FLORIDA TAX REVIEW

VOLUME 1 | *1993* | *NUMBER 11*

Schneer v. Commissioner: Continuing Confusion Over the Assignment of Income Doctrine and Personal Service Income

*Ronald H. Jensen**

I. INTRODUCTION
II. DEVELOPMENT OF THE ASSIGNMENT OF INCOME DOCTRINE AND EXAMINATION OF ITS UNDERLYING RATIONALE
- A. *Gratuitous Assignments of Personal Service Income*
- B. *Gratuitous Assignments of Investment Income*
- C. *Rationale of the Assignment of Income Doctrine*
- D. *Nongratuitous Assignments of Income: A Different Case*

III. VARIATIONS ON A THEME: THE ASSIGNMENT OF INCOME IN DIFFERENT CONTEXTS
IV. THE "SIMILARITY" AND "AGENCY" TESTS: FAILED SOLUTIONS
- A. *Introduction*
- B. *The Similarity Test*
- C. *The Agency Test*

V. RESOLVING THE CONFLICTS: A RETURN TO BASICS
- A. *The Overlooked Distinction*
- B. *Formal Statement of Approach*
- C. *Issues Involved in Applying Proposed Approach*
- D. *The Personal Service Corporation: A Case of Nonrecognition?*
- E. *The Basketball Player: A Case of Deferral*
- F. *A Loose End: Should* Schneer *Have Been Taxed on the Fee that Was Fully Earned at the Time of the Assignment?*

VI. CONCLUSION

* Professor of Law, Pace University School of Law. A.B., Yale University; LL.B., Harvard Law School.

I would like to express my appreciation to Gregory Holder for his insight into the "Basketball Player Case," discussed infra part V.E., and to Charles H. Simmons, Walter E. Swearingen, and Peter C. Bruzzese for research assistance.

I. INTRODUCTION

More than sixty years have elapsed since Justice Holmes first enunciated in Lucas v. Earl[1] the principle that income from personal services "must be taxed to him who earns it"[2] and that assignments of such income "however skilfully devised"[3] will not be respected for tax purposes. The Supreme Court has described this principle—now known as the assignment of income doctrine—as the "first principle of income taxation."[4] Yet despite its venerable lineage and importance, the doctrine remains today beset by confusion and uncertainty. This was vividly demonstrated in Schneer v. Commissioner[5] where the Tax Court agonized over the application of the doctrine to a simple, indeed pedestrian, set of facts. The twenty-page majority opinion brought forth a concurrence,[6] based on an entirely different theory, and two vigorous dissents,[7] one of which attacked the court's decision as "unprincipled."[8] The decision has given rise to considerable comment, some of it heated. One commentator described the decision as not only wrong but "exquisitely wrong, so misguided at every turn, that it becomes a wayward sort of achievement,"[9] while another described the first commentator's analysis as "wrong, although not exquisitely wrong."[10] All commentators, however, have recognized the case's significance. The Tax Lawyer, the official publication of the American Bar Association Section of Taxation, designated the case as one of the important tax decisions of 1992,[11] while

---

1. 281 U.S. 111 (1930).
2. Commissioner v. Culbertson, 337 U.S. 733, 739-40 (1949) (restating the holding in *Earl*).
3. *Earl*, 281 U.S. at 115.
4. *Culbertson*, 337 U.S. at 739. The classic work on the assignment of income doctrine is Charles S. Lyon & James S. Eustice, Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case, 17 Tax L. Rev. 293 (1962), as supplemented by James S. Eustice, Contract Rights, Capital Gain, and Assignment of Income—the Ferrer Case, 20 Tax L. Rev. 1 (1964).
5. 97 T.C. 643 (1991).
6. Id. at 663 (Beghe, J., concurring).
7. Id. at 664 (Wells, J., dissenting); id. at 667 (Halpern, J., dissenting).
8. Id. at 669.
9. Lee A. Sheppard, Partnership Mysticism and the Assignment-of-Income Doctrine, News Analysis, 54 Tax Notes 8, 8 (Jan. 6, 1992).
10. Michael Asimow, Applying the Assignment of Income Principle Correctly, Letter to the Editor, 54 Tax Notes 607, 607 (Feb. 3, 1992).
11. James P. Holden, Note, Important Tax Decisions of 1992: Forward, 46 Tax Law. 507, 510-11 (1993). See also Gina L. Bozajian, Note, A Case of Mistaken Identification: When Income Is Earned and the Classification of Earnings as Individual or Partnership Income in Schneer v. Commissioner, 46 Tax Law. 583 (1993). The Tax Lawyer was employing editorial license in describing *Schneer* as one of the "important tax decisions of 1992"; the decision in

a publication of the Section on Taxation of the Association of American Law Schools recommended its use in the classroom as the "practically perfect case" for teaching the assignment of income doctrine.[12] The *Schneer* case therefore presents an opportune occasion to reexamine the assignment of income doctrine as applied to personal service income.

The facts of *Schneer* are as follows. Stephen Schneer, a law firm associate, had an agreement with his firm entitling him to a certain percentage of all fees collected from clients he brought to the firm.[13] Schneer thereafter left the firm and became, on successive occasions, a partner in two other firms.[14] Schneer agreed, as a condition to becoming a partner in the latter two firms, that while serving with them as a partner he would turn over to them any fees he collected under his agreement with the first firm.[15]

After leaving the first firm, Schneer continued to render legal advice and consultation on those matters handled by the first firm in which he was entitled to share the fees.[16] The parties themselves were uncertain whether Schneer would have been entitled to share in the fees had he refused to provide these consulting services.[17]

Schneer fully complied with his agreements and turned over to the second and third firms all fees he received from the first firm.[18] All of these fees, save one in the amount of $1,250, involved work performed after Schneer left his first firm; the $1,250 fee was fully earned before his departure from that firm.[19]

The issue was whether the fees paid to Schneer were taxable to him in full under the assignment of income doctrine, because he had earned them, or whether they constituted partnership income, in which case Schneer would be taxable only on his distributive share of such fees. Had the Service been successful in applying the doctrine in this case, Schneer apparently would have been taxed on more than 100% of such fees. He had already reported his distributive share of the fees as income, and the Service did not offer to

---

Schneer was actually filed on December 12, 1991. *Schneer*, 97 T.C. at 643.

12. Boyd K. Dyer, New Cases for Teachers, Newsl. (Ass'n of Am. Law Sch., Section on Taxation, Wash., D.C.), Apr. 1993, at 9.

13. *Schneer*, 97 T.C. at 644.

14. Id. at 645.

15. Id.

16. Id.

17. Id.

18. Id. at 646.

19. Id. Schneer received a total of $31,914 from the first firm, which he remitted to the second and third firms. With the exception of one fee in the amount of $1,250, all of these fees (representing more than 96% of the total amount of fees collected) were for work performed after Schneer left the first firm. Id.

adjust his distributive share or allow him a deduction for the amounts paid over to his new firms if the court applied the doctrine.[20]

The Tax Court held that the $1,250 fee which was fully earned before Schneer left his first firm was taxable to him, because it had already accrued to him under the "all events" test.[21] In the case of the fees earned after Schneer's departure from the first firm, the court perceived a conflict between the assignment of income doctrine, which taxes income to the person who earns it, and the principles of partnership taxation, which tax partnership income to the partners in accordance with the terms of the partnership agreement regardless of whose personal efforts generated the income.[22] Relying on several revenue rulings and case authority, the Tax Court held that income in such cases should be treated as partnership, not personal, income *provided* the services performed by the partner in his individual capacity were "similar" to those performed by the partnership.[23] The court held that since the consulting services performed by Schneer were essentially of the same nature as those performed by the second and the third firms, the fees which he turned over to them should be treated as partnership income.[24] Schneer was therefore not taxable on such fees except to the extent of his distributive share of them.

The court did not explain why the similarity between the taxpayer's activities which generated the fees and work normally performed by the firm should have any bearing on the application of the assignment of income doctrine,[25] and it is this aspect of the decision which caused the dissent and other critics to denounce it as "unprincipled."[26]

---

20. See Martin B. Cowan, Tax Court Leaves Confusion in Wake of Decision on Assignment of Income to Partnership, Special Report, 55 Tax Notes 1535, 1535 (June 15, 1992).

21. *Schneer*, 97 T.C. at 649-52. Although the Tax Court applied an accrual concept, that is, the "all events" test, in determining that Schneer was taxable on the fee that was fully earned before he left the first firm, he was a cash-basis taxpayer. Id. at 645.

22. Id. at 657-58.

23. Id. at 652-56.

24. Id. at 656.

25. Judge Halpern commented that:

> [t]he majority fails to explain why the similarity of the work done by the partner to earn the fees to the work of the partnership is determinative. That failure not only casts doubt upon the correctness of this decision, but foreshadows the difficulty future courts will have in resolving the question: how similar is similar enough? Without any inkling of why similarity has been deemed important, future courts will lack any effective guidelines for answering that question.

Id. at 669 n.3 (Halpern, J., dissenting).

26. Id. at 669 (Halpern, J., dissenting). See Cowan, supra note 20, at 1541.

I agree with the critics who have denounced the rationale of *Schneer* as unprincipled, yet at the same time I believe the results in the case are substantially correct. However, both the court and its critics failed to grasp the true rationale for the assignment of income doctrine and were diverted into chasing will-o'-the-wisps such as the tests of "similarity" and "agency." The true nature of the assignment of income doctrine is simply this: it is a remedial doctrine designed to prevent high income taxpayers from fragmenting their taxable income among related and lower income taxpayers thereby undermining the graduated nature of the income tax system. The assignment of income doctrine implements this policy by refusing to give effect, for tax purposes, to gratuitous shifts of taxable income from one taxpayer to another. If this widely accepted rationale of the doctrine is respected, many puzzles encountered in applying the doctrine yield themselves to easy solution.

This is true of *Schneer* itself. *Schneer* did not involve the *gratuitous* shifting of income from a high income family member to a low income family member, the classic case for applying the doctrine, but rather it involved a hard-headed negotiation conducted at arm's-length between unrelated parties. For every dollar of taxable income that Schneer assigned to his new partnership, he received (or expected to receive) a dollar of taxable income in return. There is simply no reason to believe that taxable income was being shifted in *Schneer* from one taxpayer to another and thus no occasion to apply the assignment of income doctrine.[27] Somehow, the courts and the Internal Revenue Service have lost sight of the crucial distinction between *gratuitous* assignments of income and assignments of income for *value* in personal service cases and as a result have produced a collection of irreconcilable and inexplicable cases and rulings.

