporation is considered a separate tax entity from the athlete.36 Therefore, the athlete is able to take advantage of the numerous benefits offered to corporations while remaining self-employed or performing services for another company.37

A major tax benefit in forming a personal service corporation is that the corporation can select any fiscal year as its taxable year.38 By

35. Van de Ven & Kauffman, supra note 14, at 478.
36. Id. For discussion of a personal service corporation as a separate legal and tax entity, see supra notes 17-18.
37. Van de Ven & Kauffman, supra note 14, at 478. These benefits include qualified retirement plans, medical reimbursement plans and insurance coverage. See infra notes 63-130 and accompanying text. Technically, the athlete is employed by the personal service corporation and is not self-employed. However, the athlete is still able to control the activities in which he participates, as he sits on the board of directors, serves as an officer and is the majority shareholder.
38. Lawson & Stiglitz, supra note 7, at 3. “Fiscal year” is defined as a taxable year for any 12 month period ending on the last day of a month other than December. I.R.C. § 441(e) (West 1994). Generally, a personal service corporation must utilize as its taxable year a calendar year, a tax year that ends on the last day of December. I.R.C. § 441(d), (i)(1) (West 1994). In some instances, however, a personal service corporation may select a fiscal year if there is a business purpose for having such a taxable year. I.R.C. § 441(i)(1) (West 1994) (stating that the deferral of income to shareholders does not constitute a valid business purpose for utilizing a fiscal year for tax purposes).

A corporation is only considered a personal service corporation for the purpose of determining the corporation's taxable year if the taxpayer's principal activity is the performance of personal services. Treas. Reg. § 1.441-4T(d)(1)(ii) (1987). An activity is only treated as the performance of personal services if it is described in I.R.C. § 448(d)(2)(A) or in the regulations. Treas. Reg. § 1.441-1T(e)(1)-(2) (1987). The performance of services by athletes is not considered to be personal services under I.R.C. § 448(d)(2)(A) and the regulations. Treas. Reg. § 1.448-1T(d)(4)(iii) (1987). An athlete who incorporates his services, therefore, may utilize any fiscal period for tax purposes. Lawson & Stiglitz, supra note 7, at 7. It is unclear whether an athlete who utilizes a personal service corporation for endorsements is rendering services as an athlete or as a performing artist. Id. (performing artists are considered to render personal services under I.R.C. § 448(d)(2)(A)).

Even if a corporation must utilize a calendar year for tax purposes, it may still elect to utilize a fiscal year. I.R.C. § 444(a) (West 1994). Upon such an election, however, the personal service corporation is subject to the minimum distribution requirements of I.R.C. § 280H. I.R.C. § 444(c)(2) (West 1994). As athletes' personal service corporations typically do not need to make this election, this Comment does not discuss the minimum distribution requirements.

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selecting a fiscal year that ends early in the year, the income received by the corporation during the previous year may be retained past the close of the calendar year.\textsuperscript{39} Therefore, the corporation is not taxed on the compensation as long as it distributes its income before the close of its fiscal year.\textsuperscript{40} By paying the athlete's salary or bonus in the following year out of the corporation's unutilized income, the athlete, who must utilize the calendar year for tax purposes,\textsuperscript{41} has the taxes on his income deferred for a year.\textsuperscript{42} However, the athlete's cash flow position must be considered, as the athlete's financial situation may not permit him to wait to receive his salary, or a majority of it, a year later.\textsuperscript{43}

In addition, personal service corporations may deduct from its gross income any benefit programs established on behalf of the athlete.\textsuperscript{44} As the athlete and the personal service corporation are separate entities, the corporation may establish fringe benefit programs for the athlete as its sole employee.\textsuperscript{45} The athlete-employee also benefits personally, as the amount of benefits received during the taxable year are

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39. Lawson \& Stiglitz, supra note 7, at 3. For example, a personal service corporation selects February as the close of its fiscal year. In year one, the corporation receives $100,000 from March until December from contracting out the player's services. The corporation may retain the $100,000 and distribute the salary to the individual in January or February.

40. Id. In the above example, as long as the corporation distributes the income before the end of February, it will have no taxable income for year one.

41. I.R.C. § 441(g) (West 1994). For a definition of calendar year, see supra note 38.

42. Lawson \& Stiglitz, supra note 7, at 3. Since individuals must utilize the cash method of accounting for tax purposes, the athlete is not taxed at the time he earns his salary, but rather when he actually receives it. I.R.C. § 541 (West 1994). The cash method of accounting is an accounting method where the taxpayer reports "income in the taxable year when the payments are actually received or constructively received" and expenses when they are paid. BANDY, supra note 4, at F3.

In the previous example, the athlete must utilize a calendar year for his taxable year and the cash method of accounting. Therefore, the athlete is taxed on the $100,000 in year two, the year in which he receives the money, rather than the year in which he performed the services. The deferral of taxes can be extremely advantageous when an athlete approaches the end of his career and may fall into a lower tax bracket upon his retirement.

43. For a discussion of the athlete's financial position as a consideration in determining whether to incorporate an athlete's services, see infra notes 101-02 and accompanying text.

44. Van de Ven \& Kauffman, supra note 14, at 478. These benefits are deductible as ordinary and necessary expenses, as they are incurred by a corporation in the carrying on of its trade or business as compensation for services actually rendered. Id.; see I.R.C. § 162(a)(1) (West 1994).

45. Van de Ven \& Kauffman, supra note 14, at 478. The fringe benefits the employer may provide for the athlete-employee include pension or profit-sharing plans, medical benefits, accident, health, disability, and group term-life insurance. Shefsky, supra note 5, § 21.06(1); see infra notes 63-130 and accompanying text.
\end{quote}
not included in the athlete's gross income. Thus, the personal service corporation provides the athlete with a means for providing tax deductible benefits that the athlete normally has to pay for with his after-tax dollars. Most personal service corporations do not benefit from the ability to take this deduction as all of their income is distributed to avoid the personal holding income tax. The athlete, however, benefits from purchasing fringe benefits with before-tax dollars.

Another advantage of forming a personal service corporation is the deferral of taxes through the use of the cash method of accounting. The cash method of accounting allows a personal service corporation to recognize income for tax purposes when it actually receives, or constructively receives, payment for the athlete's services, rather than

46. Van de Ven & Kauffman, supra note 14, at 479. Any amounts contributed to a qualified retirement plan by a corporation, or earnings from a trust for the benefit of an employee, are not taxable to the employee until the year of distribution. I.R.C. §§ 402(a)(1) & 501(a) (West 1994). An employee's gross income does not include premiums on employer-provided accident or health insurance. I.R.C. § 106 (West 1994). Group-term insurance provided by the corporation is also not taxable to the employee to the extent that the amount of the insurance does not exceed $50,000. I.R.C. § 79(c)(1) (West 1994). Additionally, amounts paid by the employer out of a corporate medical reimbursement plan to reimburse the employee, his spouse, or his dependents are excluded from the employee's gross income. I.R.C. § 105(b) (West 1994).

47. Van de Ven & Kauffman, supra note 14, at 479. "After-tax dollars" refers to the value of money after taxes are paid on income. "Before-tax dollars" refers to the full-value of income prior to paying taxes. Thus, before-tax dollars are more valuable than after-tax dollars. For example, if an unincorporated athlete earns $100,000 per year and pays insurance premiums of $5000, the athlete is paying out of his after-tax dollars, as the entire $100,000 is included in his gross income and taxed. The premiums are then paid out of the amount remaining after taxes are imposed. This results in the athlete paying $5000 for the insurance in addition to the tax on the $5000. However, if a personal service corporation is formed and the corporation pays the premiums, the premiums are paid out of before-tax dollars. Thus, the athlete is only taxed on the $95,000 distributed to him by the corporation, not the $5000 utilized for insurance premiums.

48. For a discussion of the advantage of paying for fringe benefits with before-tax dollars, see supra note 47. For a discussion of the personal holding company tax, see infra notes 134-54 and accompanying text.

49. See Lawson & Stiglitz, supra note 7, at 5. According to § 448(a) of the Internal Revenue Code, corporations must utilize the accrual method of accounting unless the corporation falls within one of the specific exceptions to the rule. I.R.C. § 448 (West 1984). These exceptions are set forth in § 448(b) of the Internal Revenue Code. I.R.C. § 448(b)(1)-(3) (West 1994). For a discussion of the exceptions, see infra notes 52-53 and accompanying text. For a definition of the cash method of accounting, see supra note 42.

50. An individual constructively receives payment if the amount is available to the
when the payment is actually earned. However, the cash method of accounting is only available to the corporation if it is considered a qualified personal service corporation, or if the average gross receipts of the corporation over the previous three years does not exceed $5 million. As athletes' personal service corporations are not considered qualified personal service corporations, and many athletes earn in excess of five million over a three year period, many personal service corporations are unable to utilize the cash method of accounting.

Personal service corporations are taxed at corporate rates, rather than at individual rates. This is particularly advantageous since the maximum corporate rate, 35%, is less than the maximum individual rate. The payor has the funds necessary to make the payment, and there are no substantial restrictions or limitations on the receipt of the payment. BANDY, supra note 4, § 3, at 10.

51. Id. This is beneficial when the athlete performs services or wins money towards the end of the year, but the corporation enters into an agreement that defers the payment of money until the following year. For example, a hockey player performs services worth $100,000 to a hockey team on behalf of the personal service corporation in December; however, the team does not pay the corporation until January. Under the cash method of accounting, the corporation does not recognize the $100,000 for tax purposes until the payment is actually received in January, resulting in the deferral of taxes. However, under the accrual method of accounting, the corporation must recognize the $100,000 in December, the period in which it was earned.

52. I.R.C. § 448(b)(2) (West 1994). In order to be a qualified personal service corporation, the corporation must meet both the function test and the ownership test. Treas. Reg. § 1.448-1T(e)(3)(i)-(ii) (1987). The function test is satisfied "if substantially all of the corporation's activities for a taxable year involve the performance of services" within one of the specified fields. Treas. Reg. § 1.448-1T(e)(4)(i)(A)-(H) (1987). However, the regulations specify that services by athletes do not fall within any of the specified fields. Treas. Reg. § 1.448-1T(e)(4)(iii) (1987). Therefore, athletes' personal service corporations are unable to utilize the cash method of accounting based upon the qualified personal service corporation exception.

