

## Income Shifting Through a Subchapter S Corporation

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### Recommended Citation

*Income Shifting Through a Subchapter S Corporation*, 37 Md. L. Rev. 809 (1978)

Available at: <http://digitalcommons.law.umaryland.edu/mlr/vol37/iss4/6>

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## INCOME SHIFTING THROUGH A SUBCHAPTER S CORPORATION\*

### INTRODUCTION

A reduction in a family's overall federal income tax liability can frequently be accomplished by shifting income from high to low bracket family members. Under general tax principles, if a taxpayer transfers title to property to a donee, the income from that property is thereafter taxed to the donee.<sup>1</sup> Thus, in the corporate context, a high bracket shareholder might transfer title to some of his stock to his low bracket child in an attempt to insure that future income from the stock will thereafter be taxed to the child. A Subchapter S corporation is a particularly useful vehicle for achieving this goal. This Comment will examine the basic advantages of using the Subchapter S format, and explore in some detail the pitfalls that must be avoided in order to make the best use of a Subchapter S income splitting arrangement.

### WHY INCOME SPLITTING IS MORE EFFECTIVELY ACHIEVED UNDER A SUBCHAPTER S FORMAT THAN A SUBCHAPTER C FORMAT

#### A. *General Income Shifting Considerations*

The goal in an income splitting scheme is to transfer to a low bracket taxpayer income that would have been taxed to a high bracket taxpayer. In a Subchapter S corporation, gains escape taxation at the corporate level and are taxed immediately to the shareholders, whether or not they are in fact distributed to the shareholders.<sup>2</sup> This direct flow of gains to the shareholders makes a Subchapter S corporation a very effective means of shifting income. For example, a father in the fifty percent bracket<sup>3</sup> who owns all of the stock of a Subchapter S corporation that earns \$80,000 net income while paying the father a reasonable salary of \$20,000, will be taxed a total of \$50,000. If, on the other hand, he transfers one-half of the stock to his son, a twenty percent taxpayer, the total taxes paid will be \$38,000, computed as follows: the father is taxed \$30,000 (fifty percent of \$40,000 net earnings and \$20,000 of salary), and the son is taxed \$8,000 (twenty percent of the \$40,000 net earnings to which his stock ownership entitles him). Thus, \$12,000 can be saved through this simple stock transfer.

In a Subchapter C corporation, the transfer of stock to a low bracket taxpayer may not yield such noticeable tax savings. In this type of

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\* The author would like to thank Professor Robert I. Keller for his great assistance in the preparation of this Comment.

1. See, e.g., *Helvering v. Horst*, 311 U.S. 112 (1940).

2. See I.R.C. § 1373(a), which states that "[t]he undistributed taxable income of an election [Subchapter S] corporation for any taxable year shall be included in the gross income of the shareholders of such corporation . . . ."

3. For the sake of simplicity, it will be assumed that all tax rates mentioned in this Comment are the marginal rates of the respective taxpayers.

corporation, there are potentially two levels of taxation — one at the corporate level and one at the shareholder level. Although the net earnings will always be taxed at the corporate level, they are not taxed to the shareholders until they are distributed in the form of dividends.<sup>4</sup> Withholding the immediate distribution of dividends to the taxpayers may actually be better tax planning than the allocation of stock to lower bracket holders followed by the payment of dividends, because the payment of dividends creates an immediate ordinary income tax liability that would not otherwise exist. If the earnings are instead kept inside the corporation until the shares are redeemed or sold, or until the corporation is liquidated, the taxpayer and his transferees will be taxed at the lower capital gains rate.<sup>5</sup> This strategy would also provide a deferral of the tax liability to the shareholders.

Of course, if for some non-tax reason, the stockholders of a Subchapter C corporation desire the distribution of some or all of the corporate earnings, the allocation of stock to lower bracket family members will result in some tax savings. The preceding discussion merely illustrates that such a distribution forces the payment of a double tax when only the corporate tax liability is necessary. In contrast, a Subchapter S corporation involves only one level of immediate taxation, so the possibility of accumulating profits to obtain capital gains treatment and deferrals is not a viable alternative.

#### *B. Allocation of Salary as an Income Shifting Device*

It has generally been held that earned income cannot be assigned to another taxpayer.<sup>6</sup> However, under a Subchapter S format the allocation of earned income to a low bracket taxpayer might be accomplished if a high bracket shareholder-employee reduces his salary after having transferred some of his stock to a low bracket taxpayer. The salary reduction makes available more corporate earnings that can then be allocated to low bracket shareholders, thereby lowering the total tax liability.