This article will analyze the proper application of the assignment of income doctrine to personal service income. Part II will trace the historical development of the assignment of income doctrine and will analyze the doctrine's underlying rationale. The importance of distinguishing between gratuitous and nongratuitous assignments of income will be developed in this Part. Part III will present a number of hypothetical situations drawn from actual cases and rulings that involve the application of the doctrine to personal service income. This will both show the pervasiveness of the doctrine and lay the basis for further analysis. Part IV will demonstrate that the tests currently used by the Internal Revenue Service and the courts in these situations—the "similarity" test and the "agency" test—fail to provide either a rational or workable basis for solving these problems. Instead, they have resulted in a welter of unintelligible and irreconcilable decisions. Finally, Part V will show how reference to the doctrine's underlying purpose,

---

27. See discussion infra part V.A.

and particularly to the basic distinction between gratuitous and nongratuitous assignments of income, solves many of the puzzles besetting the application of the doctrine.

II. Development of the Assignment of Income Doctrine and Examination of its Underlying Rationale

A. *Gratuitous Assignments of Personal Service Income*

In Lucas v. Earl,[28] a married couple entered into an agreement in 1901 which granted each spouse absolute ownership of one-half of any income earned by the other.[29] On his 1920 and 1921 tax returns, the husband reported only half of his earnings for those years as taxable income contending that under the agreement the other half was owned by his wife and thus was taxable to her.[30] Justice Holmes, in a unanimous opinion for the Supreme Court, held the husband taxable on all of his earnings:

> There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skilfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.[31]

Thus was born the assignment of income doctrine: one is taxable on all income earned through one's personal services, regardless of who actually receives that income. This principle is so deeply embedded in our tax jurisprudence it is difficult to consider it afresh. Nevertheless, we need to do so to understand the basis for the doctrine. The holding in *Earl* is not self-evident; indeed, the taxpayer's case was quite substantial. Mr. Earl argued that income should be taxed to the person beneficially entitled to receive it.[32] The Court took for granted that the agreement was legally enforce-

---

28. 281 U.S. 111 (1930).
29. Id. at 113-14.
30. Id.
31. Id. at 114-15.
32. Id. at 114. See Alan Gunn, Tax Avoidance, 76 Mich. L. Rev. 733, 762 (1978) (acknowledging that "[s]ome common definitions of income suggest the benefit approach"); Michael J. McIntyre & Oliver Oldman, Taxation of the Family in a Comprehensive and

able.[33] Thus, although the Court held Mr. Earl taxable on all his earnings, he in fact had a legal right to only half of those earnings. Although the practical effect of this agreement might be minimal in a harmonious marriage, it would have significant consequences if the marriage were dissolved or troubled, or the parties separated; and it might also have significant consequences if the husband became insolvent and creditors sought to levy upon his earnings. Moreover, the agreement clearly had not been made to avoid tax, since it was entered into in 1901—twelve years before the adoption of the Sixteenth Amendment. Given these considerations, the Court's conclusion that income should be taxed to the person whose efforts generated the income, rather than to the person entitled to receive it, is hardly incontrovertible. Nor does the Court enlighten us as to why its conclusion should be so; it merely states that this result "seems to us [to be] the import of the statute."[34]

The rationale of the Court's holding must therefore be inferred. In retrospect it appears that what concerned the Court was the effect a contrary holding would have had upon the tax system. Had the Court upheld Mr. Earl's claim, taxpayers could easily subvert the progressive tax rate structure by making multiple assignments of income among family members.[35] If either the income earner dominated his family, or the family was a harmonious unit, such assignments would have little, if any, effect on the economic status of the assignor. Of course, the Court could have implemented this "policy" by limiting the *Earl* doctrine to tax-motivated assignments, but such a limitation would have required lengthy, expensive, and uncertain findings as to the assignor's motives. Moreover, such an approach would have laid bare that the Court was making policy at a time when the prevailing jurisprudence held that courts should find, not make, law. Accordingly, the Court held that "no distinction can be taken according to the motives leading to the arrangement."[36]

The result in *Earl* might have been explained by the husband's continuing power to affect the flow of his earned income to his wife even

---

Simplified Income Tax, 90 Harv. L. Rev. 1573, 1582 (finding that assignment approach lacks "support in any normative model of the income tax").

33. *Earl*, 281 U.S. at 114.

34. Id. at 115. As Professor Bittker has commented, "[t]he opinion in Lucas v. Earl is late-vintage Holmes, magisterial in tone, studded with quotable phrases, and devoid of analysis." Boris I. Bittker, Federal Income Taxation and the Family, 27 Stan. L. Rev. 1389, 1401 (1975) (footnote omitted).

35. Ernest J. Brown, The Growing "Common Law" of Taxation, 34 S. Cal. L. Rev. 235, 243 (1961) ("The Government, particularly in its petition for certiorari, less clearly in a short brief on the merits, presented Mr. Earl's claim as a threat to the statutory scheme of graduated rates.").

36. *Earl*, 281 U.S. at 115.

after he had assigned such income to her. That is, Mr. Earl, even after the assignment, retained the ability to increase, decrease, or cut off altogether the flow of earned income to his wife simply by working more, working less or ceasing to work completely. This continuing ability to control the flow of the income might be thought to justify taxing the husband on such income. Therefore, the result might be different where the assignor had already earned the income at the time of the assignment; in such a case, the assignor would lose all ability to affect the flow of that income to the assignee once he made the assignment. The Supreme Court rejected this distinction in Helvering v. Eubank.[37] There the taxpayer assigned to a family trust his right to future insurance renewal commissions which he had earned through his sale of insurance policies in prior years.[38] Although Mr. Eubank forever lost his ability to affect the amount of assigned income flowing to the trust once he made the assignment, the Court in a brief, cryptic opinion held Mr. Eubank fully taxable on all renewal commissions as they were paid to the trust.[39] In so holding, the Court reinforced the rule that income is taxable to him who earns it, and further limited the ability of taxpayers to circumvent the graduated tax rate structure by making gratuitous assignments of income.

B. *Gratuitous Assignments of Investment Income*

In the meantime, the law relating to the gratuitous assignment of investment income (that is, income derived from property as opposed to income derived from personal services) developed along somewhat different lines. The Supreme Court held that income from property, in contrast to income from personal services, could be effectively assigned for tax purposes provided that the assignor assigned the income-producing property itself.[40] Thus, a parent who gives stock to a child will not be taxed on future dividends paid on the stock. By giving away the stock, the parent effectively transfers the incidence of taxation on future dividends to the child. On the other hand, if the taxpayer merely assigns income from the property while retaining the property itself (or, in terms of Holmes's metaphor, merely assigns the "fruit" but retains the "tree"), the taxpayer will continue to be taxed on the assigned income as it is received by the assignee.[41] Moreover,

37. 311 U.S. 122 (1940).

38. Id. at 124.

39. Id. at 125.

40. Blair v. Commissioner, 300 U.S. 5, 12 (1937) (stating that "tax liability attaches to ownership").

41. Helvering v. Horst, 311 U.S. 112 (1940). Consequently, a parent who transfers interest coupons to a child while retaining the bond will be taxed on the interest when the coupons mature. Id.

even where the taxpayer assigns the income-producing property he will be taxed on any income that had already accrued on the property at the time of the assignment.[42]

C. *Rationale of the Assignment of Income Doctrine*

In making these decisions, the Supreme Court spoke in broad conclusionary terms rather than in terms of the policies it was seeking to implement. As Professor Chirelstein has written:

> On the whole, the Supreme Court's opinions in this field are over-long and confusing . . . . The problem throughout, perhaps, was how the Court could aid in developing a set of anti-tax avoidance rules—how it could act to give protection to the graduated rate structure—without directly admitting that it was engaged in judicial law-making. Operating under a limited mandate, the Court sought to safeguard the rates by manipulating the legal concepts of "income," "property," and "ownership" instead of making bald utterances about tax-avoidance.[43]

Of the seminal cases, only Helvering v. Clifford[44] alludes (and even then obliquely) to the Court's underlying policy concern. In *Clifford*, a husband had set up a five-year trust for the benefit of his wife but named himself trustee and in that capacity retained extensive administrative powers as well as the power to determine whether income would be paid currently to his wife or accumulated for her benefit.[45] The Court held that the totality of the factors—the short duration of the trust, the retention of income within the family group, and the husband's retained powers over the principal of the trust as trustee—irresistibly led to the conclusion that the husband had parted with no substantial control or benefit in the transferred property and hence remained taxable on its income.[46] In posing the problem, the Court, through Justice Douglas, stated that "where the grantor is the trustee and the beneficiaries are members of his family group, special scrutiny of the arrangement

---

42. See generally Boris I. Bittker & Martin J. McMahon, Jr., Federal Income Taxation of Individuals ¶ 31.3, at 31-21 to 31-24 (1988).

43. Marvin A. Chirelstein, Federal Income Taxation: A Law Student's Guide to the Leading Cases and Concepts ¶ 8.05, at 191-92 (6th ed. 1991).

44. 309 U.S. 331 (1940).

45. Id. at 332-33.

46. Id. at 335.

is necessary lest what is in reality but one economic unit be multiplied into two or more,"[47] and added:

> We have 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 substantial change in his economic position. . . . For where the head of the household has income in excess of normal needs, it may well make but little difference to him (except income-tax-wise) where portions of that income are routed—so long as its stays in the family group.[48]

Here is the essence of the assignment of income doctrine: the concern that the progressive tax rate schedule not be subverted by permitting income to be artificially split among formally separate taxpayers who in fact constitute a single economic unit.[49] In more recent years, the courts have become more candid in acknowledging this policy as the basis for the assignment of income doctrine. For example, the Supreme Court in 1973 extolled the doctrine as "a cornerstone of our *graduated* income tax system."[50] Today, this explanation is commonplace among both courts[51] and commentators.[52]

---

47. Id.

48. Id. at 335-36.

49. This conclusion is reinforced by the Court's citation of Randolph E. Paul, The Background of the Revenue Act of 1937, 5 U. Chi. L. Rev. 41 (1937). *Clifford*, 309 U.S. at 335 n.2. Mr. Paul emphasized that many of the tax "schemes" the 1937 Revenue Act was designed to curtail involved splitting a taxpayer's income among multiple related taxpayers comprising a single economic unit:

> One characteristic underlies several of these devices; the multiplication of the taxpayer's personality. A taxpayer, in almost all the cases mentioned, starts with single individuality and subdivides himself by various mechanisms into a group of people. He subdivides himself into several people, some of whom are incorporated, and others of whom are not. It is a common denominator of the several schemes that the income of a family economic unit shall be treated as if there were no such economic unit.

Paul, supra at 48-49 (footnotes omitted).