53. I.R.C. § 448(b)(3), (c)(1) (West 1994). Many athletes earn more than $5 million per year. Lane & Midgett, supra note 1, at 94. Therefore, these athletes do not fulfill the average gross receipts exception and cannot utilize the cash method of accounting.

54. Lawson & Stiglitz, supra note 7, at 5. For a discussion of the reason that athletes' personal service corporations are not considered qualified personal service corporations, see supra note 52. For a discussion of the reason that athletes often do not satisfy the $5 million average gross receipts requirement, see supra note 53.

55. See Lawson & Stiglitz, supra note 7, at 3-4. Historically, one of the main reasons an athlete would form a personal service corporation was to benefit from corporate tax rates, which are much lower than individual tax rates. See Shefsky, supra note 6, § 21.06[1] n.262. For example, as recently as 1981, the maximum corporate tax rate was 48% compared with the maximum individual tax rate of 70%. Id.

56. I.R.C. § 11(b)(1)(D) (1994). This rate only effects corporate taxable income exceeding $10,000,000. Id. An additional tax of 3% is imposed on taxable income between $15,000,000 and $18,333,333. I.R.C. § 11(b) (1994). The corporate tax rate for taxable income between $75,000 and $10,000,000 is 34%. I.R.C. § 11(b)(1)(c) (1994).
rate, 39.6\%". Due to the differences in the graduated tax scale for individuals and corporations, most individuals with higher income, such as athletes, would benefit from corporate tax rates.\(^6\) However, personal service corporations, as defined in § 448 (d)(2), are now taxed at a rate of 35\% on all taxable income.\(^6\) This prevents personal service corporations from benefitting from the graduated tax rates.\(^6\) Athletes' personal service corporations, however, are able to utilize the graduated corporate tax rates, as they are not considered qualified personal service corporations under § 448(d)(2) of the Internal Revenue Code.\(^6\) Most per-

However, an additional tax of 5\% is imposed on taxable income between $100,000 and $335,000. I.R.C. § 11(b)(1)(D) (1994).

Taxable income is defined as the amount of income "applied to the rate of income tax in order to determine the income tax payable." BLACK'S LAW DICTIONARY 482 (3d ed. 1991). For a complete discussion of determining taxable income and tax liability, see generally BANDY, supra note 4.

57. I.R.C. § 1 (1994). The maximum individual rate is applied to taxable income that exceeds $250,000 for married individuals filing joint returns and unmarried individuals and $125,000 for married individuals filing separate returns. I.R.C. § 1(a), (c), (d) (1994).

58. Compare I.R.C. § 11(b) (1994) with I.R.C. § 1(a), (c), (d) (1994). For example, an unmarried athlete who has $400,000 of taxable income lowers his tax liability by $3172 ($139,172 - $136,000) when he forms a personal service corporation. Utilizing § 1(c) of the Internal Revenue Code, the individual's tax liability is $139,172 ($79,772 plus $59,400 (.396 * $150,000 [which is the excess of $400,000 over $250,000])]. Under § 11(b) of the Internal Revenue Code, the athlete's tax liability utilizing corporate rates is $136,000. The computation is as follows:

\[
\begin{align*}
$50,000 \times .15 &= 7500 \\
$25,000 \times .25 &= 6250 \\
$325,000 \times .34 &= 110,500 \\
\text{Surtax on } $100,000 - $335,000 &= 11,750 \\
\text{TOTAL} &= 136,000
\end{align*}
\]

Due to the graduated scale and the additional surtax on corporations, each athlete should compute his tax liability as a corporation and as an individual to determine if his tax liability decreases by incorporating his services, as well as to determine the extent of the tax savings.


60. Compare I.R.C. § 11(b)(2) (1994) with I.R.C. § 1(a), (c), (d) (1994). The amount of taxable income when the personal service corporation's tax liability, without the benefit of the graduated tax rates, is less than the individual's tax liability can be computed by utilizing the above cited sections. This Comment does not make these computations since most athlete's personal service corporations can benefit from the graduated corporate tax rates, because they are not considered qualified personal service corporations under § 448(d)(2). Treas. Reg. § 1.448-1T(e)(4)(iii) (1987).

sonal service corporations do not benefit from the corporate tax rates, as all of their income is distributed to avoid the personal holding company tax.\textsuperscript{62}

\section*{B. Qualified Retirement Plans}

The ability to establish a qualified retirement program is one of the main benefits received by an athlete who incorporates his services.\textsuperscript{63} Qualified retirement programs provide favorable tax benefits for both the employer and the employee.\textsuperscript{64} The employer-personal service corporation, for example, may immediately deduct contributions to the plan that are within the specific deductible limitations.\textsuperscript{65} In addition, the employee-athlete is not currently taxed on the contributions, but taxation is deferred until distributions are received in the future.\textsuperscript{66} The

\textsuperscript{62} See infra notes 134-54 and accompanying text.

\textsuperscript{63} Weisbart & Lowell, supra note 14, § 7.11, at 880-81. Qualified retirement programs include qualified pension plans, as well as qualified profit-sharing plans. Van de Ven & Kauffman, supra note 14, at 479. The two most common types of nonqualified deferred compensation plans are unfunded deferred compensation plans and restricted property plans. Bandy, supra note 4, § 9, at 34-36. The purpose of nonqualified plans is to provide incentives to executives and to attract and retain key executives. Id. In a personal service corporation, the key executive is usually the athlete. Thus, there is no need to provide incentives to the athlete who will act in his own best interest. In addition, there is no need to attempt to retain key executives, as the athlete will not leave for another corporation. Since nonqualified plans are not beneficial to a personal service corporation, they are not discussed in detail in this Comment.

\textsuperscript{64} Bandy, supra note 4, § 9, at 30. Benefit plans must fulfill certain requirements to be considered a qualified plan. Id. § 9, at 32. First, the plan must be for the employee's exclusive benefit. I.R.C. § 401(a) (West 1994). Second, contributions or benefits may not discriminate in favor of highly compensated employees. I.R.C. § 401(a)(4) (West 1994). Third, contributions should bear a uniform relationship to covered employee's compensation. I.R.C. § 401(a)(6)(B) (West 1994). Fourth, certain coverage requirements must be met. Bandy, supra note 4, § 9, at 32. Finally, employer contributions must satisfy either the five-year vesting rule or the three-to-seven year vesting rule. I.R.C. § 411(a)(2)(A) and (B) (West 1994). Employee contributions vest as long as the contributions are nonforfeitable. I.R.C. § 411(a)(1) (West 1994).

\textsuperscript{65} I.R.C. § 404 (West 1994). Limitations on deductible amounts vary depending on the plan. See infra notes 79-81 and accompanying text. In most instances, a personal service corporation does not benefit from these deductions, as all income is distributed to avoid the personal holding company tax. See infra notes 134-54 and accompanying text.

\textsuperscript{66} I.R.C. § 402(a) (West 1994). The athlete can further defer taxation of the income by rolling the distributions into another qualified corporate plan or individual retirement account. I.R.C. § 402(c)(1)(A)-(C) (West 1994). A 15\% excise tax is imposed on excess distributions from qualified retirement plans. I.R.C. § 4980A(a) (West 1994). In addition, a 15\% excise tax is imposed on excess accumulations in plans at the time of the participant's death. I.R.C. § 4980A(d) (West 1994). Distributions made prior to the participant reaching 59 1/2 years of age are subject to a 10\% penalty tax, which must be included in the participant's gross income. I.R.C. § 72(t)(2)(A)(i) (West
athlete may make tax-deferred investments with the money in the retirement plan,\textsuperscript{67} as well as borrow funds from the plan.\textsuperscript{68} Also, the athlete may control the timing of distributions from the retirement plan.\textsuperscript{69} Qualified retirement plans also encourage an athlete to save money.\textsuperscript{70}

1. Qualified Pension Plans

A qualified pension plan provides employees with incidental benefits that are paid out of a pension trust established by systematic and definite payments.\textsuperscript{71} Pension plans may be either contributory or non-contributory.\textsuperscript{72} Under a noncontributory plan, only the employer makes contributions to the pension plan, however, both the employer and the employee make contributions under a contributory plan.\textsuperscript{73}

Pension plans may further be classified as either a defined benefit

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\textsuperscript{67} I.R.C. § 501(a) (West 1994).

\textsuperscript{68} Klinger, \textit{supra} note 30, at 3. Participants in a qualified retirement plan were once allowed to borrow unlimited funds from the plan. \textit{Id.} Loans to participants, however, are now limited to $50,000 and must be repaid within five years. I.R.C. § 72(c)(3)(A), (B) (West 1994). If the participant receives over $50,000 from a qualified plan or is not required to repay the loan within five years, then the amount received by the participant is considered a disbursement from the plan, rather than a loan. \textit{Id.} The disbursement is included in the gross income of the participant in the taxable year in which it was received. I.R.C. § 61(a)(11) (West 1994).

\textsuperscript{69} Klinger, \textit{supra} note 30, at 3. The athlete is able to control the timing of distribution in that the corporation and the trust may be terminated if the money in the trust is needed after the athlete's retirement. Van de Ven & Kauffman, \textit{supra} note 14, at 479. The athlete may also terminate the plan and the trust prior to his retirement if the plan is considered permanent. \textit{Id.} This allows the athlete the flexibility of distributing the money at a time when he is in a lower tax bracket. \textit{Id.}

\textsuperscript{70} Van de Ven & Kauffman, \textit{supra} note 14, at 478.

