Foglesong v. Commissioner, 77 T. C. 1102 (1981)

Section 482 of the Internal Revenue Code may be used to allocate income between a controlling shareholder and their controlled corporation when transactions do not reflect arm's-length dealings.

Summary

Frederick H. Foglesong, the controlling shareholder and sole income-generating employee of his personal service corporation, incorporated to split his income and limit liability. Initially, the Tax Court held the corporation's income taxable to Foglesong under Section 61, but the Seventh Circuit reversed, remanding for reconsideration under Section 482. On remand, the Tax Court upheld the Commissioner's reallocation of 98% of the corporation's net commission income to Foglesong, as his total remuneration did not reflect an arm's-length transaction. The decision emphasizes the application of Section 482 to ensure income is clearly reflected when transactions between related parties deviate from those of unrelated parties.

Facts

Frederick H. Foglesong, a real estate broker, incorporated his business to split his income between himself and the corporation, limit his liability, and diversify his business. He was the controlling shareholder and sole income-generating employee of the corporation. The corporation's net commission income was substantial, and Foglesong received a salary that was significantly less than the total income he would have earned had he not incorporated. The Commissioner of Internal Revenue sought to allocate 98% of the corporation's net commission income to Foglesong.

Procedural History

The Tax Court initially held that 98% of the corporation's income was taxable to Foglesong under Section 61 and the assignment of income doctrine. This decision was appealed and reversed by the Seventh Circuit Court of Appeals, which remanded the case for reconsideration under Section 482. On remand, the Tax Court upheld the Commissioner's reallocation of income under Section 482.

Issue(s)

1. Whether Section 482 can be applied to allocate income between a controlling shareholder and their controlled corporation.
2. Whether the Commissioner's allocation of 98% of the corporation's net commission income to Foglesong was arbitrary, capricious, or unreasonable.

Holding

1. Yes, because Section 482 is designed to encompass all kinds of business activity

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and can be applied to transactions between a controlling shareholder and their controlled corporation.
2. No, because Foglesong's total remuneration from the corporation did not reflect an arm's-length transaction, and he failed to prove the Commissioner's determination was arbitrary, capricious, or unreasonable.

Court's Reasoning

The Tax Court applied Section 482, which authorizes the Commissioner to allocate income between controlled entities to clearly reflect income or prevent tax evasion. The court rejected Foglesong's argument that Section 482 could not apply to him as an employee, citing the broad scope of the section and its application to any entity with independent tax significance. The court followed precedent from *Keller v. Commissioner* and *Achiro v. Commissioner*, which held that Section 482 could be used to allocate income between a controlling shareholder and their controlled corporation. The court found that Foglesong's transactions with the corporation did not reflect arm's-length dealings, as his total remuneration was significantly less than his worth to the corporation. The court emphasized that the Commissioner's determination must be upheld unless proven arbitrary, capricious, or unreasonable, which Foglesong failed to do.

Practical Implications

This decision clarifies that Section 482 can be used to allocate income between a controlling shareholder and their controlled corporation when transactions do not reflect arm's-length dealings. Practitioners should advise clients that incorporating a personal service business solely to split income may trigger Section 482 reallocations if the shareholder's total remuneration does not reflect their worth to the corporation. The decision encourages the use of the corporate form for legitimate business purposes, such as providing benefits, but warns against using it solely for tax avoidance. Subsequent cases have applied this ruling to similar situations, emphasizing the importance of arm's-length transactions between related parties.

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