50. United States v. Basye, 410 U.S. 441, 450 (1973) (emphasis added).

51. See, e.g., Foglesong v. Commissioner, 621 F.2d 865 (7th Cir. 1980), wherein the court states:

> The impact of the graduated income tax is eroded when income is split artificially among several entities or over several tax years. The assignment of income doctrine under Section 61 of the Internal Revenue Code (as formulated in Lucas v. Earl) seeks to recognize "economic reality" by cumulating income diffused among several recipients through "artificial"

D. *Nongratuitous Assignments of Income: A Different Case*

All the cases above involved *gratuitous* assignments of income. What should the rule be when the right to future personal service income is assigned, or exchanged, for consideration? If, as is commonly agreed, the assignment of income doctrine is intended to preserve the integrity of the graduated tax rate schedule, the assignor should be taxed on the amount he receives for the assignment but no more, while any amount collected by the assignee over and above the amount paid for the assignment should be taxed to the assignee. This is in fact the approach adopted by the courts.

The vice of a gratuitous assignment of income is that, if respected for tax purposes, it would enable the assignor to *shift* the incidence of tax on the assigned income to one or more other taxpayers. Therefore, a taxpayer, by assigning income, could fragment his aggregate taxable income among multiple taxpayers and thereby avoid the higher rates prescribed by the progressive tax rate schedule. If, however, the assignor assigns his earned income for full and adequate consideration, that is, if he "sells" his right to the earned income for its full value, the incidence of taxation will not be shifted since the taxpayer will receive, and report as taxable income, one dollar for every dollar of income he assigns.[53] Since the vice which the doctrine seeks to prevent does not exist in this case, there is no reason to apply the doctrine.

But what if the amount received by the assignor differs from the amount ultimately collected by the assignee? Provided the transaction is at arm's-length, the assignor still should be taxed on the amount he receives for

---

legal arrangements.

Id. at 868.

52. Bittker & McMahon, supra note 42, ¶ 31.1, at 31-3 ("[T]he courts recognized at the outset that transfers within the family, if honored by federal tax law, could seriously undermine the progressive rate schedule."); Ralph S. Rice, Judicial Trends in Gratuitous Assignments to Avoid Federal Income Taxes, 64 Yale L.J. 991, 991 (1955) (tracing doctrine to the fact that "[t]axpayers in the higher income brackets often seek to redirect their income to objects of their bounty in order to minimize the progressive features of the tax"); Lloyd G. Soll, Intra-Family Assignments: Attribution and Realization of Income, 6 Tax L. Rev. 435, 435 (1951) ("The problem of the gratuitous intra-family assignment is a creature of the progressive surtax."). But see Gunn, supra note 32, at 760-65 (arguing that the assignment of income doctrine is not based on notions of tax avoidance but rather on notions of convenience and fairness).

53. Where the assignor receives full consideration for his assignment of income, the assignment will generally not alter the total *amount* of income the assignor reports. The assignment may, however, affect *when* he reports the income. For example, the assignor may attempt to defer recognition of his income by assigning income which he is to receive over the next three years in exchange for a lifetime annuity. The applicability of the assignment of income doctrine to tax-motivated attempts to defer income is discussed infra part V.E.

the assignment—no more, no less. This is particularly clear where the assignor receives more from the assignee than the assignee collects. In such case, the assignor should be taxed on the full amount received because that is the amount which constitutes his accession to wealth.[54]

There are two possible reasons why the amount received by the assignor may be less than the amount collected by the assignee: (1) the shortfall may be a discount for early payment of the income representing the time value of money; or (2) the shortfall may be the result of an improvident bargain by the assignor. If the shortfall merely represents a discount for the time value of money, the assignor clearly should be taxed only on the amount he receives, since that amount is the financial equivalent of the amount ultimately collected. The government will not lose under this approach, since sale of the income right accelerates the taxation of the earned income and thus the government collects its tax sooner.[55]

The crucial test of this approach comes where the assignor made an improvident bargain and sold his right to receive income for less than the amount ultimately collected by the assignee. If the dictum that "income must be taxed to him who earns it"[56] is taken as a metaphysical truth rather than a pragmatic device to prevent tax avoidance, then the assignor should be taxed on all amounts collected on account of his personal services even where that amount, after discount for the time value of money, exceeds what he received from transferring his right to such income. Otherwise, not all of the income will "be taxed to him who earns it."[57]

If, however, the doctrine is recognized as a prophylactic against tax avoidance, the assignor should be taxed only on the amount he receives for his assignment. This is the proper approach and the one adopted by the courts.

The effect of this approach on tax revenues should be neutral. Where the price of the assignment has been negotiated in good faith on an arm's-length basis, there is no reason to suppose *a priori* that the amount paid for the assignment will be less or greater than the amount ultimately collected under the assignment. Naturally, in some cases the amount received for the assignment will be less than the amount collected by the assignee, but among all the assignments negotiated in good faith at arm's-length there should be

---

54. See Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955) (treating "undeniable accessions to wealth" as gross income).

55. Moreover, the assignee will have to report any amount he collects in excess of what he paid for the assignment as taxable income. Wilkinson v. United States, 304 F.2d 469, 472 (Ct. Cl. 1962) ("[T]he assignee is taxed on any amount ultimately collected . . . in excess of his cost.").

56. Commissioner v. Culbertson, 337 U.S. 733, 739-40 (1949).

57. Id. at 740.

an equal number of cases where the reverse is true. As the Supreme Court observed in a different context, "the United States is in business with enough different taxpayers so that the law of averages has ample opportunity to work."[58]

In many, probably most, gratuitous assignment of income cases the assignee will be in a lower marginal tax bracket than the assignor, thereby creating the loss of tax revenue. In contrast, there is no reason to suppose that this will be true where the assignment of income is in exchange for valuable consideration in an arm's-length transaction.

Moreover, taxing the assignor on income collected in excess of the amount he received for his rights would give rise to double taxation. In the case of gratuitous assignments of income, no problem of double taxation arises because the collection of the assigned income by the assignee is simply the realization of the "gift" from the assignor and is therefore excluded from the assignee's income by section 102 of the Code. However, section 102 is unavailable to protect the assignee who collects more than what he paid for the assignment in an arm's-length transaction. Unless the assignor's income is limited to the amount he receives, the excess amount collected by the assignee would be taxed to both the assignor and the assignee.

Finally, taxing the assignor on income he does not receive seems inequitable where he has transferred his right to that income in a bona fide arm's-length transaction. Of course, the assignor is taxed on income he does not receive in gratuitous assignment of income cases, but the harshness of this result is mitigated since the assignee is an object of the assignor's bounty. This is not true where the assignment is made in an arm's-length transaction.

One disadvantage of this approach is that the Service and the courts will be required to monitor assignment-for-consideration cases to ensure that they are truly negotiated at arm's-length and are not merely a cover for transferring income to an intended beneficiary of the taxpayer for less than a full and adequate consideration. But this problem is common in our tax system and does not seem to have significantly hindered the effective administration of the tax laws.[59]

Where the courts have recognized that a case involves a sale of an income right for bona fide consideration, they have uniformly taxed the assignor only on the amount he received from the sale, and no more. Thus, insurance agents who sell their rights to renewal commissions are taxable only on the amounts for which they sold their rights and not on the amount

58. Northeastern Pa. Nat'l Bank & Trust Co. v. United States, 387 U.S. 213, 224 (1967) (quoting Gelb v. Commissioner, 298 F.2d 544, 552 (2d Cir. 1962)).

59. One instance in which such a problem has arisen is in determining whether a payment to the sole shareholder of a corporation is to be characterized as deductible compensation or a nondeductible dividend.

collected by the buyers of such rights;[60] a construction contractor who sells his claim against the government for unpaid construction work is taxable only on the amount for which he sold his claim and not on the amount collected by the assignee;[61] and one who sells his right to a contingent fee is taxed only on the amount received by him on the sale and not the fee ultimately collected.[62]

Thus the courts have firmly established two rules in the case of assignments of personal service income: first, all amounts collected by an assignee under a gratuitous assignment of personal service income will be taxed to the assignor; second, a taxpayer who exchanges his right to such income for bona fide consideration will be taxed on the consideration he receives and no more.[63] Unfortunately, the courts and the Service have

---

60. Cotlow v. Commissioner, 228 F.2d 186 (2d Cir. 1955). The case involved the tax status of the purchaser of the renewal commissions, but in the course of its opinion the court stated: "Where there is an arm's-length assignment of income rights for a valuable consideration, it is clear that the assignor realizes *only* the amount of the consideration received, and the assignee is taxable for receipts in excess of this amount." Id. at 188 (emphasis added) (citation omitted).

61. Jones v. Commissioner, 306 F.2d 292 (5th Cir. 1962).

62. In Wilkinson v. United States, 304 F.2d 469, 472 (Ct. Cl. 1962), Captain Bonnin had sold a partial interest in a contingent fee to Wilkinson in 1938 for $12,092.17. Wilkinson gave that interest to charities in September 1951; later that year the court awarded total legal fees of $2,794,616.43, of which Wilkinson's share came to $191,363.28. Id. The court held that Wilkinson was taxable on the difference between the amount of the awarded fee ($191,363.28) and the amount he paid for the interest in the contingent fee ($12,092.17). Id. at 474. This holding, together with the court's observation that "[i]n an arm's-length transaction the assignor of a personal services contract right is taxed on the consideration received, and the assignee is taxed on any amount ultimately collected under the assignment in excess of his cost," id. at 472, strongly suggests that the court would have taxed Captain Bonnin only on the consideration received from Wilkinson and not on the amount of the fee ultimately awarded.

63. This rule is also applied where the taxpayer sells his right to future *investment* income. See, e.g., Estate of Stranahan v. Commissioner, 472 F.2d 867 (6th Cir. 1973) (holding seller of right to future dividends taxable on consideration received). A number of cases have held that a purported sale of future income failed to accelerate the recognition of income. See, e.g., Mapco, Inc. v. United States, 556 F.2d 1107 (Ct. Cl. 1977); Hydrometals, Inc. v. Commissioner, 31 T.C. Memo (CCH) 1260, T.C. Memo (P-H) ¶ 72,254 (1972), aff'd per curiam, 485 F.2d 1236 (5th Cir. 1973), cert. denied, 416 U.S. 938 (1974); Martin v. Commissioner, 56 T.C. 1255 (1971), aff'd per curiam, 72-2 U.S. Tax Cas. (CCH) ¶ 9637, 30 A.F.T.R.2d (P-H) 72-5396 (5th Cir. 1972) (not officially reported). These cases do not reject the principle that a bona fide sale of future investment income will cause the seller to be taxed on the consideration received and no more; rather, they were decided on the ground that the particular transaction before the court was in the nature of a "loan" rather than a bona fide "sale." For example, the court in *Mapco* stated:

> We . . . recognize that a taxpayer may sell a property right to future income. If the bona fide sale occurs at arm's-length for adequate consider-

frequently failed to appreciate the relevance of this basic distinction between gratuitous and compensated assignments of personal service income and have instead been sidetracked by the chimera of the "similarity" and "agency" tests.