\textsuperscript{71} BANDY, \textit{supra} note 4, § 9, at 30. The amount of the payments are determined using actuarial tables. \textit{Id.} Incidental benefits may include "disability, death or medical insurance benefits." \textit{Id.}

\textsuperscript{72} \textit{Id.}

\textsuperscript{73} BANDY, \textit{supra} note 4, § 9, at 30. Employees are fully taxed upon the receipt of payments from noncontributory plans under § 61(a)(11) of the Internal Revenue Code. \textit{Id.} § 9 at 33. If the plan is contributory, then the employee treats part of each payment as a tax-free return of his contribution and part as a taxable payment on the employer's contribution. \textit{Id.} For example, if the total expected return is $300,000, the employee's contribution is $100,000 and the employee is to receive payments of $24,000 per year for life when payments begin, then one-third ($100,000/$300,000) of each payment, $8000 ($24,000/3) is excluded from the employee's gross income each year and two-thirds of each payment, $16,000 ($24,000 * 2/3), is included in the employee's gross income each year. \textit{Id.}
plan or a defined contribution plan.\textsuperscript{74} The majority of pension plans established by employers are defined benefit plans.\textsuperscript{75} Under a defined benefit plan, the employer "promises the beneficiary [the athlete] a certain level of benefits at retirement and then [the plan] is funded based upon annual actuarial determinations of the future cost of providing those benefits."\textsuperscript{76} Under a defined contribution plan, the employer contributes a specific amount each year, based upon a formula, to a separate account for each employee.\textsuperscript{77} The retirement benefits accrue yearly and the balance in the account at the time of the employee's retirement is the amount of the employee's retirement benefits.\textsuperscript{78}

The limitations imposed on the deductibility of the employer's contributions depend upon whether the plan is a defined contribution plan or a defined benefit plan.\textsuperscript{79} Under a defined contribution plan, contributions are limited to the lesser of $30,000 or 25% of the employee's compensation.\textsuperscript{80} Under a defined benefit plan, however, contributions are limited to the amount needed to fund a plan to yield an annual annuity benefit of the lesser of $90,000 or 100% of the employee's average compensation for his highest three years.\textsuperscript{81}

\textsuperscript{74} \textit{Id.} § 9, at 30-31. The difference in the two plans is important, as it determines the amount of the contribution that may be deducted by the corporation each year. \textit{See infra} notes 79-81 and accompanying text.

\textsuperscript{75} Shefsky, \textit{supra} note 5, § 21.05[2].

\textsuperscript{76} \textit{Id.} The amount of the fixed monthly benefit to be received upon retirement depends upon a variety of factors, including years of service and the compensation received by the employee. Brown, \textit{supra} note 33, at 247. An example of a defined benefit plan is to provide "fixed retirement benefits equal to 40% of an employee's average salary for the five years prior to retirement." \textit{Bandy, supra} note 4, § 9, at 31.

\textsuperscript{77} \textit{Bandy, supra} note 4, § 9, at 30-31. The usual method for determining annual contributions to a plan is based upon a percentage of the employee's compensation for the year. \textit{Id.}

\textsuperscript{78} \textit{Id.} § 9, at 30-1. The money in the fund may be utilized to make investments, such as purchasing stocks and bonds. \textit{See} Robert J. Samuelson, \textit{Pension Time Bomb}, \textit{WASH. POST}, Mar. 4, 1993, at A25. Often the employees are able to choose where their pension fund money is invested. \textit{Guaranteeing Pensions}, \textit{WASH. POST}, Feb. 19, 1993, at A20.

\textsuperscript{79} I.R.C. § 415(b)(1), (c) (West 1994).

\textsuperscript{80} I.R.C. § 415(c)(1)(A)-(B) (West 1994). For example, if an employee's compensation for the year is $150,000, then 25% of this amount is $37,500. Thus, the limitation is $30,000 (the lesser of $37,500 or $30,000). However, if the employee's compensation for the year is $80,000, then 25% of this amount, $20,000, is the limitation (the lesser of $20,000 or $30,000).

\textsuperscript{81} I.R.C. § 415(b)(1)(A)-(B) (West 1994). For example, if the employee's highest three salaries are $100,000, $110,000 and $120,000, then the average compensation for his highest three years is $110,000. Thus, the limitation on the contribution is limited to the amount needed to yield a benefit of $90,000 (the lesser of $90,000 or $110,000). However, if the employee's compensation for his highest three years is $70,000, $75,000 and $80,000, then the average compensation for those years is
2. Profit-Sharing Plans

Employers may establish profit-sharing plans instead of, or combined with, a qualified pension plan. All profit-sharing plans are defined contribution plans. A predetermined formula is utilized to determine the employer's contribution to each employee's plan. The employee may be given the option of receiving cash directly as compensation or having the amount deferred as a contribution to a profit-sharing trust. Annual employer contributions are not required, but substantial and recurring payments must be made to the plan for the plan to be considered permanent. In addition, there must be a predetermined formula to establish benefit payments after a fixed number of years, attainment of a certain age, or the occurrence of a specific event.

Profit-sharing plans have limitations on the contributions that may be deducted by a corporation. An employer may not deduct greater than 15% of compensation paid or accrued to employees participating in a profit-sharing plan. However, if the employer has more than one qualified plan, the employer may deduct 25% of compensation paid or accrued during the taxable year.

$75,000. Thus, the limitation on the contribution is an amount necessary to yield an annual annuity benefit of $75,000 upon retirement (the lesser of $90,000 or $75,000). See id. In 1982, when personal service corporations were more prevalent, a defined benefit pension plan could provide an annual annuity benefit of $136,425 per year upon retirement. Lawson & Stiglitz, supra note 7, at 4.

82. BANDY, supra note 4, § 9, at 31. Certain requirements must be met for a profit-sharing plan to be considered qualified. Id. § 9, at 32. For a discussion of the requirements, see supra note 64.

83. Shefsky, supra note 5, § 21.06(2).

84. BANDY, supra note 4, § 9, at 31. The formula for determining contributions need not be based upon profits. I.R.C. § 401(a)(27)(A) (West 1994). The plan must state whether the plan is a profit-sharing plan, or a pension plan, for the trust to be a qualified trust. I.R.C. § 401(a)(27)(B) (West 1994).

85. I.R.C. § 401(k)(2)(A) (West 1994); see also BANDY, supra note 4, § 9, at 31.


87. Treas. Reg. § 1.401-1(b)(1)(ii) (1960); see also Brown, supra note 33, at 247 (stating that events that usually trigger profit-sharing payments include "layoffs, illness, disability, retirement, death or severance of employment").

88. BANDY, supra note 4, § 9, at 33-34.


90. I.R.C. § 404(a)(7)(A)(i) (West 1994). An employer has greater than one qualified plan if he has, for example, a profit-sharing plan combined with a pension plan, or a combination of one or more defined contribution plans and one or more defined benefit plans. I.R.C. § 404(a)(7)(A)(i) (West 1994).
3. Utility of Qualified Retirement Plans

The utility of a personal service corporation no longer hinges upon the ability of the corporation to deduct qualified retirement plan payments, as most personal service corporations do not benefit from the deduction since all of their income is distributed to avoid the personal holding company tax. Instead, the utility of qualified pension and profit-sharing plans depends upon two factors. First, athletes should consider any benefits, contributions or deductions that may be forfeited by forming a personal service corporation. Second, athletes should consider their cash position, as they receive a smaller salary due to the contributions made to the retirement plan.

The benefits that might be forfeited by athletes in forming a personal service corporation depend upon whether the athletes are employed by a team or self-employed. Athletes employed by a team need to consider the possible loss of league or team pension benefit plans. Non-team, or self-employed, athletes must consider the loss of the retirement plans available to self-employed individuals, such as Keough plans and individual retirement accounts. Although self-em-

91. See infra notes 134-54 and accompanying text.
92. Van de Ven & Kauffman, supra note 14, at 479-80.
93. Id. at 479.
94. Id. at 480.
95. Id. at 479-80. An employee of a team may be forced to forego benefits that the league or team normally pays on the athlete's benefit in accordance with the collective bargaining agreement between the players' union and the owners. Id. at 479.
96. Van de Ven & Kauffman, supra note 14, at 479. If an athlete forms a personal service corporation, he is considered an employee of the personal service corporation rather than an employee of the team for which he plays. Shefsky, supra note 5, § 21.06[1]. The team or the league, therefore, need not contribute to pension plans on the athlete's behalf, as the athlete is not considered its employee. However, these benefits often may be retained through proper negotiations and the structuring of the contract between the personal service corporation and the team. Van de Ven & Kauffman, supra note 14, at 478.
97. Van de Ven & Kauffman, supra note 14, at 479-80. Usually, the team athlete need not consider individual retirement accounts (IRAs). IRAs allow individuals not participating in an employer-sponsored retirement plan or those participating with a low adjusted gross income to make deductible contributions to an IRA in the amount of the lesser of $2000 or 100% of compensation. I.R.C. § 219(a)(b) (West 1994). The Internal Revenue Service considers an individual with less than $25,000 gross income and a married couple filing jointly with less than $40,000 gross income to have low adjusted gross income. I.R.C. § 219(g)(3)(B) (West 1994). For a definition of adjusted gross income, see infra note 109. As most team athletes participate in an employer-sponsored retirement plan or make more than the low adjusted gross income amount, individual retirement account's usually are not available to team athletes.
98. Van de Ven & Kauffman, supra note 14, at 479-80. Self-employed individuals
ployed athletes may establish their own retirement plan with the same deduction limitations as a corporate retirement plan, they are unable to control the timing of the distribution as they would if their personal service corporation established a qualified retirement plan. Therefore, self-employed athletes, as well as team athletes, might benefit from the establishment of a qualified retirement plan.

The cash position of the athlete is another extremely important factor to consider when incorporating the athlete's services. The athlete's salary decreases upon the formation of a personal service corporation because part of his salary is utilized for qualified retirement plans and his expenses that are paid for by the corporation. The athlete must be able to meet his individual needs with the smaller salary. Therefore, the ultimate utility of a qualified retirement plan must be determined on an individual basis.