For example, if a father who is a fifty percent taxpayer and his son, who is in the twenty percent bracket, each own one-half of a Subchapter S corporation's stock, and the corporation earns \$80,000 net income and pays the father a salary of \$20,000, the total tax liability of father and son would be \$38,000. If, on the other hand, the father reduces his salary by \$10,000, he simultaneously raises the corporate earnings by \$10,000, and half of this gain is allocated to the son. As a result, the total taxes are reduced to \$36,500 — \$27,500 paid by the father, and \$9,000 by the son.

This salary reduction device does not result in such tax savings in a Subchapter C corporation. If the father and son are each fifty percent

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4. Section 11 of the Internal Revenue Code states that "[a] tax is hereby imposed for each taxable year on the taxable income of every corporation." When the net earnings of a corporation are distributed to the shareholders as dividends, they are taxed to the shareholders. I.R.C. § 61(7). Thus, the corporate earnings distributed as dividends are subject to a double tax, except for the first \$100 of dividends of domestic corporations which are excluded from the taxpayer's income under § 116 of the Code.

5. See I.R.C. §§ 302, 1222, and 331 as to tax treatment of redemptions, sales, and liquidations respectively.

6. See, e.g., *Lucas v. Earl*, 281 U.S. 111 (1930).

shareholders in a corporation taxed at a rate of forty-eight percent, a \$10,000 salary reduction would lower the father's tax bill by \$5,000, but would increase the corporation's income by \$10,000, producing an additional corporate tax liability of \$4,800. Thus, there would be only a relatively small tax savings resulting from the reduction of salary because the reduction of the father's personal tax is almost completely offset by the increase in the tax levied on the corporation.<sup>7</sup> If the remaining \$5,200 is then distributed to the father and his son, each will pay an income tax on the dividend for a total tax of \$6,620 on the salary redistribution (\$1,820 income tax plus \$4,800 corporate tax).

The advantages of using the Subchapter S corporation as a vehicle for family income splitting are thus apparent, but it must be noted that this tax-planning strategy is subject to two important judicial and statutory constraints. The first constraint is the requirement that the stock transfer be bona fide; the second involves the use of sections 1375(c) and 482 of the Internal Revenue Code to limit the manipulation of salary in an income-splitting scheme.

#### MAINTAINING THE BONA FIDES OF THE STOCK TRANSFER

In order to achieve the desired income splitting under a Subchapter S corporation, it is necessary to insure that the transfer of stock will be treated as a bona fide gift by the courts. Otherwise, the income distribution plan will fail if challenged by the Internal Revenue Service.

The landmark Supreme Court decision in *Helvering v. Clifford*<sup>8</sup> established the rule that the party who controls an asset will be taxed on the income arising from it, despite his attempts to shift the ownership of that income.<sup>9</sup> In *Clifford*, the grantor created a trust for the benefit of his wife that was to terminate at the end of five years, at which time the corpus would be paid over to the grantor as remainderman. The grantor also appointed himself the sole trustee with exclusive powers to sell, exchange, mortgage or pledge any of the trust property, to reinvest the property or the income therefrom, and to compromise any claims held by him as trustee. In addition, an exculpatory clause purported to protect him from all losses except those occasioned by his own wilful and deliberate breach of duties as trustee.<sup>10</sup>

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7. Of course, if the corporation were taxed at a lower rate there would not be the almost complete offset illustrated by this example. However, the fact that there is, in the Subchapter C situation, a separate corporate tax on salary not taken by the high bracket taxpayer, means that more taxes will be paid in the Subchapter C situation than when a Subchapter S corporation is used. Therefore, the income-shifting effect of the reduction in salary will be less in a Subchapter S corporation.

8. 309 U.S. 331 (1940).

9. For a general discussion of *Helvering v. Clifford* and the tax consequences of short term, revocable and irrevocable trusts, see Note, *The Income Tax on Short Term and Revocable Trusts*, 53 HARV. L. REV. 1322 (1940); Note, *Irrevocable Trusts and the Federal Income Tax*, 49 YALE L. J. 1305 (1940).

10. 309 U.S. at 332-33.