III. Variations on a Theme: The Assignment of Income in Different Contexts

Set forth below are a number of hypotheticals that have been drawn from actual cases and revenue rulings; these represent the principal controversies that have arisen over the application of the assignment of income doctrine to personal service income. They provide an overview of the diverse but intriguing situations where assignment of income questions occur while at the same time laying the basis for further analysis in the following Parts.[64]

> *Army Reserve Pay Case*: P is a partner in a law firm and under the partnership agreement is obligated to pay over to the firm all "outside" earned income. P is also a member of the United States Army Reserves and pursuant to the partnership agreement, he dutifully turns over all of his Army Reserve pay to the firm. Is the Army Reserve pay reportable by P, under the assignment of income doctrine, or by the firm?[65]
>
> *Vow-of-Poverty Case*: Father John is a member of the Franciscan order. One of the order's missions is serving the poor and the infirm. At the direction of the order, Father John applies to become chaplain at a mental hospital run by the state. His application is accepted and he undertakes the duties of being a chaplain. One of his tasks is the celebration of the Eucharist and the administration of the Sacraments, which in the Roman Catholic Church can only be performed by a priest. Father John's religious superior visits him annually to

---

> ation, the seller is taxed in the year of sale on the amount of consideration he actually receives and the buyer is taxed on any excess of income received over his purchase price.

Mapco, 556 F.2d at 1110.

64. Unless otherwise indicated, the taxpayers in the hypothetical cases described in this article employ the cash receipts and disbursements method of accounting.

65. This hypothetical was suggested by I.T. 3824, 1946-2 C.B. 37 (a partner's compensation for service in the armed forces does not constitute partnership income).

observe and monitor performance of his priestly duties. Pursuant to Father John's vow of poverty (which is legally enforceable), he remits all of his pay from the state, less a small allowance for his subsistence, to his order. Is the amount Father John remits taxable to him under the assignment of income doctrine?[66]

Law School Clinic Case: Law School X operates a criminal law clinic which is supervised by a full-time faculty member F. From time to time, F is appointed by the Federal District Court under the Criminal Justice Act to represent indigent defendants in criminal matters, and in those instances students in the clinic assist F in the defense of the defendants. The Act authorizes the payment of compensation to the counsel of record—but not to the law school. However, F has agreed with the law school, as a condition of her participation in the program, to turn over to the law school any fees she may receive from the court. Therefore, F endorses all checks received by her under the Act to Law School X. Is F taxable on these fees under the assignment of income doctrine?[67]

Personal Service Corporation Case: O was a manufacturers' representative for producers of steel tubing. Operating as a sole proprietor, O netted about $250,000 a year. No more than $5,000 of this amount represented a return on the few assets he used in the business (e.g., his word processor, photocopier, etc.); the balance ($245,000) was solely attributable to O's personal services. On the advice of his attorney, O at the beginning of 1970 formed Newco, Inc. in which he was the sole shareholder and employee. Thereafter, he conducted his business of representing manufacturers through the corporation. O's salary from Newco, Inc. for 1970 was fixed at $100,000 leaving the corporation with a net profit of $150,000. Was O taxable on $245,000 in 1970 under the assignment of income doctrine, since that was the amount of income his services produced?[68]

---

66. This hypothetical was suggested by Kircher v. United States, 872 F.2d 1014 (Fed. Cir. 1989).

67. This hypothetical was suggested by Rev. Rul. 74-581, 1974-2 C.B. 25.

68. This hypothetical was suggested by Foglesong v. Commissioner, 35 T.C. Memo (CCH) 1309 (1976), rev'd and remanded, 621 F.2d 865 (7th Cir. 1980), on remand, 77 T.C.

> *Basketball Player Case*: B, a basketball player, is acutely aware that the life of a professional athlete is short. He wishes to spread out the income he earns during his "good years" over his lifetime to reduce his overall tax burden. On the advice of his attorney, he enters into an agreement with an *unrelated* corporation, X Corp., to provide all his services in professional sports to X Corp. for six years in return for $18,000 a year for the rest of his life. B's attorney then attempts to negotiate an agreement between Hawks, a professional basketball club, and X Corp. under the terms of which X Corp. would provide the Hawks with B's services as a basketball player for the next three years for $100,000 a year. However, because of the Hawks' adamant insistence that it will only deal directly with B, B enters into an agreement with the Hawks to play basketball for it for the next three years for $100,000 a year, and then assigns his rights to this pay to X Corp. Is B taxable on $100,000 a year under the assignment of income doctrine, or only on the $18,000 a year he receives from X Corp.?[69]

A preliminary question is whether the earner of the income in these cases would be entitled to a deduction for the amounts he or she pays over to the assignee even if the assignment of income doctrine applies? The answer is that the payment over to the assignee generally qualifies as a deduction but frequently fails to provide a full offset. If the earner is an employee who turns over the earned income to her employer pursuant to her employment contract (as in the "law school clinic case") the amount turned over will qualify as an ordinary and necessary business deduction[70] but will be deductible only to the extent that it and other "miscellaneous deductions" exceed two percent of the employee's adjusted gross income.[71] If the earner turns his earned income over to a religious organization (as in the "vow-of-poverty case"), the amount turned over will qualify as a charitable deduction[72] but will only be deductible to the extent of fifty percent of the

1102 (1981), rev'd, 691 F.2d 848 (7th Cir. 1982).

69. This hypothetical was suggested by Johnson v. United States, 698 F.2d 372 (9th Cir. 1982), and Johnson v. Commissioner, 78 T.C. 882 (1982), aff'd, 734 F.2d 20 (9th Cir.), cert. denied, 469 U.S. 857 (1984).

70. See, e.g., Rev. Rul. 66-377, 1966-2 C.B. 21 (permitting a deduction under IRC § 162 for fees from private practice turned over to medical school by faculty members as required by their employment agreements).

71. IRC § 67.

72. See, e.g., Rev. Rul. 76-323, 1976-2 C.B. 18 (holding compensation from outside

earner's adjusted gross income.[73] Since most members of religious orders have no other taxable income, their income almost invariably exceeds the amount deductible as a charitable contribution. If the earner is a partner who turns his outside income over to his partnership pursuant to the partnership agreement (as in the "Army Reserve pay case"), the answer is unclear. Judge Beghe, who concurred with the result in *Schneer*, would allow a full deduction for the income turned over,[74] but Judge Halpern in his dissent suggested that possibly no portion of the amount turned over would be deductible since it may constitute a nondeductible contribution to capital under section 721 of the Code.[75] In short, whether it is theoretically correct to apply the assignment of income doctrine in the above cases is of crucial practical significance.

IV. THE "SIMILARITY" AND "AGENCY" TESTS: FAILED SOLUTIONS

A. *Introduction*

This Part will review and analyze the attempts of the courts and the Service to resolve assignment of income problems by using the "similarity" and "agency" tests. This analysis will show that these tests are wholly inadequate to the task; they are neither rational nor workable, and they lead to irreconcilable results.

The most noteworthy feature of the cases and rulings discussed below is failure of the courts and the Service to discern the relevance of the basic distinction between *gratuitous* and *nongratuitous* assignments of income to the question at hand. Not one of these cases or rulings even alludes to this basic distinction despite its relevance. Part V will show that this distinction provides a rational basis for resolving these problems and for reconciling the cases and rulings.

---

employment remitted by member of religious order to order deductible under IRC § 170).

73. IRC § 170(b)(1)(A)(i) (limiting charitable deduction to 50% of donor's contribution base); IRC § 170(b)(1)(F) (defining "contribution base" as taxpayer's adjusted gross income computed without regard to any net operating loss carryback).

74. *Schneer*, 97 T.C. at 663-64 (Beghe, J., concurring).

75. Id. at 669-70 (Halpern, J., dissenting). Martin B. Cowan asserts that if the amount paid over to the firm is a nondeductible capital contribution under IRC § 721, then that amount must be excluded from the firm's taxable income. He further argues that the reduction in the firm's taxable income must be allocated solely to the contributing partner's share of taxable income to satisfy the economic effect requirement of IRC § 704(b). The result is that the contributing partner will not be taxed twice on the same income. Cowan, supra note 20, at 1542-44.

B. *The Similarity Test*

Partnership agreements frequently require every partner to turn over to the partnership all income he earns regardless of whether he earns that income in his capacity as a partner or in his individual capacity.[76] Thus, many law partnerships require their partners to turn over to the partnership all fees they earn for serving as executors or as corporate directors.[77] The purpose of this provision is to assure that no partner will be tempted to divert his time and attention from partnership matters to those matters in which he receives all the income.[78] By requiring the partners to pool all their earned income from whatever source derived, the partnership ensures that the partners will maximize their efforts on behalf of the partnership as a whole.

A series of rulings has considered whether income earned by a partner in his individual capacity which he pays over to the partnership pursuant to such an agreement is taxable to the partner under the assignment of income doctrine or reportable by the partnership. The Service initially ruled that the income was taxable to the individual partner if the activity producing the income was one which the partnership could not, or did not, perform as an entity. Thus, it held that compensation received by a partner for his active service in the military that he paid over to the partnership was taxable to him and not reportable by the partnership:

> Obviously, a partnership can not [sic] exist for the purpose of serving in the armed forces, and it is clear that compensation and allowances received by an individual for military service can not [sic] be transmuted, in the manner here involved, into earnings and profits (as such) of a partnership of which he is a member.[79]

---

76. Cowan, supra note 20, at 1541; William L. Raby, Outside Income of Professionals Who Practice in Firms, 54 Tax Notes 423, 423-24 (Jan. 27, 1992) (listing types of income that partners are usually required to turn over to their partnerships).

77. See Raby, supra note 76, at 423-24.

78. See Cowan, supra note 20, at 1541. The author noted that:

> [a] firm cannot long exist if each partner can go off on his own whenever he determines his personal interest would be benefitted by doing so. . . . Accordingly, it is common, if not close to universal, to insist that all partners . . . bring all of their law and law-related activities into the firm and that any services they render in connection with such matters be on behalf of the firm.

Id.