C. Other Fringe Benefits

The formation of a personal service corporation enables an athlete to obtain certain fringe benefits that are otherwise often unavailable. Some of these benefits might already be provided to athletes employed by a team; however, none of these fringe benefit programs are provided to the self-employed athlete. Corporate medical reimbursement establishing Keough plans are subject to the same deductibility limitations as qualified corporate plans. BANDY, supra note 4, § 9, at 40. Self-employed individuals may establish these plans, as the term "employee" includes self-employed individuals, and the term "employer" includes owners of an entire interest in an unincorporated business. I.R.C. § 401(c)(1), (4) (West 1994). In addition, self-employed athletes may deduct contributions to an individual retirement account in the amount of the lesser of $2000 or the individual's compensation for the year. I.R.C. § 219(b)(1)(A)-(B) (West 1994).

98. See supra note 97.
99. For a discussion of the timing distribution advantages for establishing a qualified retirement plan by a personal service corporation, see supra note 69.
100. Van de Ven & Kauffman, supra note 14, at 480.
101. Id.
102. Id.
103. Id.
104. Shefsky, supra note 5, § 21.06[1]. Many of these benefits are unavailable to many athletes, as only corporations may establish such programs.
105. Id. § 21.06[1]. Athletes employed by a team may receive some of these benefits from his team or league, a factor that should be considered in determining whether it is beneficial to incorporate the athlete's services. In deciding whether to incorporate, the athlete should compare the amount paid to the team's plan against the
plans and employer-provided insurance are the fringe benefits from which the athlete derives the most benefit.  

Under a corporate medical reimbursement plan, an athlete may exclude from gross income any amounts paid by the personal service corporation to the athlete for medical expenses. This is a significant benefit, as the athlete is typically only able to deduct unreimbursed medical expenses to the extent they exceed 7.5% of adjusted gross income. Additionally, the personal service corporation may deduct any contributions to a medical plan set up on behalf of the athlete. However, most personal service corporations distribute all of their income to avoid the personal holding company tax, few benefit from the deduction.

A personal service corporation also may provide the athlete with accident, health and disability insurance. Any insurance premiums paid by the personal service corporation on behalf of the athlete are deductible by the corporation and excluded from the athlete's gross amount contributed to his own plan. Van de Ven & Kauffman, supra note 14, at 479. In addition, this further emphasizes the point that the utility of a personal service corporation for an athlete must be determined on an individual basis.

Van de Ven & Kauffman, supra note 14, at 480.

Coverage under these corporate medical plans usually includes the athlete as well as any spouse or dependents. Id.

I.R.C. § 105(b) (West 1994). The reimbursements must be paid from a plan and cannot have already been deducted by the athlete on the athlete's personal income tax return. Treas. Reg. § 1.105-2 (1960).

I.R.C. § 213(a) (West 1994). Adjusted gross income is defined as "the income amount that is used as the basis for calculating the floor or ceiling for numerous other tax computations." BANDY, supra note 4, at F2. See also BLACK'S LAW DICTIONARY 228 (3d ed. 1991) (Adjusted gross income is "the gross income of the taxpayer reduced by certain specified deductions that generally represent the taxpayer's business deductions.") If the athlete's itemized deductions are less than the standard deduction, the athlete receives no tax benefit for the unreimbursed medical expenses, as the athlete is only entitled to either take the standard deduction or itemize his deductions. I.R.C. § 63(b) (West 1994). The standard deduction is [a] floor amount set by Congress to simplify the tax computation . . . used by taxpayers who do not have enough deductions to itemize." BANDY, supra 4, at F16. Itemized deductions are "personal expenditures" allowed for certain items, such as medical expenses and state and local taxes, that are only utilized when their cumulative amount exceeds the standard deduction amount. Id. at F9-F10. For a detailed discussion of determining tax liability, see generally BANDY, supra note 4 (discussing the basic formula for individual income tax preparation).

Treas. Reg. 1.162-10(a) (1960).

For a discussion of the personal holding company tax, see infra notes 134-54 and accompanying text.

Shesky, supra note 5, § 21.02[1][h][iii][B].

Treas. Reg. § 1.162-10(a) (1960). Premiums paid on behalf of self-employed persons are normally not deductible. BANDY, supra note 4, § 4, at 9.

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income. In contrast, if the athlete pays for his own medical and health insurance, the premiums are deductible to the extent that they exceed 7.5% of the athlete's adjusted gross income, but the accident and disability insurance premiums are not deductible.

In addition, any benefits received from medical insurance provided by the personal service corporation are excluded from the athlete's gross income to the extent that they are computed without regard to lost wages. However, benefits received from accident and disability insurance provided by the corporation must be included in the athlete's gross income. If, on the other hand, the athlete provides his own insurance coverage, any benefits received are not included in the athlete's gross income. As a result, the benefit to the athlete in having the personal service corporation provide insurance coverage is that the athlete is able to obtain insurance out of before-tax dollars, rather than after-tax dollars.

Additionally, the personal service corporation may deduct the insurance premiums, however, most personal service corporations do not benefit from this deduction, as they must distribute all of their income to avoid the personal holding company tax.

A personal service corporation may also provide the athlete with life insurance. Premiums paid on behalf of the athlete may be de-
ducted by the personal service corporation and must be included in the gross income of the athlete. In contrast, if the athlete provides his own coverage, the premiums are not deductible. However, if the corporation provides group-term life insurance coverage, then the athlete’s gross income need only include an amount, determined by Internal Revenue Service tables, attributable to insurance protection that exceeds $50,000. Thus, an athlete may be able to obtain life insurance coverage through premiums that are deductible to the personal service corporation, rather than providing coverage out of his after-tax dollars. As with medical insurance premiums, the advantage of corporate deductions for life insurance premiums paid is limited by the distribution of all of the corporation's income to avoid the personal holding company tax.

Other benefits of personal service corporations include limited liability from tort actions, and the ability of the corporation to take deductions without being subject to the 2% limitation for individuals. The use of the latter is now limited since, again, most personal service corporations distribute all of their income to avoid the personal holding company tax.

122. I.R.C. § 162(a) (West 1994); see also BANDY, supra note 4, § 4, at 10.
123. BANDY, supra note 4, § 4, at 10. If the employer is the beneficiary of the policy, then the premiums need not be included in the gross income of the athlete and are not deductible by the personal service corporation. I.R.C. § 79(b)(2)(A) (West 1994).
125. I.R.C. § 79(a)(1) (West 1994). The method for determining the amount of the premium for inclusion when group-term life insurance coverage exceeds $50,000 differs depending upon whether the covered employee is a key employee. I.R.C. § 79(d) (West 1994); see also BANDY, supra note 4, § 4, at 11. The personal service corporation may still deduct the entire premium paid for the group-term life insurance. I.R.C. § 162(a) (West 1994); see also BANDY, supra note 4, § 4, at 11. Group-term insurance is not available to self-employed individuals. Id.
126. Van de Ven & Kauffman, supra note 14, at 480. Despite the type of coverage, any proceeds received from a life insurance policy are excluded from the recipient’s gross income. I.R.C. § 101(a) (West 1994). For a discussion of after-tax dollars, see supra note 47.
127. See infra notes 134-54 and accompanying text.
129. Lawson & Stiglitz, supra note 7, at 7. These deductions usually involve miscellaneous itemized deductions, such as unreimbursed employee expenses that are deductible under § 162(a) of the Internal Revenue Code. Id. This is extremely useful to self-employed athletes, as most teams reimburse their athletes for everything except union dues. In addition, many of these business expenses are not deductible by the self-employed athlete, as they are not provided for the convenience of the employer. Shefsky, supra note 5, § 21.08[1].
130. See infra notes 134-54 and accompanying text.
V. DISADVANTAGES OF PERSONAL SERVICE CORPORATIONS

An athlete must also seriously consider the problems in forming a personal service corporation. The Internal Revenue Service utilizes a variety of theories to limit the benefits of incorporating one’s services. These theories include: personal holding company tax, sham corporation theory, assignment of income doctrine, reallocation of income principle and reallocation when the principle purpose is to evade taxes. Other disadvantages include the incorporation costs and annual corporation expenses.

A. Limitations on Personal Service Corporations

1. Section 541: Personal Holding Company Tax

The Internal Revenue Service may attempt to deny the personal service corporation some tax benefits by classifying it as a personal holding company. A personal holding company is subject to a special penalty tax of 39.6% on all undistributed personal service income. This special penalty tax is imposed in addition to the normal corporate income tax. An athlete who forms a personal service corporation must be careful to avoid the personal holding company tax on undistributed personal service income.

A personal service corporation is considered a personal holding company if it meets two requirements, an adjusted ordinary gross in-

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131. WElstart & Lowell, supra note 14, § 7.12, at 881; see infra notes 134-54 and accompanying text. Although the Internal Revenue Service recognizes the validity of personal service corporations for tax purposes, it continues to attack the tax advantages of such corporations.
132. Halperin, supra note 6, at 76.
133. Klinger, supra note 30, at 5. For other disadvantages that should be considered before incorporating an athlete’s services, see infra notes 218-35 and accompanying text.
134. I.R.C. § 541 (West 1994); see also Weistart & Lowell, supra note 14, § 7.12, at 888 (stating that the personal holding company tax severely limits the utility of personal service corporations); Brown, supra note 33, at 252-53; Shefsky, supra note 5, § 21.06[1]; Van de Ven & Kauffman, supra note 14, at 481.
135. I.R.C. § 541 (West 1994). “In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the undistributed personal holding company income . . . of every personal holding company . . . a personal holding company tax equal to 39.6(%) of the undistributed personal holding company income.” Id. The personal holding income tax rate has been as high as 70%. Weistart & Lowell, supra note 14, § 7.12, at 888.
come requirement and a stock ownership requirement. The adjusted ordinary gross income requirement is satisfied if "at least [sixty] percent of [the corporation's] adjusted ordinary gross income . . . for the taxable year is personal holding company income." The stock ownership requirement is satisfied if "at any time during the last half of the taxable year more than [fifty] percent in value of [the corporation's] outstanding stock is owned, directly or indirectly, by or for not more than [five] individuals." If the personal service corporation fulfills both requirements, then it is considered a personal holding company and is taxed on its undistributed personal holding income.