On these facts the Court held that the grantor, not his wife, was the owner of the trust and hence taxable on the trust income, stating that "the short duration of the trust, the fact that the wife was the beneficiary and the retention of control over the corpus by the [taxpayer] lead irresistibly to the conclusion that [the taxpayer] continued to be the owner" of the trust property.<sup>11</sup> The Court further stated that the trust was

at best a temporary reallocation of income within an intimate family group. Since the income remains in the family and since the husband retains control over the investment, he has rather complete assurance that the trust will not effect any change in his economic position. . . . [W]hen the benefits flowing to him directly through the wife are added to the legal rights he retained, the aggregate may be said to be a fair equivalent of what he previously had.<sup>12</sup>

The principle enunciated in *Clifford* is directly applicable to the question of who is the proper party to be taxed on the earnings of a Subchapter S corporation. When a taxpayer transfers legal title in corporate stock to a family member but still retains the true "economic ownership" of the stock, he, not the transferee, will be taxed on any earnings attributable thereto. In such a situation, the Service and the courts will look to the substantive realities of the transferor's control of the stock despite the transferee's nominal ownership. On the other hand, when the transferor parts with the real benefits of stock ownership rather than just the bare legal title, the transferee will be held to be the proper party to bear the burden of taxation. The necessity of a bona fide stock transfer in the Subchapter S context has been codified by a Treasury Regulation that states:

A donee or purchaser of stock in the [Subchapter S] corporation is not considered a shareholder unless such stock is acquired in a bona fide transaction and the donee or purchaser is the real owner of such stock. The circumstances, not only as of the time of the purported transfer but also during the periods preceding and following it, will be taken into consideration in determining the bona fides of the transfer. Transactions between members of a family will be closely scrutinized.<sup>13</sup>

Three major United States Tax Court decisions have dealt with the question of the bona fides of a stock transfer under a Subchapter S corporation. The first such case was *Duarte v. Commissioner*,<sup>14</sup> a case in which the taxpayer operated a business supplying temporary office personnel as well as several office-related services. At the time of incorporation, all of the stock was issued to the taxpayer. The taxpayer transferred twenty-five percent of the corporation's stock to each of his two children and shortly thereafter the corporation elected to be taxed as a Subchapter S corporation.

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11. *Id.* at 335.

12. *Id.* at 335-36.

13. Treas. Reg. § 1.1373-1(a)(2) (1960).

14. 44 T.C. 193 (1965).

The taxpayer's wife, the mother of the stockholding children, was then appointed as custodian of the children's shares.<sup>15</sup> Shortly thereafter, the corporation, in an apparent attempt to split some of the income generated by the corporation, reduced the taxpayer's salary from \$30,000 per year to \$15,000 per year. In addition, although the records showed that nearly all of the \$100,000 of corporate income had been distributed proportionately to the shareholders, no money had ever been received by the children, and the taxpayer could not satisfactorily explain what happened to the money. In fact, no custodial accounts had been opened for the children, and although tax returns were filed for the children by the parents, the taxes were paid out of the taxpayer's checking account.<sup>16</sup> On these facts the court found that the purported transfers of stock to the two children lacked economic reality. Because neither the children nor their mother (as custodian of their shares) had any influence in the operations of the corporation, and because the taxpayer-father was thus the true economic owner of all of the stock, all of the corporation's income was taxed to the father.<sup>17</sup>

The second Tax Court case in this area was *Beirne v. Commissioner*.<sup>18</sup> In *Beirne*, the taxpayer formed a corporation and issued thirty percent of its shares to each of his three children, retaining ten percent for himself. When a fourth child was born to the taxpayer, he gave that child a proportionate interest in the company equal to that of his other children by requiring the older children to donate a portion of their shares to the newly born child. The taxpayer's wife was named custodian of the children's shares, and shortly thereafter a Subchapter S election was made. During the period from 1960 to 1965, the corporation earned about \$130,000. Although the children each year reported taxable income equal to their proportionate holdings in the corporation, the only distributions actually made to the children's bank accounts by the corporation were for the payment of their income taxes. On the other hand, the taxpayer-father, ostensibly a ten-percent shareholder, received over \$72,000 in unsecured advances from the corporation during the same period.<sup>19</sup>

In ruling that all of the income earned by the corporation was taxable to the taxpayer-father, the court followed *Duarte*, reasoning that the transfers lacked economic reality. As it did in *Duarte*, the Tax Court first noted that there was no evidence that either the children or their mother as custodian, had any influence in the affairs of the corporation. Their complete lack of influence was viewed by the court as strong evidence that the petitioner controlled the company.<sup>20</sup> Moreover, the manner in which the father readjusted the children's stock holdings when the new child was born — his ability to direct the children to transfer their shares to the new child —

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15. *Id.* at 194-95.