79. I.T. 3824, 1946-2 C.B. 37, 38.

Likewise, it ruled that the salary received by a partner for his service as an elected official which he turned over to the partnership was taxable to the partner individually since "[a] partnership cannot exist for the purpose of serving as an elected public official."[80]

The Service retreated from this position in a 1964 ruling which held that fees turned over to a partnership by a partner for a service which the partnership did not, or could not, provide would nevertheless be reportable by the partnership so long as the service was "similar" to those performed by the partnership.[81] The Service expanded on the "similarity" test in a 1980 ruling which held that executor's commissions turned over by a partner to his accounting firm pursuant to the partnership agreement were reportable by the partnership, and not the partner, even though state law prohibited a partnership from acting as executor.[82] The ruling reasoned that although state law prohibited a partnership from serving as executor, such a "function was within the range of services undertaken by accountants," and added that "[i]t is not unusual in an accounting or legal practice that specific responsibilities must be assumed by an individual partner rather than by the partnership."[83]

In each of the above rulings, the Service made its pronouncements *ex cathedra*; it did not deign to *explain* why the similarity between the services performed by a partner in his individual capacity and the services performed by the partnership as an entity should have any bearing on the applicability or nonapplicability of the assignment of income doctrine. In Schneer v. Commissioner, the Tax Court also held in favor of the taxpayer on the basis of the similarity test: it found that the consulting services performed by Schneer for the clients he had introduced to his old firm were "similar" to the legal services provided by his new firm.[84] But like the Service, the court offered no convincing rationale or justification for the similarity test. It was

---

80. Rev. Rul. 54-167, 1954-1 C.B. 152, 152. Cf. Hamm v. Commissioner, 40 T.C. Memo (CCH) 284, T.C. Memo (P-H) ¶ 80,154 (1980) (holding that salary earned by partner in his capacity as a judge did not constitute partnership income), aff'd, 683 F.2d 1303 (10th Cir. 1982). The rationale of the holding is unclear. The Tax Court stated that income earned by a partner for services "outside of the scope of his partnership duties" is taxable directly to the partner even if he assigns it to the partnership, and it found that taxpayer's duties as "a district court judge were not within the scope of any partnership duties." *Hamm*, 40 T.C. Memo (CCH) at 285. However the court found that the salary was earned after the dissolution of the partnership. *Hamm*, 40 T.C. Memo (CCH) at 285, T.C. Memo (P-H) at 80-747. The Court of Appeals affirmed solely on the ground that the partnership had been dissolved. *Hamm*, 683 F.2d at 1304.

81. Rev. Rul. 64-90, 1964-1 C.B. (Part I) 226, 227.

82. Rev. Rul. 80-338, 1980-2 C.B. 30.

83. Id.

84. *Schneer*, 97 T.C. at 656 ("His referral fee income was clearly earned through activities 'within the ambit' of the business of his new partnerships.").

this aspect of the decision which caused Judge Halpern, and has since caused others, to denounce the court's decision as "unprincipled."[85]

The *Schneer* court did find that an inherent tension existed between the assignment of income doctrine and the partnership provisions of Subchapter K.[86] In a partnership, different individuals may agree in advance on the division of partnership income. That agreement will be respected for tax purposes even if it turns out that the amounts payable under the agreement to some partners are disproportionately large or disproportionately small relative to the amount of partnership income their services generated. In effect, those partners whose efforts generated a disproportionately large amount of income relative to their distributive shares are making assignments of some of the income they earned to the other partners; yet those partners are taxed only on their distributive shares and not the amount of income their services produced. From this, the court concluded that Congress intended for the partnership rules permitting the pooling of gains and losses to override, at least in part, the assignment of income doctrine.[87] The problem, in the court's mind, was to determine the extent to which the pooling permitted by Subchapter K displaced the assignment of income doctrine. The court concluded that the similarity test gave the answer: pooling would be permitted so long as the services performed by an individual partner are similar to the services performed by the partnership. The trouble with the court's opinion is its failure to provide any reason for its conclusion. If the pooling provisions of Subchapter K override the assignment of income doctrine where the individual partner's services are similar to those offered by the partnership, why do they not also prevail where the individual's services are unrelated to those offered by the partnership? The court gave no answer to this question.[88]

Commentators, however, have offered several possible explanations or justifications for the similarity test. One has suggested that the test provides a "rough and ready" basis to determine the bona fides of the

---

85. Id. at 669 (Halpern, J., dissenting); see supra note 20.

86. *Schneer*, 97 T.C. at 657-58.

87. Id.

88. The court observed that "[i]f the partners perform services in the name of the partnership or *individually* they are, nonetheless, associated with the partnership as a partner." Id. at 661-62 (emphasis added). It is unclear whether this statement was meant to justify the similarity test, but in any event the statement is equally true whether the services performed by the partner are similar or dissimilar to those performed by the partnership. Consider the law firm partner who is also a United States Senator and who turns his salary as Senator over to the firm pursuant to the partnership agreement. Service as a Senator would probably not be considered similar to the services provided by his law firm. Nonetheless, the notoriety of the Senator's position and the possible perception that the Senator's position gives the firm's clients access and influence (whether true or not) will inevitably increase the firm's business.

partnership.[89] For example, in Mayes v. Commissioner,[90] the Tax Court refused to permit a son's income as an airplane engine mechanic to be pooled as partnership income with his father's accounting and real estate rental income.[91] Although the court did not say so, perhaps it suspected that the purported partnership was merely a device for splitting income between two related parties to minimize their overall tax burden. The close family relationship between the parties and the dissimilarity in the types of income which they were attempting to pool may have fanned the court's skepticism. This may indeed "explain" why the courts have used the similarity test, but it does not "justify" its use. Even as a warning device alerting the court to greater scrutiny, the similarity test has little utility where the parties are unrelated and are dealing with each other at arm's-length. And where the parties are related, the test's use should be limited to raising a cautionary "go slow" sign, not for automatically disregarding a bona fide partnership.

Some have suggested that "public policy" concerns may justify the use of the similarity test, at least in certain instances.[92] In other words, the courts and the Service may have felt that it violated public policy to give effect to an arrangement under which a publicly elected official, or a member of the armed forces, shares his salary from these activities with his law partnership. However, neither the courts nor the Service asserted public policy as the basis for the similarity test.[93] Moreover, it is difficult to discern any compelling public policy that is being violated in these cases. Consider the case of a law firm partner who is also a justice of the peace. The Code of Judicial Conduct strictly prohibits him from hearing any case involving any

---

89. Cowan, supra note 20, at 1538.

90. 21 T.C. 286 (1953).

91. Id. The Court of Appeals for the Tenth Circuit reached the same result in a proceeding involving the father's tax liability for other years. Mayes v. United States, 207 F.2d 326 (10th Cir. 1953). See also Villere v. Commissioner, 133 F.2d 905 (5th Cir. 1943), in which the court refused to recognize a partnership between two brothers, who had purportedly agreed to split their aggregate income equally, where one brother earned a large salary and had dividend income while the other had only a small income.

92. Cowan, supra note 20, at 1541-42.

93. See, e.g., Rev. Rul. 64-90, 1964-1 C.B. (Part I) 226; Rev. Rul. 54-167, 1954-1 C.B. 152; I.T. 3824, 1946-2 C.B. 37. Moreover, the relatively mild sanction that these rulings imposed upon a partner who did pool one of these types of income with partnership income suggests that public policy was not the basis for their holdings. In general, these rulings adopted an approach that, aside from matters of timing, produced the same taxable result as if such income had been permitted to be pooled. Thus, if the amount of the income assigned by a partner exceeded his share of the pooled income under the partnership agreement, the rulings allowed him a deduction for the difference. For an illustration of this approach, see Rev. Rul. 64-90, 1964-1 C.B. (Part I) 226, 226-27. *Schneer* appears to be the first instance where the Service did not adjust the partner's distributive share of partnership income when it applied the assignment of income doctrine.

client of his firm, regardless of the nature of his financial arrangement with his firm.[94] Since this rule largely, if not entirely, precludes conflicts of interest from arising between his role as judge and his role as a partner of the firm, it is difficult to see how public policy is violated if he pays his justice of the peace salary to his firm.[95] It is even more difficult to see how public policy is violated when a member of the armed forces pays his salary into the firm. Furthermore, the Supreme Court has stated that the normal rules of taxation should give way to public policy concerns only where the policy is "sharply defined"[96] and publicly stated.[97] Diligent research has failed to unearth any statute, cannon of ethics, bar association ruling, or case holding that it is improper for a publicly elected official, a justice of the peace, or a member of the armed forces to pay his salary into a partnership. Thus the

94. The Code of Judicial Conduct permits a part-time judge, such as a justice of the peace, to continue to practice law. Model Code of Judicial Conduct, Compliance with the Code of Judicial Conduct ¶ A(1) (1972). But he may not participate "in a proceeding in which his impartiality might reasonably be questioned." Model Code of Judicial Conduct Canon 3C(1). This of course would preclude the justice of the peace from hearing any case in which his firm was involved.

95. *Cowan*, supra note 20, at 1541-42 states:

> Where a partner renders services as a corporate director or as a fiduciary, the loyalty and conflict of interest issues normally require a pooling, and there is no public policy that prohibits this. However, working as a judge, or as a soldier, does not require pooling, and the allocation of time, expenses, and other resources should be determined by considerations that may be utterly inconsistent with those dictated by firm loyalty and possible conflicts of interest. Serving in the armed forces or as a judge requires sole loyalty to that employer, and a sharing of loyalty with a partnership of other individuals is completely contrary to public policy.

I have two observations. First, the issue of whether a partnership needs pooling with respect to a given activity seems best resolved by the partners themselves. Second, the possibility of significant conflicts of interest arising between a partnership and an outside party seems most likely where the partnership and the outside party have an ongoing relationship, as in the case of an estate or a corporation represented by the firm. Thus, in the case of a partner who serves as an executor there will be obvious conflicts in selecting legal counsel for the estate, determining the amount of legal fees to be charged, and determining whether the partner should be permitted to receive both legal fees and executor's commissions. In contrast, the possibility of significant conflicts of interest arising between a partnership and the United States Army where a partner serves in the Army Reserves seems highly remote.

96. Commissioner v. Heininger, 320 U.S. 467, 473 (1943) (stating that "ordinary and necessary" business deductions may be disallowed only if the allowance of such deductions would "frustrate sharply defined national or state policies").

97. Lilly v. Commissioner, 343 U.S. 90, 96-97 (1952) (stating that "ordinary and necessary" business deductions may be disallowed only where their allowance would frustrate national or state policies which are "evidenced by some governmental declaration of them").

minimum requirements for invoking public policy in a tax case have not been met.