An athlete's personal service corporation almost always satisfies the adjusted ordinary gross income requirement. The primary source of personal holding income for athletes is personal service contracts. Personal service contracts, however, are only considered personal holding income "if the individual who is to perform the services is designated . . . in the contract" and that individual owns, either directly or indirectly, 25% of the value of the outstanding stock. Almost all professional sports contracts are considered personal holding income, as the contracts almost always designate the athlete as the one who must perform the services, and the athlete is usually either the sole shareholder or the majority shareholder of the corporation. Thus, the adjusted gross income requirement is satisfied in most situations, as a personal service corporation has little gross income from sources outside its personal service contracts.

137. I.R.C. § 542(a)(1)-(2) (West 1994); see Kenyatta Corp. v. Commissioner, 86 T.C. 171, 171 (1986) (holding that a personal service corporation formed by Bill Russell, a former professional basketball player, was a personal holding company, as it fulfilled the two requirements of § 542(a)), aff'd, 812 F.2d 577 (9th Cir. 1987).
139. I.R.C. § 542(a)(2) (West 1994). For a further discussion of the stock ownership test, see infra notes 147-50 and accompanying text.
140. Weistart & Lowell, supra note 14, § 7.12, at 888.
141. Id. § 7.12, at 888-89.
142. Id. Personal holding income also includes income from dividends, rents, mineral, oil and gas royalties, copyright royalties, produced film rents, use of corporate property by shareholder as compensation, and estates and trusts. I.R.C. § 543(a)(1)-(8) (West 1994).
143. I.R.C. § 543(a)(7)(A) (West 1994). Personal holding income also includes personal service contracts in which "some person other than the corporation has the right to designate . . . the individual who is to perform the services" and at some time during the taxable year the individual to be designated to perform the services owns, either directly or indirectly, 25% of the value of the outstanding stock. Id.
144. Brown, supra note 33, at 253.
145. See supra note 14 and accompanying text.
146. See Weistart & Lowell, supra note 14, § 7.12, at 888. Personal service corre-
An athlete's personal service corporation usually also satisfies the stock ownership requirement of section 542(a) of the Internal Revenue Code. This condition is satisfied when the athlete is the sole shareholder of the corporation. Even if the athlete is not the sole shareholder, this requirement is usually satisfied, as personal service corporations typically have five or less individuals as minority shareholders. Thus, the stock ownership test is almost always satisfied when the athlete incorporates his services.

As most personal service corporations are considered personal holding companies, the advantages of incorporating an athlete's services are diminished. The personal holding income tax may only be avoided by distributing all of the corporation's gross income for the taxable year. Thus, a personal service corporation should use all of the corporation's income for the taxable year to pay deductible expenses, qualified retirement programs, other fringe benefits programs and compensation to the athlete. As a result, the athlete loses many of

porations are established for the purpose of contracting out one's personal services, therefore, it rarely has greater than 40% of gross income from sources other than personal service contracts.

147. Id.; see also Brown, supra note 33, at 253. The corporation does not need to issue stock certificates to fulfill this requirement if the intended stock ownership ratio is known. See Kenyatta Corp. v. Commissioner, 86 T.C. 171, 181-82 (1986) (stating that the "issuance of stock certificates is not determinative of stock ownership for purposes of [section] 542(a)" of the Internal Revenue Code if there is other evidence, such as articles of incorporation or the incorporating attorney's testimony, that demonstrates the intended stock ownership ratio), aff'd, 812 F.2d 577 (9th Cir. 1987).

148. In most personal service corporations, the athlete is the sole shareholder. See supra note 22 and accompanying text.

149. WEINSTART & LOWELL, supra note 14, § 7.12, at 888 n.315.

150. See id., supra note 14, § 7.12, at 888; see also Brown, supra note 33, at 253 (stating that the majority of professional sports service contracts constitute personal service company income).

151. Brown, supra note 33, at 253. If a personal service corporation is classified as a personal holding company, the corporation is not subject to the accumulated earnings tax. I.R.C. § 532(b)(1) (West 1994). For a discussion of the accumulated earnings tax, see supra note 228 and accompanying text.

152. See Brown, supra note 33, at 253. The tax is avoided, as the corporation has no undistributed personal holding income that is subject to the penalty tax. See I.R.C. § 541 (West 1994).

153. Halperin, supra note 6, at 74. After all of the corporate expenses are paid and contributions are made to qualified retirement programs and fringe benefit programs, the remaining income should be paid out to the athlete as compensation for rendering his services on behalf of the corporation. See supra note 31 and accompanying text.
the advantages for which personal service corporations were originally devised, such as corporate deductions and corporate tax rates.154

2. Sham Corporation Theory

The Internal Revenue Service often refuses to recognize the establishment of a personal service corporation for tax purposes by calling the corporation a sham.155 For tax purposes, a sham corporation is a corporation that has no meaningful business purpose.156 If the IRS disregards the corporate form for tax purposes, the athlete is taxed directly on the income, rather than the income passing through the personal service corporation,157 which defeats the purpose of forming a personal service corporation.158 However, courts generally reject the sham corporation theory.159 The theory is only sustained if the corporation has no obvious business purpose and is not a viable entity independent from the person providing services on behalf of the personal service corporation.160

In Patterson, the tax court found the personal service corporation formed by Floyd Patterson to be a sham corporation, as it lacked a viable business purpose.161 The corporation was established to handle

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154. The lost deductions include payments for qualified retirement plans, fringe benefit programs and miscellaneous business expenses. See supra notes 63-130 and accompanying text. For a discussion of the advantage of lower corporate tax rates, see supra notes 55-62 and accompanying text.

155. WEISTART & LOWELL, supra note 14, § 7.12, at 881-82 (stating that one method of attacking a personal service corporation is calling it a sham); see also Lawson & Stiglitz, supra note 7, at 5; Van de Ven & Kauffman, supra note 14, at 481.

156. WEISTART & LOWELL, supra note 14, § 7.12, at 882. In addition to complying with state incorporation laws, a corporation must have substance in the manner in which it operates to be a valid corporation for tax purposes. Patterson v. Commissioner, 25 T.C.M. (CCH) 1230, 1234 (1966), aff'd, 22 A.F.T.R.2d (P-H) P 5810 (2d Cir. 1968). There must be “flesh on the bones of the corporate skeleton,” otherwise, the “bones are so transparent that the Corporation should more properly be classified as a wraith.” Id.

157. WEISTART & LOWELL, supra note 14, § 7.12, at 882.

158. Id.

159. Lawson & Stiglitz, supra note 7, at 5.

160. WEISTART & LOWELL, supra note 14, § 7.12, at 258. Even if a corporation meets the Internal Revenue Service's requirements for forming a valid corporation for tax purposes, the corporate form may be disregarded if there is no viable business purpose. Higgins v. Smith, 308 U.S. 473, 477-78 (1940). The requirements for corporate tax status include the presence of associates, a business purpose, continuity of life, centralized management, limited liability of shareholders and transferability of shareholder's interests. Treas. Reg. § 301.7701-2(a) (as amended in 1993).

161. Patterson v. Commissioner, 25 T.C.M. (CCH) 1230, 1234 (1966), aff'd, 22 A.F.T.R.2d (P-H) P 5810 (2d Cir. 1968); see also Johansson v. United States, 336 F.2d 809, 813 (5th Cir. 1964) (holding that a personal service corporation formed by a boxer, Ingemar Johansson, had no legitimate purpose, but was instead formed to
the ancillary rights to Patterson's boxing matches. Subsequent to the formation of the corporation, Patterson engaged in boxing matches in which the contracts were entered into by Patterson's manager instead of the personal service corporation. Although the corporation had its own phone number, it shared the same office with Patterson and owned no equipment or furniture. In addition, no records were kept, except for worksheets detailing cash transactions and a folder containing miscellaneous papers. The tax court held that Floyd Patterson Enterprises was a sham corporation, as it failed to manage the activities for which it was formed and to carry out the daily activities of a normal corporation.

Once a personal service corporation is properly organized, it may avoid the sham corporation theory by exercising common corporate formalities to ensure the independence of the corporation. Most importantly, the personal service corporation should enter into a contract with the athlete for his services and contract out his services to a team or event that desires the athlete's services. Some other com-

tenarily avoid taxation on his income. Floyd Patterson was a boxer who formed a personal service corporation, Floyd Patterson Enterprises. Patterson, 25 T.C.M. (CCH) at 1231.

162. Patterson, 25 T.C.M. (CCH) at 1236. Ancillary rights include all rights other than ticket receipts, such as television, radio and movie rights. Id.

163. Id. at 1232. Furthermore, Floyd Patterson Enterprises never received any income from the agreements entered into by Patterson's manager on behalf of Patterson. Id.

164. Id. at 1234.

165. Id.

166. Id. at 1236. The corporation had the skeleton of a corporation, but lacked many of the corporate activities necessary to "put flesh on the bones" of the skeleton to be considered a corporation for tax purposes. Id.

167. See supra notes 13-31 and accompanying text.

168. See Halperin, supra note 6, at 74. Establishing the independence of the corporation ensures that the corporation is performing "some meaningful business function in order to gain recognition as a separate entity for tax purpose." Patterson, 25 T.C.M. (CCH) at 1234. Thus, as long as the personal service corporation is organized and operates like a corporation, the sham corporation theory is not a viable theory for attacking the corporation for tax purposes. Van de Ven & Kauffman, supra note 14, at 481.

169. Van de Ven & Kauffman, supra note 14, at 478. If the athlete plays for a team, his corporation would probably enter into a personal services contract with that team, and if the athlete is a non-team player, his corporation would probably only enter into individual contracts with sponsors or organizers of specific events. Id. This is the proper method of setting up a personal service corporation for an athlete. See supra notes 29-30 and accompanying text.
mon corporate formalities include holding organizational meetings with minutes taken at each meeting, adopting corporate by-laws, and electing officers and directors. In addition, the corporation should have its own checking account, file its own tax returns, and maintain records of the corporation's income and expenses. The independence of the personal service corporation may be further strengthened if the corporation has its own office, purchases its own office equipment, utilizes stationery with the corporate logo, and obtains a telephone number and listing in the corporation's name. By following these formalities, the personal service corporation demonstrates that it has a meaningful business purpose and will not be subject to attack by the Internal Revenue Service.

