Haag v. Commissioner, 88 T. C. 604 (1987)

A professional corporation's income can be allocated to its controlling shareholder under section 482 if it does not reflect arm's-length transactions.

Summary

Dr. Stanley Haag transferred his medical partnership interest and other businesses to his professional corporation (P. C.). The IRS sought to allocate the P. C. 's income to Haag under section 61 and the assignment of income doctrine, and under section 482. The court held that the P. C. controlled the income from the medical partnership, rejecting the section 61 claim. However, it upheld the section 482 allocation for 1979 and 1980, finding that Haag's compensation from the P. C. was not at arm's length compared to what he would have earned without incorporation.

Facts

Stanley Haag, a physician, formed a professional corporation (P. C.) in 1976, transferring his medical partnership interest in Hilltop Medical Clinic, farms, a dog kennel operation, and other businesses to it. Haag became an employee of the P. C. , receiving minimal or no salary. The P. C. also operated a restaurant and provided medical services to other institutions. Haag made cash advances to the P. C. , which were repaid without formal loan agreements. The IRS sought to allocate the P. C. 's income to Haag under sections 61 and 482 of the Internal Revenue Code.

Procedural History

The IRS determined deficiencies in Haag's federal income taxes for 1979, 1980, and 1981, leading Haag to petition the U. S. Tax Court. The court found that the P. C. was a validly organized and operated entity under Iowa law, and the case proceeded to address the tax allocation issues under sections 61 and 482.

Issue(s)

1. Whether the income reported by Haag's P. C. from the medical partnership is taxable to Haag under section 61 and the assignment of income doctrine.
2. Whether the P. C. 's income is allocable to Haag pursuant to section 482.

Holding

1. No, because the P. C. controlled the earning of income from the medical partnership.
2. Yes, because Haag's compensation from the P. C. in 1979 and 1980 was not at arm's length compared to what he would have earned without incorporation.

Court's Reasoning

© 2025 SCOTUSreports.com. All rights reserved.

The court applied the control test for the assignment of income doctrine, finding that the P. C. controlled the income from Hilltop because Haag was an employee subject to the P. C. ‘s direction, and the medical partnership recognized the P. C. as the partner. For section 482, the court analyzed whether Haag’s compensation from the P. C. reflected arm’s-length transactions. It found that Haag’s salary was significantly lower than what he would have earned without incorporation, especially in 1979 and 1980. The court upheld the section 482 allocation for those years but found that Haag’s 1981 compensation was comparable to what he would have earned without incorporation. The court also determined that Haag’s cash advances to the P. C. were not bona fide loans but disguised salary, further supporting the section 482 allocation.

Practical Implications

This decision underscores the importance of ensuring that transactions between a closely held corporation and its controlling shareholder reflect arm’s-length dealings to avoid section 482 allocations. It highlights the scrutiny the IRS may apply to the compensation arrangements of professional corporations, particularly when shareholders receive minimal or no salary. Practitioners should advise clients to document all transactions, including loans, and ensure that compensation levels are reasonable and comparable to industry standards. This case also influences how similar cases involving the assignment of income and section 482 are analyzed, emphasizing the need for clear evidence of corporate control and arm’s-length transactions.

© 2025 SCOTUSreports.com. All rights reserved.