An obvious difficulty in applying the similarity test is determining whether one activity is similar to another. For example, in the District of Columbia nonlawyers are permitted to be partners with lawyers.[98] Are the services performed by an economist or a lobbyist in such a firm similar to those performed by lawyers?[99] Are services performed by a trust lawyer who is primarily engaged in drafting and tax analysis similar to those of a criminal lawyer who is constantly in court trying cases? What about services performed by an architect and an engineer?[100] Since neither the Service in its rulings nor the court in *Schneer* explains the reason for the similarity test, there is no meaningful guidance on how to make this type of determination.[101]

But the real deficiency of the similarity test is this: any test which purports to define the limits and contours of a doctrine like the assignment of income doctrine should be grounded in policies underlying that doctrine. That is, the test should limit application of the doctrine where the policies underlying the doctrine cease to be relevant. Neither *Schneer* nor the Service's rulings justify the similarity test in terms of the policies underlying the assignment of income doctrine. Part V below, shows how reference to the policies underlying the assignment of income doctrine leads to a proper resolution of the problem posed by *Schneer* and similar cases.

C. *The Agency Test*

Outside the partnership area, the most popular test for resolving assignment of income questions is the "agency" test. Under this test, if the person who earned the income was acting on his own behalf, the income will be taxed to him; however, if he was acting as another's agent, the income will be taxed to his principal.

This approach is illustrated by the "vow of poverty" cases where typically a member of a religious order takes "outside" employment at the order's direction and then, pursuant to her vow of poverty, turns over the earnings from that employment to the order. The Service has consistently

---

98. See District of Columbia Rules of Professional Conduct Rule 5.4(b), reprinted in D.C. R. Civ. P. 5.4(b).

99. This question is posed in Sheppard, supra note 9, at 9.

100. This question is posed in Cowan, supra note 20, at 1541.

101. In his dissent in *Schneer*, Judge Halpern observed that the failure of the majority to articulate an understandable rationale for the similarity test left the courts without "any effective guidelines" for resolving future cases. *Schneer*, 97 T.C. at 669 n.3 (Halpern, J., dissenting). See supra notes 25-26 and accompanying text.

ruled that a member's earnings are not taxable to her where she is acting as the order's agent in working for the employer, but are taxable to her if she is acting on her own behalf.[102] Both the Service and the courts have recognized that vows of poverty are legally enforceable so that if the member fails to remit her earnings to the order, the order can legally collect them from her.[103] Early rulings involved situations where the work performed by the member was unrelated to the work or mission of the order, for example, where the member took a job in the plumbing or construction industry[104] or as an associate in a law firm.[105] In each of these rulings, the Service found that the member was not acting as the order's agent but on her own behalf to benefit the order and therefore was taxable on the full amount of her earnings. None of these rulings explained the reasons for finding that the member was not acting as her order's agent. It might have been inferred from the facts that the crucial factor was the dissimilarity between the order's mission and the services performed by the members—in other words, that the Service was importing the similarity test from the partnership rulings—but a 1979 ruling made it clear that similarity, even identity, would not suffice to make the member an agent of the order.[106] That ruling involved a military chaplain in the United States Armed Forces who turned over his pay to the order pursuant to his vow of poverty.[107] Here, the services performed by the chaplain were not only similar to the work or mission of the order, they were identical with that of the order. Nevertheless, the ruling found that the chaplain was working on behalf of himself and not as an agent of the order. The ruling stated that "an agency relationship is established when it appears, based on all the facts and circumstances, that the payer of the income is looking directly to the order, rather than to the individual member, for the performance of the services."[108] Since the chaplain was an employee of the Armed Services and subject to its rules and regulations, the ruling found that the Armed Services were looking to the chaplain, not his order, for the performance of his services, and hence he was not acting as agent of his order.[109]

The agency test, as refined by the 1979 ruling, has become possibly the most popular test in resolving assignment of income issues. In practice it

102. See, e.g., Rev. Rul. 77-290, 1977-2 C.B. 26, 27.

103. See, e.g., id. and Fogarty v. United States, 780 F.2d 1005, 1009 (Fed. Cir. 1986), each relying on Order of St. Benedict v. Steinhauser, 234 U.S. 640 (1914), for the proposition that vows of poverty are legally enforceable.

104. Rev. Rul. 76-323, 1976-2 C.B. 18, 19.

105. Rev. Rul. 77-290, 1977-2 C.B. 26, 26-28.

106. Rev. Rul. 79-132, 1979-1 C.B. 62.

107. Id. at 62.

108. Id. at 63.

109. Id.

works in a highly mechanistic manner: if a contract or agreement exists between the employer and a third party under which the third party provides the services of the employee to the employer, the employee will be treated as the third party's agent. In the absence of such a contract or agreement, the employee will be treated as acting on his own behalf and accordingly will be taxed on his earnings.

The Tax Court adopted this approach, sometimes called the "agency triangle" theory, in Schuster v. Commissioner,[110] another vow of poverty case. Sister Francine Schuster was a member of an order one of whose purposes was "the care and treatment of suffering humanity."[111] Members were allowed to obtain outside employment provided they received the prior approval of the order; approval depended on whether the proposed employment furthered the charitable objectives of the order.[112] Members who received outside employment agreed they would obey any direction of the Provincial Superior concerning their employment including a direction to terminate that employment.[113] Sister Schuster obtained the permission of the order to serve as a midwife in an underserved area in a clinic aided by the National Health Services Corps ("NHSC"), a federal agency.[114] Sister Schuster was employed by and received her checks from the NHSC.[115] The order had attempted to enter into a contract directly with the NHSC but the NHSC did not respond to the order's request.[116] Sister Schuster, pursuant to her vow of poverty, endorsed over to the order all checks she received from the NHSC and asserted on her income tax returns that she was not taxable on the salary she received from the NHSC since she was acting as the agent of the order.[117]

The Tax Court rejected this claim because the order was under no contractual liability to provide midwife services to the NHSC.

> [I]n the legal sense, one can perform services for a third party on someone's "behalf" only if some sort of obligation to perform the services rests initially with the person on whose behalf one wishes to act. If the "principal" is under no duty to perform the services itself, or to ensure that the services be performed, but merely approves of the

---

110. 84 T.C. 764 (1985), aff'd, 800 F.2d 672 (7th Cir. 1986).
111. *Schuster*, 800 F.2d at 673.
112. Id. at 673-74.
113. Id. at 674.
114. Id.
115. Id. at 675.
116. Id.
117. Id.

> performance as an irrelevant bystander, then, in the legal sense of the word, one cannot act on the other's behalf.[118]

A variation of the "agency triangle" theory was utilized by the Tax Court in Johnson v. Commissioner[119] which involved a so-called "loan out" corporation.[120] Johnson was a basketball player with the San Francisco Warriors.[121] In 1974, he entered into an agreement with an unrelated Panamanian corporation ("PMSA") under which he granted the corporation exclusive rights to his professional services in sports for the next six years in exchange for monthly payments of $1,500 for the rest of his life.[122] Johnson's attorney, who was negotiating the renewal of Johnson's contract with the Warriors at that time, attempted to have the Warriors contract with PMSA for Johnson's services.[123] However, the Warriors adamantly insisted that it would only sign a contract with Johnson.[124] Consequently, Johnson signed a contract directly with the Warriors and assigned his salary under the contract to PMSA.[125] The Internal Revenue Service determined a deficiency based on the difference between the amount Johnson received from PMSA and his salary under his contract with the Warriors.[126] The court held for the Service.

> An examination of the case law from Lucas v. Earl hence reveals two necessary elements before the corporation, rather than its service-performer employee, may be considered the controller of the income. First, the service-performer employee must be just that—an employee of the corporation whom the corporation has the right to direct or control in some meaningful sense. . . . Second, there must exist between the corporation and the person or entity using the services a contract or similar indicium recognizing the corporation's controlling position.[127]

---

118. *Schuster*, 84 T.C. at 774.

119. 78 T.C. 882 (1982), aff'd, 734 F.2d 20 (9th Cir.), cert. denied, 469 U.S. 857 (1984).

120. Id.

121. Id. at 883.

122. Id. at 884. PMSA could terminate the $1,500 monthly payments if Johnson failed to play for any professional athletic teams for any consecutive 24-month period. Id. at 886-87.

123. Id. at 884.

124. Id.

125. Id. at 884-85. In fact, Johnson assigned his salary to PMSA's assignee. Id.

126. Id. at 889.

127. Id. at 891 (footnote omitted) (citation omitted).

Although the court assumed arguendo that the first requirement was met, it held against Johnson since clearly the second requirement was not met.[128]

Some courts have rejected both the "agency triangle" theory and the *Johnson* "two part test" as overly rigid and have opted instead for a supposedly more flexible approach. On the appeal of the *Schuster* case from the Tax Court, the Court of Appeals for the Seventh Circuit expressly rejected both tests and chose instead to make its determination of whether an agency relationship existed on the basis of the six factors listed by the Court of Claims in Fogarty v. United States:[129]

> 1) the degree of control exercised by the Order over the member; 2) ownership rights [to the compensation as] between the member and the Order; 3) the purposes or mission of the Order; 4) the type of work performed by the member vis-a-vis the purposes or mission; 5) the dealings between the member and the third-party employer, including the circumstances surrounding inquiries and interviews, and the control or supervision exercised by the employer; and 6) the dealings between the employer and the Order.[130]

While the *Schuster* court acknowledged that the third and fourth factors "arguably" pointed toward the existence of an agency relationship, it nevertheless held that Sister Schuster was not acting as agent of her order.[131] The court emphasized that the order did not exercise "day-to-day control" over Sister Schuster in her activities as midwife in the clinic (the first factor), that the checks were issued to Sister Schuster rather than the order thereby giving her greater control over the compensation (the second factor), and that Sister Schuster, not her order, had been employed to act as midwife (the fifth and sixth factors).[132] Although the *Fogarty* "six-part" factor test purports to be more flexible than the "agency triangle" test or the *Johnson* "two part test,"

---

128. Id. at 891-92. In Sargent v. Commissioner, 93 T.C. 572 (1989), rev'd, 929 F.2d 1252 (8th Cir. 1991), the taxpayers, professional hockey players, formed professional service corporations, which in turn contracted with the owner of the Minnesota North Stars hockey team to furnish the services of the taxpayers. Thus, the second part of the *Johnson* test was satisfied. However, the Tax Court found the hockey team exerted such extensive "on-the-job" control over the taxpayers that it, rather than the professional service corporations, was the true employer of the taxpayers. *Sargent*, 93 T.C. at 580. The Eighth Circuit reversed, holding that the contracts between the taxpayers and their respective professional service corporations established the requisite employer-employee relationships. *Sargent*, 929 F.2d at 1261.