3. Assignment of Income Doctrine

The Internal Revenue Service often attacks personal service corporations by utilizing the assignment of income doctrine. This doctrine prohibits an individual from assigning one's earned income to another individual to avoid paying taxes on the income. Instead, the income tax is imposed on the individual who actually earned the income. Thus, the Commissioner often attacks personal service corporations by arguing that the athlete performing the services and earning the income should be taxed on the income, rather than the personal service corporation. If the assignment of income doctrine is applied the athlete is

170. Van de Ven & Kauffman, supra note 14, at 481. Organizational meetings might include board of directors' meetings and annual stockholders' meetings.
171. Id. The appropriate tax returns include federal and state income tax returns, employment tax returns, and franchise tax returns. Id.
172. Id. These are not necessarily corporate formalities, but strengthen the independence of the corporation from the individual rendering the personal services.
173. Id. The determination of whether a personal service corporation is a sham corporation for tax purposes is made on a case-by-case basis. See id. Therefore, the failure to observe one or more of the corporate formalities is not per se a lack of a valid business purpose, but is weighed against the surrounding circumstances. See id.
174. Lawson & Stigitz, supra note 7, at 5; see also Johnson v. United States, 698 F.2d 372, 374 (9th Cir. 1982) (utilizing the assignment of income doctrine to void the transfer of payments from a basketball player to a corporation); Foglesong v. Commissioner, 621 F.2d 865, 872-73 (7th Cir. 1980) (recognizing the assignment of income doctrine as a viable method for decreasing the utility of personal service corporations). This doctrine was first recognized in Lucas v. Earl, 281 U.S. 111 (1930).
175. BANDY, supra note 4, § 3, at 6-7. Individuals in high income tax brackets who want to reduce their taxable income by gifting property or income to a spouse or a child in a lower tax bracket usually fall under the assignment of income doctrine. Id.
176. Lucas, 281 U.S. at 114-15. The Lucas court analogized income to a fruit and stated that fruit (the income) cannot be attributed to a tree other than the tree from which it grew (the individual who earned the income). Id. at 115.
177. WEISTART & LOWELL, supra note 14, § 7.12, at 884-85.
taxed on the entire amount paid by the team to the personal service corporation, rather than the lesser amount distributed to him as compensation by the personal service corporation.\textsuperscript{178}

The assignment of income doctrine is only applied to the athlete who is considered an employee of the team for whom he plays, as opposed to an employee of his personal service corporation.\textsuperscript{179} There are two elements that must be fulfilled before an athlete is considered an employee of his personal service corporation and, therefore, avoid the assignment of income doctrine.\textsuperscript{180} First, the personal service corporation must have the right to control the athlete's activities as one of its employees.\textsuperscript{181} Second, there must be a contract or agreement between

\textsuperscript{178} Sargent v. Commissioner, 929 F.2d 1252, 1258 (8th Cir. 1991). This destroys the purpose of forming a personal service corporation, which is the ability to pass income through the corporation. Van de Ven & Kauffman, supra note 14, at 461.

\textsuperscript{179} Johnson v. United States, 698 F.2d 372, 374 (9th Cir. 1982); see also Sargent, 929 F.2d at 1258. Compare Hundley v. Commissioner, 48 T.C. 339, 349-50 (1967) (holding that the assignment of income doctrine did not apply when Hundley, a professional baseball player, assigned a portion of his signing bonus to his father in accordance with a contingent contract in compensation for acting as his coach, agent and advisor, as the payment was for a valid and reasonable business expense) with Allen v. Commissioner, 50 T.C. 466, 477-78 (1968) (holding that the assignment of income doctrine applied when Allen, a professional baseball player, transferred a portion of his signing bonus to his mother where she had no duties in connection with his professional development and no pre-existing agreement existed), aff'd per curiam, 410 F.2d 398 (3d Cir. 1969).

Self-employed athletes need not worry about the assignment of income doctrine, as they are always considered employees of their personal service corporation. Self-employed athletes control their own activities and enter into a contract with the personal service corporation recognizing its control over their activities. In addition, the signing of a contract between the sponsors of the events in which the athlete participates and the personal service corporation exemplifies that the sponsor recognizes the corporation's control over the athlete.

\textsuperscript{180} Treas. Reg. § 31.3121(d)-(1)(c)(2) (as amended in 1980). This is known as the "contract" theory for determining whether an athlete is an employee of his personal service corporation or the team for whom the athlete performs services. Sargent, 929 F.2d at 1258. This theory acknowledges the viability of contractual relations between players and their personal service corporations and replaces the "team" theory. \textit{id.}

The "team" theory stated that an athlete was an employee of the team for whom he played, as the team had the right to control the activities of the player on the field and the athlete was to act in the best interest of the team. Sargent v. Commissioner, 93 T.C. 572, 577-79 (1989).

\textsuperscript{181} Sargent, 929 F.2d at 1256 (citing Treas. Reg. § 31.3121(d)-(1)(c)(2)); see also Johnson, 698 F.2d at 374 (recognizing that the corporation must be able to control the athlete's activities for the athlete to be considered an employee of that personal service corporation).
the personal service corporation and the team recognizing the corporation's control over the athlete.\textsuperscript{182} If both elements are present, the athlete is considered an employee of the personal service corporation, rather than an employee of the team, and the assignment of income doctrine does not apply.\textsuperscript{183}

The assignment of income doctrine does not apply as long as the formalities for forming a personal service corporation are followed, as they fulfill the elements necessary for the athlete to be an employee of the personal service corporation.\textsuperscript{184} The first element is satisfied when the athlete enters into an exclusive contract to render personal services on behalf of the personal service corporation.\textsuperscript{185} The second element is met when the personal service corporation and the professional sports team enter into an agreement for the athlete's services.\textsuperscript{186} Therefore,

\textsuperscript{182} Sargent, 929 F.2d at 1256 (citing Treas. Reg. § 31.3121(d)-(1)(c)(2)); see also Johnson, 698 F.2d at 374 (recognizing that an agreement between the team and the personal service corporation must recognize and accept the corporation's control over the athlete for the athlete to be considered an employee of the personal service corporation).

\textsuperscript{183} Sargent, 929 F.2d at 1256, 1258-59.

\textsuperscript{184} See id. at 1258-57.

\textsuperscript{185} Id. (discussing the Tax Court's holding in Johnson). The existence of a contract between the athlete and the personal service corporation gives the corporation a right to control the athlete's services. Johnson, 698 F.2d at 374. In Johnson, Charles Johnson, a professional basketball player, entered into a contract with a Panamanian corporation to convey the exclusive rights of his services as a professional athlete in exchange for a life annuity. Id. at 373. After the Panamanian corporation assigned its contract to a British Virgin Islands corporation, Johnson attempted to assign payments from a separate contract, which he entered into with a professional basketball team, to the same corporation. Id. The court held that Johnson was an employee of the professional basketball team, rather than the corporation, and should be taxed on the income from his personal service contract. Id. at 374. The court emphasized that Johnson was under the control of the Panamanian corporation due to their agreement (first element), but there was no agreement recognizing control between the Panamanian corporation and the professional basketball team (second element). Id. Thus, Johnson was viewed as an employee of the professional basketball team and the assignment of income doctrine applied to the income transferred to the corporation. Id.

\textsuperscript{186} Sargent, 929 F.2d at 1258-57. The existence of a contract between the personal service corporation and the team for whom the athlete renders services constitutes evidence that the team recognizes the personal service corporation's control over the athlete's services. Id. In Sargent, Gary Sargent and Steve Christoff, professional hockey players, each formed their own personal service corporation. Id. at 1254. Both corporations then entered into contracts with the Minnesota North Stars Hockey Club. Id. The court found that both hockey players were employees of their respective personal service corporations, rather than the Minnesota hockey team. Id. The court reasoned that both elements of the Treasury Regulation § 31.3121(d)-(1)(c)(2) were fulfilled since the athletes maintained contracts with their respective personal service corporation (first element) and these corporations had contracts with the hockey club (second element). Id. at 1256-57; see also Johnson, 698 F.2d at 374 (holding that the
by following the proper contract formalities, a personal service corporation can avoid the application of the assignment of income doctrine.\textsuperscript{187}

4. Section 482: Reallocation of Income

The Internal Revenue Service might attempt to attack a personal service corporation by "reallocating" a portion of the income from the corporation to the athlete.\textsuperscript{188} Section 482 of the Internal Revenue Code provides that the Commissioner may allocate income and deductions between two commonly controlled entities when it is necessary to prevent tax evasion or to more accurately reflect the income of such entities.\textsuperscript{189} This section differs from the assignment of income doctrine, as it allows the reallocation of income to reflect the income earned separately by the athlete and the corporation, rather than allocating the income as earned entirely by the athlete.\textsuperscript{190} As a result, only a portion of the income received by the personal service corporation for the athlete's services is reallocated to the athlete.\textsuperscript{191} The amount of income

second element was not fulfilled where the corporation and the professional basketball team did not enter into a contract for Johnson's basketball services).  
187. Sargent, 929 F.2d at 1258.  
188. WeisTARt & LOWELL, supra note 14, § 7.12, at 886 (stating that reallocation of income under § 482 is one method of attacking a personal service corporation); see Borge v Commissioner, 405 F.2d 673, 675-76 (1968) (applying § 482 of the Internal Revenue Code to personal service corporations), cert. denied sub nom. Danica Enterprises v. Commissioner, 396 U.S. 933 (1969); see also Brown, supra note 33, at 249 (applying § 482); Shefsky, supra note 5, § 21.06[1] (applying § 482).  
189. I.R.C. § 482 (West 1994). Section 482 states:  
[In any case of two or more organizations, trades, or businesses . . . 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 organization, 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.  
190. Id.; see also Borge, 405 F.2d at 675-76.  
191. Id. Section 482, unlike the assignment of income doctrine, is usually utilized since it is less severe and easier to support. Id. at 887. In Borge, the shareholder-employee entered into a contract to perform entertainment and professional services in exchange for $50,000 per year for five years. Borge, 405 F.2d at 675. However, the corporation received over $160,000 per year from the shareholder-employee's services. Id. at 677. The court reallocated an additional $25,000 per year to the shareholder-employee, as it determined that the personal service corporation did not provide services or aid to the shareholder-employee's business activities to merit the income
that is reallocated equals the compensation that the athlete would have received if the parties were dealing in an arm's length transaction.\textsuperscript{192}