16. *Id.* at 195-96.

17. *Id.* at 197.

18. 52 T.C. 210 (1969).

19. *Id.* at 211-15.

20. *Id.* at 218-19.

further convinced the court of the taxpayer's continued control of the shares.<sup>21</sup>

Finally, the opinion focused on the disposition of the corporation's earnings. As previously stated, of the \$130,000 earned by the corporation in the tax years in question (1960-1965), only \$22,000 was distributed to the children — and these distributions were made *only* for the payment of their income taxes. The bulk of these earnings, \$72,000, was borrowed by the taxpayer for his personal use. These loans were unsecured and the taxpayer made only erratic repayments. By 1965 only \$17,000 of the \$72,000 had been repaid, and as the court noted, the manner of repayment of the principal and interest was less than bona fide. For example, the taxpayer partially repaid the unsecured advances by transferring to the corporation notes of questionable value that were issued by a financially troubled corporation of which he was a major stockholder. In another instance, the taxpayer financed an interest payment by borrowing the funds from the corporation. The court thus concluded that the taxpayer had no genuine intention of repaying the advances he obtained from the corporation. Because the taxpayer was reaping the benefits of complete corporate ownership without bearing the full burden of taxation, the court taxed all of the corporation's income to him.<sup>22</sup>

The third case decided by the Tax Court in this area, *Kirkpatrick v. Commissioner*,<sup>23</sup> exemplifies a successful shifting of income among family members in a Subchapter S corporation. In *Kirkpatrick*, the taxpayers apparently were aware of *Duarte* and *Beirne*, and fashioned the arrangement so as to avoid the errors made by the taxpayers in those cases and thereby prevent a finding that the stock transfers lacked economic reality.

The plaintiffs in *Kirkpatrick* were a husband and wife who had originally owned all of the corporation's stock, but gave ten percent of the stock to each of their three children. Three years later a fourth child was born to the taxpayers and he was also given ten percent of the corporation's stock out of the stockholdings of the parents. The mother was made custodian of the children's shares.<sup>24</sup> Although the children's proportionate share of corporate income from 1967 to 1972 was about \$195,000, none of this was distributed to them. Instead, these funds were distributed in large part to the taxpayer-father who used them to purchase real estate and to construct a building to house the corporation's principal offices, warehouses, and plant facilities. Other corporation proceeds were used to acquire real estate investments for the corporation.<sup>25</sup>

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21. *Id.*

22. *Id.* at 219-20. In *Beirne v. Commissioner*, 61 T.C. 268 (1973) ("*Beirne II*"), the Internal Revenue Service determined that there were additional income tax deficiencies for 1965 to 1967. Because it found the salient facts unchanged since the earlier decision, the court extended the taxpayer's full tax liability for the corporation's income through 1967. *Id.* at 277.

23. 36 T.C.M. (CCH) 1122 (1977).

24. *Id.* at 1123.

25. *Id.* at 1124.

Promissory notes for each of the children were prepared for the principal amount of their distributive shares of the corporation's 1967 to 1972 income, plus interest thereon, less the taxes paid on behalf of the children as a result of their reporting their shares of the taxable income from the corporation. These notes were secured by the taxpayers' shares of the corporation's stock, and were made payable to the mother as custodian for each of the four children. The petitioners financed the interest payments by borrowing from a local bank, and by the time of trial, \$95,000 of the \$195,000 principal and interest on the notes had been repaid.<sup>26</sup>

The children's custodian, their mother, had a very significant role in the company. As an officer and director, she was involved in all major corporate decisions. Moreover, because she wrote all of the checks for the company, she was aware of each withdrawal made by her husband, and was thus in a position to protect the interests of the children-shareholders.<sup>27</sup> The court in *Kirkpatrick* ultimately found that the children's stock ownership for the years in question did not lack economic substance, and in contrast to *Duarte* and *Beirne*, held that part of the income earned by the corporation during those years was taxable to the children according to their proportionate shares of the corporation's stock.<sup>28</sup> In reaching this decision, the Tax Court compared the facts in *Kirkpatrick* with those in *Duarte* and *Beirne*, focusing on four factors. The court's discussion of these factors greatly clarifies what it regards as a bona fide stock transfer that will be sustained as an income distribution device.