129. 780 F.2d 1005 (Fed. Cir. 1986).

130. Schuster v. Commissioner, 800 F.2d 672, 677 (7th Cir. 1986).

131. Id. at 678.

132. Id. at 678-79.

it almost invariably will produce the same result. If the employer's contract is with the member instead of the order, then the employer will normally exercise more day-to-day control over the member than the order does and the checks will be issued to the member instead of the order.

There are many difficulties with the agency tests as applied by the Service and the courts. First, they are irreconcilable with many of the Service's own rulings. In Revenue Ruling 58-515,[133] a police officer in the performance of his official duties took a job in private industry "for the purpose of obtaining certain information for the [police] department *without disclosure of his identity*."[134] During this period of employment, the officer continued to receive his regular pay from the department, and in accordance with departmental regulations turned over his pay from the private employer to the police pension fund.[135] The ruling held that the police officer was not taxable on the pay from the private employer since he "was employed in private industry as an agent of the police department."[136] Obviously, the private employer here was looking to the officer and not the police department for the performance of his duties; it did not even know that its employee was a police officer. Obviously, it was the private employer, rather than the department, that exercised greater control over the police officer in the performance of his day-to-day activities on the employer's job, and both his pay and the Form W-2 were issued to the officer and not the department.[137]

Although the inconsistency may not be as pointed, other rulings also diverge from the "agency triangle" theory and related tests. For instance, in Revenue Ruling 65-282[138] attorneys accepted employment at a fixed salary with a legal aid society and agreed, as a condition of their employment, to turn over any court-awarded fees to the society.[139] Under the applicable state statute, the court appointed individual attorneys to represent indigent persons accused of crimes, and upon completion of their representation, the attorneys were paid by the county on order of the appointing court.[140] The ruling held the attorneys who immediately paid over such fees to the society in accordance with their employment agreements were not taxable on the fees since "the attorneys are considered to be receiving the fees as agents for the legal aid society."[141] The ruling found that the individual attorneys were

133. 1958-2 C.B. 28.
134. Id. at 28 (emphasis added).
135. Id.
136. Id.
137. Id.
138. 1965-2 C.B. 21.
139. Id. at 21.
140. Id.
141. Id.

agents of the society even though (1) the court appointed the individual attorneys rather than the society to represent the indigent; (2) the court exercised disciplinary authority over the individual attorneys; (3) there was no contract between the court and the legal aid society for the society to provide the services of the attorneys; (4) the court awarded the fees to the attorney rather than the society; and (5) checks were issued to the attorney and not the society.

The striking divergence in the Service's treatment of seemingly similar cases is illustrated by a comparison of its holding in Revenue Ruling 74-581[142] with the Service's successful litigating position in Kircher v. United States.[143] Revenue Ruling 74-581 involved a law school's clinical program.[144] From time to time, a Federal district court or a state supreme court would assign a faculty member who was an attorney to represent an indigent defendant in a criminal matter pursuant to the Criminal Justice Act of 1964.[145] Students in the clinical program would assist the attorney-faculty member in the defense of the case.[146] The faculty members participating in the program had agreed, before entering the program, to endorse over to the law school any fees received under the Criminal Justice Act.[147] In the ruling, the clerk of the court took the "generally acknowledged position" that fees under the Act could not be paid to the law school but must be paid directly to the assigned attorney.[148] Therefore, in practice, the attorney-faculty member would submit vouchers to the appropriate court in his or her name, and upon receipt of the check would endorse it to the law school.[149] The ruling held, without explanation, that the attorney-faculty member was not taxable on the fees.[150]

In Kircher v. United States, a mental hospital operated by the State of Ohio had an organized pastoral service to meet the needs of its patients.[151] The hospital required that before any candidate could be appointed as chaplain, he must first be appointed by the ecclesiastical body of which he is a member.[152] Since only a priest can celebrate the Eucharist and administer the Sacraments in the Roman Catholic Church, only ordained

142. 1974-2 C.B. 25.
143. 872 F.2d 1014 (Fed. Cir. 1989).
144. 1974-2 C.B. 25, 25.
145. Id.
146. Id.
147. Id.
148. Id. at 25-26.
149. Id. at 26.
150. Id.
151. 872 F.2d at 1016.
152. Id. at 1016.

priests could serve as Catholic chaplains at the mental hospital.[153] In 1972, the Franciscan Order appointed Father Waldschmidt to serve as chaplain at the state mental hospital.[154] However, before undertaking his duties as chaplain, Father Waldschmidt was required to submit his application for employment to the hospital and have it approved by the superintendent of the hospital; this was duly done.[155] The hospital did not interfere with Father Waldschmidt's performance of his priestly duties, except to the extent his duties "would violate the rules and regulations governing the care of the patient."[156] Father Waldschmidt had an annual visitation by his religious superior and various other visits by members of the Franciscan Order to monitor the manner in which he was performing his duties.[157] The State of Ohio treated Father Waldschmidt as a full-time state employee and issued checks for his service payable to him which he then duly remitted to the Franciscan Order.[158] The court sustained the Service's contention that Father Waldschmidt was not the order's agent and that therefore the salary was taxable to him.[159]

The results in Revenue Ruling 74-581 and *Kircher* cannot be reconciled on the basis of any of the tests for determining agency. In both cases, the contract or appointment from the third-party "employer" (the hospital in *Kircher* and the court in the ruling) ran directly to the purported agent rather than the purported principal; in neither case was there a contract by the purported principal to provide the services of its agent to the third party. In both cases, the checks were payable to the purported agent and not the purported principal. In both cases, there was a close nexus between the "principal's" mission and the services performed by its purported "agent." Finally, nothing in the ruling suggests that the law school exercised any greater control over the faculty member-attorney in his or her representation of the indigent client than the Franciscan Order exercised over Father Waldschmidt's performance of his priestly duties. In short, there seems to be no principled basis for distinguishing the ruling and *Kircher* on the basis of agency. Either *Kircher* is wrong or the ruling is wrong, or else the courts and the Service have overlooked the basis on which they may be reconciled.

153. Id. at 1016-17.
154. Id. at 1017.
155. Id.
156. Id.
157. Id.
158. Id.
159. Id. at 1019-20.

V. Resolving the Conflicts: A Return to Basics

A. *The Overlooked Distinction*

Surprisingly none of the cases or rulings discussed above even alludes to the basic distinction between gratuitous assignments of income and assignments for consideration. Invariably, each of them cites the classic *gratuitous* assignment of income cases—*Earl*, *Horst*, and *Eubank*—without regard to the type of case under consideration. This is strange since some of these cases fall in one category while the remainder fall in the other, and thus are subject to dramatically different rules of taxation.

Schneer, for instance, is clearly an assignment-for-value case. In negotiating the terms of his admission as partner to the second and third firms, Schneer was engaged in an arm's-length transaction with unrelated parties in an effort to maximize his economic position. Schneer intended to get back a dollar for every dollar of income he assigned; and the law presumes that in an arm's-length transaction the amount transferred by one party equals what he receives in return.[160] Although the opinion is silent on the point, the transcript shows that in return for Schneer's agreement to share his fees from the first firm with the partners of the second firm, Schneer was permitted to share in the fees the second firm collected for work it performed *before* he joined the firm.[161] Clearly, there was a quid pro quo for the release of his right to the fees from the first firm. There is simply no reason to believe that income was being gratuitously shifted in this case from one taxpayer to another.

Revenue Ruling 74-581[162] (the law school clinic ruling) and Revenue Ruling 65-282[163] (the legal aid society ruling) are also assignment-for-consideration cases. In Revenue Ruling 74-581, the full-time faculty member operating the criminal law clinic received consideration, her law school salary, for endorsing over her checks to the law school.[164] Her salary was intended to compensate her for all her duties as faculty member, *including* her duties in running the law school clinic.[165] Permitting her to retain both the court-awarded fees *and* her salary would have resulted in double compen-

---

160. United States v. Davis, 370 U.S. 65, 72-73 (1962); Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184, 189 (Ct. Cl. 1954).

161. Record at 28-29, *Schneer* (No. 31804-88) (testimony of Robert Sylvor).

162. 1974-2 C.B. 25.

163. 1965-2 C.B. 21.

164. 1974-2 C.B. 25, 25.

165. Id. "[T]he time spent in supervising work of students on these cases and in the representation of the client is part of the faculty member's teaching duties for which the faculty member is compensated by a total annual salary . . . ." Id.

sation for the same services. If her salary did not fully compensate her for her service to the law school, including her operation of the clinic, she presumably would have declined to participate in the clinical program or else would have bargained for an increase in her salary. On the other hand, if the law school had permitted the faculty member to retain the court-awarded fees, it undoubtedly would have reduced her law school salary by a corresponding amount.[166] There is no reason to believe that income either was intended to be, or was in fact being, shifted from the faculty member to the law school.

In Revenue Ruling 65-282, the attorneys in the legal aid society received for their services and their agreement to pay over to the society all court-awarded fees a fixed salary and presumably the use of office facilities and staff support.[167] If this package of benefits did not fully compensate the attorneys, they presumably would not have accepted employment from the society. Again, there is no evidence that these attorneys intended to, or did in fact, shift any income from themselves to the society.

In contrast, in the "vow-of-poverty" cases both the intent and effect of gratuitously shifting income from the member to the order were present. The member upon entering the order had vowed "never [to] claim or demand, directly or indirectly, any wages, compensation, remuneration, or reward . . . for the time or for the services or work I devote for or with [the Order]" thereby evidencing his intent to benefit the order;[168] while the disparity between the amount earned by the member and the small allowances he was permitted to retain for his subsistence evidence the fact that income was being shifted.

As shown above, in assignment for consideration cases, the earner is taxed only on the consideration he receives in exchange for his earned

---

166. In fact, many firms and businesses resolve the "outside income" issue by permitting the partner or employee to *keep* the outside income and then crediting the amount of such outside income against the amount of income the employee or partner would otherwise be entitled to receive. For an example of such a provision in a partnership agreement and a description of how it operates, see Raby, supra note 76, at 424-25.

167. 1965-2 C.B. 21.