An athlete's services are considered to be a trade or business, therefore, the athlete is deemed to control two entities if he owns a personal service corporation, the corporation and his own services.\textsuperscript{193} However, an athlete and his personal service corporation are considered commonly controlled businesses only if the athlete fails to work exclusively for the personal service corporation.\textsuperscript{194} An athlete, therefore, need only be concerned with § 482 if he renders services for someone other than his personal service corporation.\textsuperscript{195} This often occurs when league rules do not permit teams to contract with a personal service corporation, thus forcing the athlete to contract directly with a team.\textsuperscript{196} Thus, the athlete is employed by both the team and the personal service corporation.\textsuperscript{197} However, § 482 may be avoided if the personal service corporation distributes the entire unutilized portion of the amount received for the athlete's services, as the athlete receives an amount substantially equivalent to the amount he would have received without the corporation.\textsuperscript{198} Since most personal service corporations avoid the personal holding company tax by not accumulating any income, therefore, § 482 does not usually apply to these corporations.\textsuperscript{199}

Even if the athlete is unable to avoid § 482, two factors diminish its impact.\textsuperscript{200} First, only a portion of the income received by the corporation is reallocated, which often is only a small portion of the income actually earned.\textsuperscript{201} Second, the application of § 482 simply results in

\begin{itemize}
  \item that exceeded $50,000. \textit{Id.} at 676.
  \item \textsuperscript{192} Agualdo Valdez, Comment, \textit{One-Man Personal Service Corporations: Singing a New Foglesong}, 58 \textit{Notre Dame L. Rev.} 652, 659 (1983). The amount to be reallocated is also considered the amount that is "substantially equivalent" to the athlete's probable compensation had the corporation not existed. \textit{Id.}
  \item \textsuperscript{193} \textit{Weisnant & Lowell}, \textit{ supra} note 14, § 7.12, at 886.
  \item \textsuperscript{194} Lawson \& Stiglitz, \textit{ supra} note 7, at 6; see Foglesong v. Commissioner, 691 F.2d 848, 851 (7th Cir. 1982) (holding that § 482 does not apply when a shareholder-employee works exclusively for his own personal service corporation).
  \item \textsuperscript{195} Lawson \& Stiglitz, \textit{ supra} note 7, at 6.
  \item \textsuperscript{196} \textit{Id.} For the leagues that do not permit teams to sign contracts with personal service corporations, see \textit{ supra} note 24.
  \item \textsuperscript{197} Lawson \& Stiglitz, \textit{ supra} note 7, at 6.
  \item \textsuperscript{198} \textit{Id.} The corporation's income is utilized for business expenses, retirement plan contributions and salary for the employee. \textit{Id.}
  \item \textsuperscript{199} Halperin, \textit{ supra} note 6, at 76. For a discussion of the personal holding company tax, see \textit{ supra} notes 134-54 and accompanying text.
  \item \textsuperscript{200} \textit{Weisnant & Lowell}, \textit{ supra} note 14, § 7.12, at 887.
  \item \textsuperscript{201} \textit{Id.; see also} Borge v. Commissioner, 405 F.2d 673, 676 n.8, 677 (holding that $82,500 of the $166,465 received by the personal service corporation as personal service income was to be reallocated to the employee-shareholder as a salary), \textit{cert. denis sub nom.} Danica Enterprises v. Commissioner, 396 U.S. 933 (1969).
\end{itemize}
the deferral of tax payments for several years.\textsuperscript{202} When the tax payments become due, the personal service corporation distributes the reallocated amount without further imposition of tax.\textsuperscript{203} Thus, the worst case scenario under § 482 is the deferral of the tax payments on income that ordinarily would have been taxed.\textsuperscript{204}

5. Section 269A: Allocation When Purpose is Tax Evasion

Section 269A allows the Internal Revenue Service to attack personal service corporations when the principal purpose of its formation is the avoidance of federal income taxes.\textsuperscript{205} Section 269A applies to personal service corporations only if "substantially all" of the services are performed for one entity and the principal purpose for incorporation is income tax evasion.\textsuperscript{206} The Commissioner may allocate all income and deductions between the personal service corporation and the employee-shareholder to prevent tax avoidance or to more clearly reflect the income of the corporation and the employee-owner.\textsuperscript{207} Therefore, § 269A could limit the utility of the personal service corporation for athletes. However, two methods exist by which an athlete might avoid the limitations of § 269A of the Internal Revenue Code.\textsuperscript{208}

202. WEISTART & LOWELL, supra note 14, § 7.12, at 887. By deferring the payment of taxes, the athlete gains the use of the money for other income generating purposes for several years. \textit{Id.}
204. WEISTART & LOWELL, supra note 14, § 7.12, at 888.
205. I.R.C. § 269A (West 1994); see also Shefsky, supra note 5, § 21.0611 (utilizing § 269A to limit the benefits of personal service corporations when the principal purpose of the corporation is the avoidance of federal income taxes); Brown, supra note 33, at 251; Lawson & Stiglitz, supra note 7, at 4. The Tax Equity and Fiscal Responsibility Act of 1982 established § 269A. Valdez, supra note 192, at 664. Section 269A differs from § 482 in that it addresses the purpose behind forming a personal service corporation, which might be to avoid federal income taxes, rather than the effect of forming such a corporation, which could be income tax evasion or the inaccurate reflection of income. \textit{Compare} I.R.C. § 269A (West 1994) \textit{with} I.R.C. § 482 (West 1994).
206. I.R.C. § 269A(a)(1)-(2) (West 1994). Avoidance or evasion of income taxes includes "reducing the income of, or securing of the benefit of any expense, deduction, credit, exclusion, or other allowance for, any employee-owner which would not otherwise be available . . . ." I.R.C. § 269A(a)(2) (West 1994).
207. I.R.C. § 269A(a) (West 1994). The Commissioner may also allocate credits, exclusions and other allowances. \textit{Id.}
208. See Lawson & Stiglitz, supra note 7, at 4; see also Brown, supra note 33, at 251. "Section 269A is a big hammer to be utilized only in extraordinary cases. It's designed to discourage fraud." Stan Soocher, \textit{Court Ruling Raises Loan-Out Con-
First, an athlete who does not perform nearly all the services of the personal service corporation on behalf of one entity may avoid § 269A. However, no precise definition exists for "substantially all" of one's services. A personal service corporation providing 90% of its services to one entity and 10% to another entity, however, might still fall within § 269A. Athletes employed by a team may be subject to this section because they perform all of their services on behalf of that one team. To avoid § 269A, team athletes can argue that by performing services for other companies, such as making public appearances or endorsing products, they are not providing substantially all of their services on behalf of one entity. Self-employed athletes, such as tennis players and golfers, can argue that they do not perform substantially all of their services for one entity, as they participate in many tournaments and endorse products.

A second method for avoiding § 269A is for the personal service corporation to have a valid business purpose. Interestingly, incorporating an athlete's services merely to obtain the benefits of incorporation constitutes a valid business purpose. The corporation's activities of booking appearances, managing correspondence, and obtaining endorsement contracts for the athlete also demonstrate the existence of a valid business purpose. Thus, a valid business purpose relieves a personal service corporation from the presumption of having been es-

209. Lawson & Stiglitz, supra note 7, at 4; see also Shefsky, supra note 5, § 21.06[1] (pointing out that only substantially all of the services, not the income, of the corporation must be performed for one entity).
210. Shefsky, supra note 5, § 21.06[1].
211. Valdez, supra note 192, at 665. If only "token" services are provided for another entity to escape § 269A, then a court still may utilize the section. Id.
213. Shefsky, supra note 5, § 21.06[1].
215. Van de Ven & Kauffman, supra note 14, at 482. Some of the benefits of incorporation include the establishment of qualified retirement plans and other fringe benefit programs. Id.; see supra notes 63-130 and accompanying text; see also Achiro v. Commissioner 77 T.C. 881, 900-01 (1981) (finding § 269A inapplicable if an individual's principal purpose for incorporation is to obtain the benefit of corporate retirement plans). But cf. Brown, supra note 33, at 251 (citing a technical advice memorandum stating that § 269A applies if the principal purpose in forming the personal service corporation is to take advantage of deductions for pension and medical plans).
216. Id. at 251. A valid business purpose is found as long as the personal service corporation performs activities pertaining to the athlete's career since the primary purpose in forming the corporation would be the support of such activities, not tax evasion.
tablished primarily for income tax evasion and prevents the imposition of § 269A.\textsuperscript{217}

B. Other Disadvantages of Personal Service Corporations

Although the limitations discussed above are the primary concerns an athlete should consider in deciding whether to incorporate his services, there are several other disadvantages of which the athlete should be aware. Most of these disadvantages, such as costs of incorporation and additional social security taxes, are minor and should not greatly affect the athlete’s decision.\textsuperscript{218}

However, one extremely important factor is the effect of incorporation on team and league benefits if the athlete is employed by a team.\textsuperscript{219} If these benefits are forfeited by incorporation, the athlete should do a cost-benefit analysis to determine whether the benefits of incorporation outweigh any lost team and league benefits.\textsuperscript{220} Sometimes, the athlete may retain the team and league benefits through “proper negotiations and structuring of the contract between the team and the [personal service] corporation.”\textsuperscript{221}

Other disadvantages of personal service corporations include the costs of incorporation and the additional annual expenses.\textsuperscript{222} The costs of incorporation are not immaterial due to the legal fees that are involved in filing the necessary documents.\textsuperscript{223} Annual expenses also are incurred in maintaining the personal service corporation.\textsuperscript{224} In addition, the corporation must pay the employer’s share of social security taxes and unemployment taxes, which are normally paid by the team.\textsuperscript{225} The amount of taxes paid by the personal service corporation

\textsuperscript{217} Id.
\textsuperscript{218} For a discussion of the minor disadvantages of forming a personal service corporation, see infra notes 222-35 and accompanying text.
\textsuperscript{219} Van de Ven & Kauffman, supra note 14, at 478. These benefits may include qualified retirement programs, medical expense reimbursements, group-term insurance, and medical insurance. Id. at 482.
\textsuperscript{220} Id. at 479.
\textsuperscript{221} Id. at 478.
\textsuperscript{222} Klinger, supra note 30, at 5.
\textsuperscript{223} Id. Legal fees are incurred in tailoring the corporation to suit the specific athlete’s needs. Id.
\textsuperscript{224} Id. These annual expenses include accounting and legal fees to prepare payroll and corporate tax returns. Id. In addition, if the corporation has a customized qualified retirement program, additional costs are incurred for actuarial estimates and administration of the trust. Klinger, supra note 30, at 5.
\textsuperscript{225} Id. For 1994, the federal social security tax, FICA, rate was 15.3%, of which
is deductible as a business expense.226 For self-employed athletes, incorporating one's services does not effect the social security tax liability of the athlete.227 These additional costs vary for each athlete and the athlete should consider them when determining whether to incorporate his services.