The first factor was whether the custodian was capable of exercising enough influence in the corporation to protect the interests of the children who were shareholders. The court noted that in *Duarte* and *Beirne* the custodians did not exercise any influence in the corporation and distinguished the case before it on the ground that the record showed that Mrs. Kirkpatrick exercised considerable influence over the affairs of the corporation — she "was an active custodian" quite capable of protecting the interests of her children.<sup>29</sup>

The second factor considered was whether the taxpayer-father exercised complete dominion over the corporate stock. In deciding that the father never controlled the ownership of his children's stock once it had been transferred to them, the court carefully distinguished its prior decision in *Beirne*. When the father in *Beirne* wanted to give some shares of the corporation to his newborn child, he caused each of his minor children to relinquish twenty-five percent of their stock. The *Kirkpatrick* court viewed this fact as strong evidence that Mr. Beirne had "retained the effective right to transfer ownership of stock in [the corporation] whenever and to whomever he desired,"<sup>30</sup> and noted that when the Kirkpatricks wanted to transfer the ownership of stock in their corporation to their newborn child, they used their own stock and did not "alter or dilute the proportionate

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26. *Id.* at 1123-24.

27. *Id.* at 1124.

28. *Id.*

29. *Id.* at 1126.

30. *Id.* at 1127.

ownership theretofore enjoyed by their other children."<sup>31</sup> Consequently, the court had no difficulty in concluding that Mr. Kirkpatrick did not exercise complete dominion and control over his children's shares.

A third factor, whether the father retained the economic enjoyment of the benefits of ownership of the children's stock by failing to distribute corporate earnings to the children, was also relied upon in distinguishing *Duarte* and *Beirne*. In *Duarte*, where the children did not receive any of the money that the corporation reported as having been distributed to them, and the taxpayer could not explain what had happened to that money; the taxpayer had apparently appropriated his children's pro-rata share of corporate earnings for his own purposes. He was therefore taxed on those earnings. Similarly, in *Beirne*, the father, a purported ten-percent shareholder, secured over one-half of the corporate earnings by borrowing on an open account from the corporation for non-corporate purposes, and he was held to have enjoyed the economic benefits of ownership of the children's stock. In *Kirkpatrick*, the court recognized that the father received cash distributions that represented a part of the children's share of undistributed income, but did not believe that the father's actions deprived his children of the economic enjoyment of owning their stock. The court stated that the failure of the corporation to distribute the earnings to the children was not significant, because the children were too young to make use of the money. To determine whether the children received the actual enjoyment of the corporate earnings for which they were taxed, the court looked at the use made of the money and the manner in which the children's interests were safeguarded. Mr. Kirkpatrick used the money to construct corporate headquarters and to make corporate real estate investments. The court held that this use of the corporate earnings "benefited the children by increasing the overall worth of the corporation, since the children, as stockholders, share in the corporation's increased net worth and profits."<sup>32</sup>

Finally, the court viewed the fact that Mr. Kirkpatrick made out promissory notes to the children's custodian in an amount equal to the money due them, thereby acknowledging that the funds belonged to the children rather than the taxpayer, as evidence of the economic reality of the transfer. Although no such note was issued for one of the tax years in question, the court held that in view of all of the facts the lack of the promissory note did not bar the existence of the debt. Further, the taxpayers' failure to establish bank accounts for their children was not viewed as controlling.

In summary, it is evident that in setting out and analyzing the factors that the Tax Court will scrutinize in deciding whether a transfer will be upheld as bona fide, *Kirkpatrick* is a useful tax-planning guide to the shifting of income in Subchapter S corporations. The court's emphasis of each of the four factors demonstrates that the form of the transaction is crucial to establishing the validity of the transfers, and it would appear that

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31. *Id.*

32. *Id.* at 1127-28.

strict adherence to the form used in *Kirkpatrick* will result in a "safe harbor" for the taxpayer-transferor. On the other hand, it is unclear from *Kirkpatrick* how much divergence from the form employed there will be tolerated by the Tax Court. It is not clear, for example, whether a parent will be able to make use of his children's funds for *non-business* purposes if formal promissory notes are executed, or whether the custodian must be a director or officer of the corporation to be deemed able to protect the children's interests. These and similar questions will keep tax planners guessing in this area for some time to come.

