Keller v. Commissioner, 77 T. C. 1014 (1981)

Section 482 of the Internal Revenue Code can be used to allocate income between a one-man professional corporation and its sole shareholder-employee to reflect an arm's-length transaction.

Summary

Dr. Daniel F. Keller formed a one-man professional corporation to provide pathology services and established a pension plan. The IRS attempted to allocate all corporate income to Keller under Section 482. The Tax Court held that while the total compensation (salary, pension contributions, and medical benefits) paid to Keller by the corporation approximated what he would have received as a sole proprietor, income from another corporation should be directly taxable to Keller for 1974. This case highlights the application of Section 482 to prevent tax evasion while recognizing the validity of one-man professional corporations.

Facts

Dr. Daniel F. Keller, a pathologist, formed a professional corporation (Keller, Inc.) in 1973 to provide pathology services through a partnership (MAL) and receive compensation from another corporation (MAL, Inc.). Keller, Inc. adopted a defined benefit pension plan and a medical reimbursement plan. The IRS attempted to allocate all of Keller, Inc. 's income to Keller under Section 482, arguing that Keller, Inc. was merely a conduit for Keller's income.

Procedural History

Keller and his wife filed a petition in the United States Tax Court challenging the IRS's determination of deficiencies in their income tax for 1974 and 1975. The Tax Court considered the applicability of Section 482 and the assignment of income doctrine to the income received by Keller, Inc.

Issue(s)

1. Whether Section 482 of the Internal Revenue Code allows the IRS to allocate all income received by Keller, Inc. to Dr. Keller?
2. Whether the income from MAL, Inc. in 1974 should be taxable directly to Dr. Keller?

Holding

1. No, because the total compensation paid to Keller by Keller, Inc. (salary, pension contributions, and medical benefits) was substantially equivalent to what he would have received absent the corporation, reflecting an arm's-length transaction.
2. Yes, because the checks from MAL, Inc. were issued to Keller individually in 1974, and he remained the true earner of that income.

Court's Reasoning

The Tax Court applied Section 482 to allocate income between Keller, Inc. and Keller based on whether the financial arrangements would have been entered into by unrelated parties at arm's length. The court found that the total compensation to Keller approximated what he would have earned without the corporation, satisfying the arm's-length test. However, income from MAL, Inc. in 1974 was taxable to Keller because he was the true earner of that income before the corporation was substituted as the recipient. The court also addressed the assignment of income doctrine, finding it inapplicable because Keller, Inc. conducted business activities and was not merely a conduit for Keller's income. The dissenting opinion argued that Keller, Inc. was an empty shell and that Keller was the true earner of all the income, advocating for the application of the assignment of income doctrine.

Practical Implications

This decision establishes that Section 482 can be applied to one-man professional corporations to allocate income between the corporation and its sole shareholder-employee, but it does not allow for the disregard of the corporate entity if it conducts business. Practitioners should ensure that compensation arrangements reflect arm's-length transactions. The ruling also clarifies that income earned before a corporation is substituted as the recipient remains taxable to the individual. Subsequent cases have distinguished this ruling when corporations are found to be mere conduits or shams. This case has implications for tax planning involving professional corporations and the structuring of compensation packages, including pension and medical benefits.