Two additional disadvantages of personal service corporations are the accumulated earnings tax228 and the non-deductibility of unreasonable compensation to the athlete.229 The accumulated earnings tax would not apply to personal holding companies since most personal service corporations distribute all of their income to avoid the personal holding company tax.230 As for the problem of unreasonable compen-
sation, the compensation is reasonable if the compensation paid to the athlete does not exceed the amount received by the corporation for the athlete's services.\textsuperscript{231} The unreasonable compensation problem rarely concerns personal service corporations, as their income is normally attributable only to personal service contracts.\textsuperscript{222} Additionally, the corporation usually does not own any capital producing items that might increase the corporation's income and the corporation does not carry-over income from year to year.\textsuperscript{233} Thus, a personal service corporation rarely has more income to pay out than the amount received for personal services during the taxable year.

Another disadvantage is the complexity of the personal service corporation.\textsuperscript{234} The formation of a corporation and running its day-to-day activities is very complex compared to when the athlete merely signs a contract with a team as an individual. Athletes may feel uncomfortable if they are confused about their financial affairs.\textsuperscript{235} Therefore, the athlete should seek the aid of financial advisors or agents who can discuss and explain the arrangement to ensure that the athlete understands the operation of a personal service corporation and the effect it has on his finances.

\section*{VI. Utility of Personal Service Corporations for Athletes}

There still remain some advantages to incorporating athletes' services.\textsuperscript{236} However, the personal service corporation "is no longer the powerful tax planning technique it once was."\textsuperscript{237} The Internal Revenue Service has substantially limited many of the tax benefits associated with personal service corporations.\textsuperscript{238} In addition, not all leagues allow teams to contract with personal service corporations.\textsuperscript{239}

For athletes who would benefit from establishing a qualified retire-
ment plan or fringe benefit programs, the personal service corporation should be seriously considered. The establishment of a qualified retirement plan reduces the athlete's tax liability, allows the athlete to make tax-deferred investments, allows the athlete to control the timing of the distributions, and forces the athlete to save money. 240 The ability to establish fringe benefit programs further reduces the athletes tax liability and allows the program to be established with before-tax dollars. 241 However, the utility of a personal service corporation depends upon the circumstances of each individual athlete. 242

Therefore, the athlete, his agent, his attorney, and his financial advisor should carefully consider all of the aforementioned advantages and disadvantages in determining whether to incorporate the athlete's services. Since each athlete's situation differs greatly, they should avoid generalizations when determining the utility of the personal service corporation. 243 Instead, they should determine whether the benefits of forming a personal service corporation outweigh the disadvantages that will accompany the formation of such a corporation for that particular athlete. 244

A basic example is the best method for understanding the potential advantages offered by a personal service corporation. National Hockey League players pension plans are extremely small; the largest amount contributed per year is $8000. 245 Therefore, professional hockey players might benefit greatly from the establishment of a qualified retirement plan. In addition, substantial tax savings result from the formation of a personal service corporation. Assume the following facts for an unmarried professional hockey player: gross income of $400,000, payment into a defined contribution plan of $30,000 and insurance premiums for medical, disability and life insurance of $10,000. 246 Assume the athlete takes the standard deduction of $3700 and the personal exemption of $2350. 247 Based upon these facts, the athlete's taxable

240. See supra notes 63-70 and accompanying text.
241. See supra notes 104-27 and accompanying text.
242. WEISTART & LOWELL, supra note 14, § 7.11, at 881.
243. Id.
244. See supra notes 32-130 and accompanying text.
245. Telephone Interview with James Oh, Investment Executive, with Piper Jaffrey (January 30, 1994) (financial advisor to professional athletes).
246. Insurance premiums paid by an individual are deductible as an itemized deduction to the extent the expenses exceed 7.5% of adjusted gross income. I.R.C. § 213(a) (West 1994). In this example it is assumed that the athlete's itemized deductions do not exceed the standard deduction amount; therefore, the athlete takes the standard deduction.
247. I.R.C. §§ 63, 151 (West 1994). See generally BANDY, supra note 4 (discussing standard deductions, itemized deductions and personal exemptions). Personal exemptions are deductions of an amount mandated by Congress for the taxpayer and any
income when the athlete does not incorporate his services is:

Gross Income to Athlete $400,000
Less:
  Personal Exemption $2,350
  Standard Deduction $3,700
  
  TAXABLE INCOME TO ATHLETE $393,950

However, when the athlete incorporates his services his taxable income is only:

Gross Income to PSC $400,000
Less:
  Defined Contribution Plan $30,000
  Insurance $10,000
  Salary to Athlete $360,000
  
  TAXABLE INCOME TO PSC $0

Gross Income to Athlete from the PSCap $360,000
Less:
  Personal Exemption $2,350
  Standard Deduction $3,700
  
  TAXABLE INCOME TO ATHLETE $353,950

Thus, the athlete's taxable income is decreased by $40,000 ($393,950 - $353,950) when he incorporates his services. This decreases the

dependents of the taxpayer, which are now phased out for high income taxpayers. BANDY, supra note 4, at F13. A detailed discussion of this topic is beyond the scope of this Comment. See generally I.R.C. § 151 (West 1994) (discussing the phaseout of personal exemptions for high income taxpayers). For a definition of the standard deduction and itemized deductions, see supra note 109.
athlete's tax liability by $15,840 ($40,000 \times .396).^{248}$ In addition, the athlete is able to establish a qualified retirement plan that he otherwise would have been unable to establish and to obtain insurance coverage with before-tax dollars.\(^{249}\) This example illustrates that the personal service corporation can still be an excellent tool for reducing an athlete's tax liability while also allowing the athlete to establish a qualified retirement plan and fringe benefit programs.

VII. CONCLUSION

The formation of a personal service corporation was once a common method for decreasing athletes' tax liability.\(^{250}\) However, many of the advantages that made the personal service corporation a powerful tax avoidance technique no longer exist due to attacks by the Commissioner of the Internal Revenue Service.\(^{251}\) These attacks include the personal holding company tax, sham corporation theory, assignment of income doctrine, reallocation of income principle, and allocation when the principle purpose of the corporation is tax evasion.\(^{252}\) The most potent attack is the personal holding company tax, which imposes an additional tax on the undistributed income of personal holding companies.\(^{253}\) Since most personal service corporations are considered personal holding companies, they no longer benefit from the additional deductions available only to corporations, as they must distribute all of their income to avoid the additional personal holding company tax.\(^{254}\)

Despite the attacks by the Commissioner, personal service corporations still have several significant advantages for athletes.\(^{255}\) First, the corporation may organize a qualified retirement plan and other fringe benefit programs that the unincorporated athlete is unable to establish.\(^{256}\) Second, athletes' tax liability decreases as the retirement plans and fringe benefit programs are funded with before-tax

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248. The maximum tax rate of 39.6% is utilized since the decrease in income occurs when the athlete has over $250,000 in taxable income. See supra note 57 and accompanying text.
249. For a discussion of before-tax dollars, see supra note 47 and accompanying text.
250. Halperin, supra note 6, at 74.
251. Lawson & Stiglitz, supra note 7, at 4-6.
252. See supra notes 121-235 and accompanying text.
253. See supra notes 134-54 and accompanying text.
254. See supra note 152.
255. See supra notes 92-34 and accompanying text.
256. See supra notes 63-130 and accompanying text.
dollars.\textsuperscript{257} In addition, there are several other possible advantages, such as deferring taxes on income by utilizing a fiscal year rather than the calendar year\textsuperscript{258} and limiting liability from tort actions.\textsuperscript{259}

The utility of personal service corporations for athletes ultimately depends upon the needs and circumstances of each individual athlete.\textsuperscript{260} Thus, the personal service corporation is not appropriate for all athletes as there are many potential disadvantages and not all athletes benefit from the advantages offered by personal service corporations.\textsuperscript{261} However, athletes, especially those who would benefit from the establishment of qualified retirement plans and fringe benefit programs, should consider forming a personal service corporation as several advantages remain to incorporating athletes' services.\textsuperscript{262}

\textbf{BRET M. KANIS, C.P.A.}

\begin{itemize}
  \item \textsuperscript{257} See supra notes 44-48 and accompanying text.
  \item \textsuperscript{258} See supra notes 38-43 and accompanying text.
  \item \textsuperscript{259} See supra note 128 and accompanying text.
  \item \textsuperscript{260} See supra notes 242-43 and accompanying text.
  \item \textsuperscript{261} See supra notes 241-43 and accompanying text.
  \item \textsuperscript{262} See supra notes 32-130 and accompanying text.
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