#### ESTABLISHING THE REASONABLENESS OF THE TAXPAYER'S SALARY

In addition to being susceptible to an Internal Revenue Service attack for not transferring the stock in a bona fide transaction, a taxpayer who splits his income under a Subchapter S arrangement faces the danger that the Service will attempt to reduce the income distribution effect by redesignating a portion of the corporation's taxable income as salary of the transferor. A taxpayer can maximize his income allocation under a Subchapter S arrangement by reducing his salary, thereby raising the corporation's earnings and increasing the allocation to the low bracket taxpayers.<sup>33</sup> In an attempt to deal with this particular situation, section 1375(c) of the Internal Revenue Code provides:

Any dividend received by a shareholder from [a Subchapter S corporation] may be apportioned or allocated by the Secretary . . . between or among shareholders of such corporation who are members of such shareholder's family . . . if he determines that such apportionment or allocation is necessary in order to reflect the value of services rendered to the corporation.

If a court agrees with the need for reallocation, some or all of the corporate income may be shifted back into the transferor's higher tax bracket. Under section 1375(c), the salary of a shareholder-employee may be raised to an "amount that would ordinarily be paid in order to obtain comparable services from a person not having an interest in the corporation."<sup>34</sup>

*Roob v. Commissioner*<sup>35</sup> was the first case decided under section 1375(c) in which the Service's reallocation from dividend to salary was sustained by the Tax Court. In that case, the taxpayer and his wife had elected Subchapter S status for their photography business. They and their seven children each owned equal amounts of the corporation's stock. The bona fides of the stock transfers to their minor children was not challenged, apparently because the income attributable to the children's shares was distributed to the children's bank accounts.<sup>36</sup>

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33. See pp. 810-11 *supra*.

34. Treas. Reg. § 1.1375-3(a) (1960).

35. 50 T.C. 891 (1968).

36. *Id.* at 892-93.

Mr. and Mrs. Roob each earned \$10,000 in 1962 and \$12,000 in 1963 and 1964 while working full time for the corporation. During those years the corporation earned and distributed to its shareholders a net income of \$9,429.71, \$4,759.72, and \$24,506.69, respectively. In asserting a deficiency, the Commissioner stated that Mr. Roob's salary should be increased by \$4,000 in 1962, \$5,000 in 1963, and \$8,000 in 1964. This allocation obviously caused a substantial decrease in the amount of income distributed to the children through the corporation.<sup>37</sup>

In sustaining the Commissioner's application of section 1375(c), the court relied on the same factors it would normally consider in determining the reasonableness of salary under section 162(a)(1), which permits business deductions based on "a reasonable allowance for salaries or other compensation for personal services actually rendered": the nature of the services performed, the responsibilities involved, the time spent, the size and complexity of the business, prevailing economic conditions, compensation paid by comparable firms for comparable services, and salary paid to company officers in prior years.<sup>38</sup> With respect to its determination of reasonableness in accordance with these criteria, the court imposed the following burden of persuasion on Mr. Roob:

In determining the correctness of [an] . . . allocation [pursuant to section 1375(c)] and the resulting deficiency, we must recognize that respondent's determination carries with it a presumption of correctness and that in order for petitioners to prevail, they must prove by a preponderance of the evidence that the determination is incorrect.<sup>39</sup>

In an attempt to meet this burden, the petitioner introduced a statistical survey compiled by a professional photographer's society that purported to indicate a percentage relationship between the owner's salary and sales of several hundred portrait and commercial studio owners and operators. The court dismissed the validity of this survey, however, because only a small percentage of the photographers contacted actually participated in the survey.<sup>40</sup> Without any other reliable evidence from which it could determine the reasonableness of Mr. Roob's salary during the years in question, the court felt compelled to sustain the IRS's section 1375(c) allocation.<sup>41</sup>

*Rocco v. Commissioner*,<sup>42</sup> on the other hand, was a case in which the taxpayers were able to convince the court that the amount of compensation received from their Subchapter S corporations was fair and reasonable so that a section 1375(c) adjustment was not permitted. Two taxpayers had each formed separate Subchapter S corporations to manage certain apartment buildings. Each taxpayer owned four percent of his corporation's

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37. *Id.* at 894-95.

38. *Id.* at 898.

39. *Id.*

40. *Id.* at 900.

