Bernard L. Pacella and Theresa Pacella v. Commissioner of Internal Revenue, 78 T. C. 604, 1982 U. S. Tax Ct. LEXIS 111, 78 T. C. No. 42 (1982)

The income of a validly operating professional corporation should not be reallocated to its shareholder-employee under Section 482 if the corporation's compensation reflects arm's-length dealing.

Summary

Dr. Pacella incorporated his clinical psychiatric practice, transferring his private practice assets to the corporation in exchange for stock. The IRS sought to reallocate the corporation's income to Dr. Pacella under Section 482, arguing the corporation was a sham. The Tax Court held that the corporation was validly organized and operated, and the compensation Dr. Pacella received was commensurate with what he would have received as a sole proprietor, rejecting the IRS's reallocation as arbitrary and capricious. This case illustrates the importance of respecting corporate formalities and ensuring compensation reflects arm's-length dealing to maintain the tax benefits of a professional corporation.

Facts

Dr. Pacella, a psychiatrist, incorporated his clinical psychiatric practice in 1970, transferring assets to Bernard Pacella, M. D. , P. C. in exchange for all 100 shares of stock. He entered into an exclusive employment contract with the corporation. The corporation billed private patients and Regent Hospital, another of Dr. Pacella's businesses, for his services. The IRS challenged the corporation's validity and sought to reallocate its income to Dr. Pacella, arguing the corporation did not engage in business and the compensation arrangement was not arm's-length.

Procedural History

The IRS issued a deficiency notice to Dr. Pacella for the years 1971-1973, seeking to reallocate the corporation's income to him. Dr. Pacella petitioned the U. S. Tax Court, which held a trial and ultimately ruled in his favor, finding the corporation validly operated and the compensation arrangement appropriate.

Issue(s)

1. Whether the income of Dr. Pacella's professional corporation should be reallocated to him under Section 482 of the Internal Revenue Code.
2. Whether Regent Hospital could deduct payments made to the corporation for Dr. Pacella's services.

Holding

1. No, because the corporation was validly organized and operated as a separate business entity, and Dr. Pacella's compensation reflected arm's-length dealing.

2. Yes, because the payments from Regent Hospital to the corporation for Dr. Pacella’s services were at arm’s-length rates.

Court’s Reasoning

The court applied Section 482, which allows the IRS to reallocate income among related taxpayers to prevent tax evasion or clearly reflect income. However, the court found that the corporation conducted business, as evidenced by its employment of staff, payment of expenses, and provision of services to patients and Regent Hospital. The court rejected the IRS’s argument that the absence of written contracts with patients and Regent Hospital negated the corporation’s business status. The court also found that Dr. Pacella’s total compensation, including salary and pension contributions, was commensurate with what he would have received as a sole proprietor, indicating an arm’s-length arrangement. The court relied on *Keller v. Commissioner* (77 T. C. 1014 (1981)), which established that a professional corporation’s income should not be reallocated if the corporation is validly organized and the compensation reflects arm’s-length dealing. The court also rejected the IRS’s attempt to use ink analysis to challenge the authenticity of corporate documents, finding the science not generally accepted.

Practical Implications

This decision underscores the importance of respecting corporate formalities and ensuring compensation arrangements reflect arm’s-length dealing when establishing a professional corporation. Practitioners should advise clients to maintain separate books and records, enter into employment contracts, and ensure compensation is commensurate with what would be received in a non-corporate setting. The case also highlights the limitations of Section 482 in challenging the tax treatment of professional corporations that are validly organized and operated. Subsequent cases have applied this ruling, emphasizing the need for the IRS to demonstrate clear abuse of the corporate form to justify reallocating income under Section 482.