41. *Id.*

42. 57 T.C. 826 (1972).

stock and worked about ten hours a week for his corporation. During the tax year in question, each took an extended vacation in Florida. For their services to their corporations, the taxpayers were paid salaries of \$14,950 and \$11,960 respectively, and had each received \$12,000 for similar services in the previous year.<sup>43</sup>

On these facts, the IRS sought to invoke section 1375(c), arguing that the proper salary for such services should have been \$35,000 per year for each taxpayer, and sought to increase the taxpayers' burden of persuasion from the preponderance of the evidence rule applied in *Roob* to a requirement that they prove the Service's determination was unreasonable, arbitrary, and capricious. This increased burden would have been similar to the standard employed in determining reasonableness under section 482,<sup>44</sup> but the court did not reach the issue of the appropriate standard of proof, deciding instead that the Service's allocation could not be upheld under either standard.<sup>45</sup>

In reaching this decision, the court noted the largely ministerial nature of the taxpayers' responsibilities and the fact that only a few hours of service were rendered each week. In addition, it gave weight to the testimony of the taxpayers and their accountants that they could have hired competent individuals who were not related to the corporation to perform these tasks at less than half of the salary they received, and noted that the Service had "presented no testimony to refute petitioners' evidence as to the amount that would ordinarily be paid in order to obtain comparable services from a person not having an interest in the corporation."<sup>46</sup> The court thus held that the salaries received by the taxpayers fairly reflected the values of the services they performed, and that the Service's allocation could therefore not be sustained.<sup>47</sup>

As noted previously, the Tax Court in *Rocco* withheld any decision on what burden of proof must be met in order to discredit the Commissioner's section 1375(c) allocation. That is, it did not decide whether the taxpayer must prove that the Commissioner erroneously allocated the salary by a preponderance of the evidence, as in *Roob*, or whether he must prove, as he must under section 482, that the Commissioner abused his discretion,<sup>48</sup> a higher standard of proof. If section 1375(c) is deemed to be an exclusive section, that is, the only section of the Code that can be utilized in the situation to which it applies, the determination of the proper burden of proof may be critical in deciding the fate of many taxpayers. If, however, section 482 is held to be available to the Commissioner when his reallocation of salary in a family-owned Subchapter S corporation is challenged, the fact

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43. *Id.* at 827-30.

44. See text accompanying note 48 *infra*.

45. *Id.* at 832-33. The burden of proof question was also left open in at least one subsequent case, *Davis v. Commissioner*, 64 T.C. 1034 (1975).

46. *Id.* at 833 (quoting Treas. Reg. § 1.1375-3(2) (1960)).

47. 57 T.C. at 833.

48. See, e.g., *Grenada Indus., Inc.*, 17 T.C. 231, 255 (1951), *aff'd*, 202 F.2d 873 (5th Cir.), *cert. denied*, 346 U.S. 819 (1953).

that a lower standard of proof is applied under section 1375(c) will be of little consequence because the Commissioner will always be able to resort to section 482's more favorable standard.

Section 482 of the Internal Revenue Code provides that:

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

In the case of family income splitting through a Subchapter S corporation, the corporation is normally the only business involved. Thus, on its face, section 482 appears to be inapplicable because it speaks of "two or more organizations, trades or businesses." Moreover, the legislative history of that section indicates a Congressional intention to limit section 482's coverage to cases in which there are two or more businesses.<sup>49</sup> If Congress had intended to include individuals, the provisions could easily have referred to "persons" instead of terms that do not literally or logically include individuals.<sup>50</sup> Nevertheless, the Commissioner has repeatedly been successful in his attempts to extend section 482's coverage to cases involving a business and an individual between whom he hopes to effect a distribution or allocation of income.<sup>51</sup> Thus, the two-business requirement will often not be a bar to the application of section 482.

There are two other preconditions, in addition to the two-business requirement, to the application of section 482. The first is that the taxpayer be in control of both "businesses." In the case of a Subchapter S corporation this merely means that the taxpayer controls the corporation, as it must be assumed that he controls himself. The other precondition is that the allocation be necessary to clearly reflect income or to prevent the evasion of taxes. In other words, the IRS must prove that the allocation is justified.<sup>52</sup>

The decision of the Court of Appeals for the Second Circuit in *Rubin v. Commissioner*<sup>53</sup> may shed some light on the question whether section 482 will be held applicable in cases to which section 1375(c) also applies. Stated

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49. The House Ways and Means Committee stated, in its report, that the reason for inserting the term "organizations" into § 482 was "to remove any doubt as to the application of this section to all kinds of *business activity*." H.R. REP. NO. 704, 73d Cong., 2d Sess. 24 (1934), *reprinted in* 1939-1 (part 2) C.B. 554, 572 (emphasis added).

50. J. LEWIS, ALLOCATIONS (SEC. 482) — GENERAL COVERAGE A-3 (BNA Tax Mngm't Portfolio No. 327, 1978).

51. *See, e.g.,* Borge v. Commissioner, 405 F.2d 673 (2d Cir. 1968), *cert. denied*, 395 U.S. 933 (1969); Ach v. Commissioner, 42 T.C. 114 (1964), *aff'd*, 358 F.2d 342 (6th Cir.), *cert. denied*, 385 U.S. 899 (1966).

52. I.R.C. § 482.

53. 429 F.2d 650 (2d Cir. 1970), *rev'g and remanding*, 51 T.C. 251 (1968).

briefly, the Service in *Rubin* argued that both sections 61<sup>54</sup> and 482 require that a corporation's controlling stockholder be taxed for the income owned by his corporation. The Tax Court decided that the income was attributable to Rubin under section 61 and therefore did not consider whether section 482 required a similar result.<sup>55</sup> On appeal, the Second Circuit held that the Tax Court erred in relying on section 61, rather than section 482. The court reasoned that section 482 was much more clearly intended to deal with the problem presented and concluded that "[r]esort to Section 482 is clearly superior to the blunt tool [of Section 61] employed by the Tax Court."<sup>56</sup>

It is quite conceivable that the analysis employed by the Second Circuit in *Rubin* could be extended to preclude reliance on section 482 when section 1375(c) is also applicable.<sup>57</sup> There can be no doubt that section 482 may be characterized as a "blunt tool" when compared with the specificity of section 1375(c). While section 482 applies "in any case of two or more . . . businesses . . . owned or controlled directly . . . by the same interests . . .," section 1375(c) applies only in the case of a family-owned Subchapter S corporation. Moreover, section 1375(c) was enacted over thirty years after the enactment of section 482,<sup>58</sup> thereby, perhaps, evincing a Congressional intent that it, rather than section 482, should govern the Commissioner's allocation in family-owned Subchapter S corporations.

There is one situation in which very little doubt exists that the Commissioner will be able to use section 482 to achieve an allocation of salary from a Subchapter S corporation to a controlling shareholder. Because section 1375(c) speaks only in terms of allocations among shareholders, and there are no rules of constructive stock ownership applicable to section 1375(c), that provision is apparently inapplicable when the taxpayer has transferred all of his stock to family members. In such a situation, section 482 should without question be applicable to insure a "proper" allocation of salary.

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54. I.R.C. §61 is a broadly phrased section that defines income. This section incorporates much of what has been called the common law of taxation. See Brown, *The Growing "Common Law" of Taxation*, 34 S. CAL. L. REV. 235 (1961). In *Rubin*, the Commissioner relied on § 61's incorporation of the *Lucas* doctrine which states that income is taxed to the true earner thereof. *Lucas v. Earl*, 281 U.S. 111 (1930).

55. 51 T.C. 251 (1968), *rev'd and remanded*, 429 F.2d 650 (2d Cir. 1970).

56. 429 F.2d at 653.

57. It should be noted, however, that the Tax Court has apparently rejected the reasoning of the *Rubin* court in certain circumstances. In *Fogelson v. Commissioner*, 35 T.C.M. 1309 (CCH) (1976), the court employed "the so-called 'common law' doctrine of assignment of income and section 61" to a situation in which § 482 could have been applied. In so doing, the court recognized that in *Rubin* the Second Circuit held that the use of § 61 "is inappropriate where there is a specific statutory provision, namely section 482, adequate to deal with the problem." *Id.* at 1312 n.2. Because *Fogelson* was not appealable to the Second Circuit, the court refused to shift the basis of its holding from § 61 to § 482.

58. Provisions similar to § 482 were contained in Int. Rev. Code of 1939, ch. 1, § 45, 52 Stat. 474. I.R.C. § 1375(c) was enacted in 1958.

## CONCLUSION

There is no doubt that a properly structured stock allocation plan can yield large tax savings to a family that controls a Subchapter S corporation. To have a plan in which the transfers will be deemed valid by the courts, the formal requirements of *Kirkpatrick* should be followed as closely as possible. In addition, the salary taken by the controlling shareholder should be comparable to compensation paid by similar firms for similar services, to avoid a section 1375(c) allocation. Because it is not certain which burden of proof will be imposed upon the taxpayer in the section 1375(c) situation, it would seem advisable to plan for the worst and assume that the harsher section 482 burden will be applied in any such action.