168. Schuster v. Commissioner, 800 F.2d 672, 673 (7th Cir. 1986) (alterations in original) (quoting vow which Sister Francine Schuster took upon entering the Order of the Adorers of the Blood of Christ). The order's constitution provided that a member withdrawing from the order was entitled to no compensation for the work she had performed while a member of the order, since "like all the Adorers of the Blood of Christ, she freely chose to serve the Lord and His people in a life of poverty, without personal gain." *Schuster*, 84 T.C. at 767 (quoting the order's constitution). See generally Sharon L. Holland, Title I: Norms Common to All Institutes of Consecrated Life [cc. 573-606], in The Code of Canon Law: A Text and Commentary 453, 465-66 (James A. Coriden et al. eds., 1985) (quoting and commenting on Canon 600, which elaborates on requirement of poverty imposed on all members of Roman Catholic religious orders).

income.[169] This principle produces the following results. In *Schneer*, the taxpayer would be taxed only on the consideration he received for surrendering his right to receive payments from the first firm, that is, on his distributive share in the firm's profits.[170] In the legal aid society ruling, the attorneys would be taxed only on the consideration they received for surrendering their right to court-awarded attorneys' fees, that is, on their fixed salaries. In the law school clinic ruling, the faculty member would be taxed only on the consideration she received for surrendering her right to court-awarded fees, that is, on the portion of her law school salary allocable to her running of the legal clinic program. In contrast, the vow-of-poverty cases involve gratuitous assignments of income, and, as discussed below, the member of the religious order should be taxed on the income his personal services generated, that is, on the compensation that the third-party employer paid for his services.

These indicated results dovetail perfectly with the actual holdings in those cases. Note, however, that these results were obtained under an approach having nothing to do with the "similarity" or "agency" rationales asserted in the those cases and rulings. As shown above, the "similarity" and "agency" tests provide no intelligible reason for applying or not applying the assignment of income doctrine.[171] Moreover, they have been applied so inconsistently from one case to another as the courts and the Service have strained to reach the "correct" result, that these tests afford no basis for predicting results or structuring transactions.[172] In contrast, the approach

---

169. See discussion supra part II.D.

170. There has been an ongoing controversy as to whether a taxpayer's receipt of a profits interest in a partnership in exchange for services is a taxable event requiring the taxpayer to report immediately as income the present value of the profits interest, or whether the taxpayer need only report as income his distributive share of the partnership's profits when and as they are earned by the partnership. See generally 1 Arthur B. Willis et al., Partnership Taxation ch. 46 (4th ed. 1993). Contrary to the hopes of the legal profession, the Eighth Circuit's decision in Campbell v. Commissioner, 943 F.2d 815 (8th Cir. 1991), did not resolve the basic issue since it held in favor of the taxpayer on the ground that his particular profits interest lacked fair market value at the time of receipt and did not pass on the question of whether receipt of a profits interest is, as a matter of law, nontaxable. Id. at 823. The Internal Revenue Service recently issued Rev. Proc. 93-27, in which it stated that it would not treat receipt of a profits interest in a partnership as a taxable event; however, the Revenue Procedure does not apply where (i) the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease, (ii) the partner disposes of his profits interest within two years of receipt, or (iii) the profits interest is a limited partnership interest in a publicly traded partnership as defined in IRC § 7704(b). 1993-24 I.R.B. 63, 64 (July 6) at § 4. In *Schneer*, the Service did not treat Schneer's receipt of a profits interest in the second and third firms as taxable events.

171. See discussion supra part IV.

172. See discussion supra part IV.

advocated here resolves these cases by reference to the basic purposes of the assignment of income doctrine and thereby avoids the practical and theoretical infirmities of the "similarity" and "agency" tests.

Note moreover that this approach resolves many of the inconsistencies created when the "similarity" or "agency" test is used. For example, it was shown in the preceding Part that the results in Revenue Ruling 74-581 (the law school clinic ruling) and Kircher v. United States (where Father Waldschmidt served as a chaplain in a state mental hospital) cannot be reconciled under the agency test approach.[173] But when one focuses on the distinction between gratuitous and compensated assignments, the results become self-evident, and the apparent inconsistencies disappear: Revenue Ruling 74-581 is an assignment-for-value case (thus the doctrine does not apply), while *Kircher* is a gratuitous assignment of income case (thus the doctrine does apply).

Operation of this approach may be further illustrated by the following example. Sister Joan, at direction of her order, teaches in a public school for which she receives a salary of $25,000. This salary is paid directly to Sister Joan, who, pursuant to her vow of poverty, endorses her pay checks over to the order. Sister Joan's duties require her to live away from the convent, and accordingly her order sends her a monthly stipend of $1,250, or $15,000 a year, for her subsistence (rent, food, utilities, clothing, etc.). Analysis shows this case involves both a gratuitous assignment of income and an assignment for value. To the extent Sister Joan receives a stipend from the order in connection with her services, her assignment of income is for value; hence she should be taxed on the consideration received, or $15,000 a year. The balance of the amount she remits to the order, $10,000, is gratuitous, and hence she should also be taxed on this amount. Sister Joan should therefore be taxed on a total of $25,000: $15,000 under the assignment for value rule, and $10,000 under the gratuitous assignment of income rule.[174] This analy-

---

173. See supra notes 142-59 and accompanying text.

174. This bifurcated analysis is consistent with the holdings in Priv. Ltr. Rul. 8105008 (Sept. 29, 1980). This ruling concerned a member of a religious order who, at the order's direction, taught in the public school system. Pursuant to her vow of poverty, she endorsed all her pay checks over to the order, and the order in turn paid her for her personal living expenses. Using the conventional "agency" analysis (i.e., the school system looked to the member rather than the order for teaching services), the ruling held the member was taxable on her salary.

However, the ruling used a more intricate analysis to determine whether the member was entitled to a charitable deduction on the amounts she endorsed over to the order. The ruling stated that a payment to a charitable organization could qualify as a charitable contribution only to the extent it was a gift. It found that the amounts that the member received for her personal living expenses were partial consideration for her assignment to the order of her public school teacher's salary. Consequently, only "the excess of the amount

sis also demonstrates that the value of Sister Joan's charitable contribution is only $10,000, not $25,000.[175]

B. *Formal Statement of Approach*

Perhaps a more formal statement of the approach proposed here would be helpful. First, of course, it must be determined that the taxpayer's services generated the income. Then two questions must be answered.

1. At the time the income was earned, was the taxpayer entitled to receive and retain the income, or was he legally compelled by agreement to turn it over to another? If he could receive and keep the income, he must be taxed on it. If he was compelled to pay the income to another, he may or may not be taxable on the assigned income depending on the answer to question 2.

2. Did the taxpayer receive consideration for agreeing to turn the income over to another person, or was his assignment of that income gratuitous? If the agreement was for consideration, the taxpayer will be taxed only on the consideration he received; any income collected by the assignee over and above the consideration paid will be taxed to the assignee. If the assignment was gratuitous, the taxpayer will be taxed on the full amount of income his personal services generated.

Question 1 makes it clear that a necessary, *but not sufficient*, condition for a taxpayer to avoid being taxed on the assigned income is that he be under a legal compulsion to turn it over to another. This requirement may be thought of as a replacement for the similarity and agency tests. Under the similarity test, income earned by a partner in his individual capacity will be reportable by the partnership, rather than the partner, only if he has agreed to turn it over to the partnership *and* the services he performs are similar to those offered by the partnership as an entity. In contrast, the test proposed here requires only that the partner have agreed, prior to the time he rendered the services, to turn over the income to the partnership. This is the more logical approach. If income from the sale of sophisticated electronic equipment, the leasing of automobiles, and the sale of bread may be treated as income of a single corporate conglomerate, there is no reason why such

---

Taxpayer remits to the order over the amounts she receives from the order for her personal living expenses" was a gift and qualified as a charitable contribution. Id.

The ruling, in effect, bifurcated the member's assignment of her salary: (1) part of her salary was exchanged for consideration, and (2) the remainder was gratuitously transferred to the order. Although the ruling used this analysis only to determine the amount of the member's charitable contribution, there is no reason why it should not also be used to determine the extent to which the member is taxable on her salary.

175. Id.

disparate types of income should not also be treated as the income of a single partnership. The requirement proposed here recognizes that the business of a partnership is whatever the partners agree to, and if they agree to pool income from a given activity, that income becomes, by virtue of such agreement, partnership income and the activity generating it part of the partnership's business.[176]

Likewise, the proposed requirement obviates the need to find an agency relationship in the nonpartnership cases. All that is required is that the taxpayer have legally obligated himself to pay the income he earns over to another. The proposed requirement recognizes that where a taxpayer agrees to remit the income from a given activity to another, the taxpayer is acting on the other person's behalf when he performs that activity. It is absurd to say, as the Tax Court did in *Schuster*, that Sister Schuster was not acting on the order's behalf in serving as midwife[177] when she was legally obligated to turn over all her earnings from that activity to the order.

But being under a legal obligation to turn one's earnings over to another does not, by itself, make the assignment of income doctrine inapplicable. Otherwise, the assignment of income doctrine would not apply to the vow-of-poverty cases. To make this determination, one must then answer question 2: Was the assignment gratuitous or for consideration?

Applying these principles to the first three hypothetical cases in Part III produces the following results: the Army Reserve pay that P turns over to his law partnership is reportable by the partnership and not by P; the fees awarded by the court to F, the faculty member who operates the law school clinic, is income to the law school and not to F; and Father John's salary as a chaplain in a state hospital is taxed to Father John and not the order.

---

176. Cf. Cowan, supra note 20, at 1537-38:

> Whether the partner is acting as an agent of the partnership with respect to a specific activity seems to depend *almost exclusively on the terms of the partnership agreement*. . . . For example, if a real estate partnership with 100 partners and 200 employees is engaged in operating shopping centers throughout the country, and one of the partners also acts as a broker in the leasing and selling of properties other than shopping centers, and all of the partners share in the profits and losses, and exposure to liability, from that activity, the partnership is *per se* also in the business of leasing and selling such other properties. . . . If there is a bona fide, mutual sharing of the economic venture, including in profits and losses, there is probably a partnership. (first emphasis added.)

However, Cowan would not recognize for tax purposes the pooling of a judge's salary or the salary of a member of the armed forces: "Serving in the armed forces or as a judge requires sole loyalty to that employer, and a sharing of loyalty with a partnership of other individuals is completely contrary to public policy." Id. at 1541-42.

177. Schuster v. Commissioner, 84 T.C. 764, 774 (1985), aff'd, 800 F.2d 672 (7th Cir. 1986).

C. *Issues Involved in Applying Proposed Approach*

The idea that a person who assigns earned income for consideration is taxed only on the consideration received is premised on the notion that for every dollar of taxable income he assigns he will receive (or could expect to receive) a dollar of *taxable* income in return. Thus, the tax treatment of the assignor, *on average*, is not changed or bettered by the assignment. In two cases, however, the assignor will benefit from the assignment of income. First, the assignor will benefit if the transaction can be structured so that amount received for the assignment of income avoids recognition. Second, the assignor will benefit if the consideration is paid out over a longer period than the earned income was to have been paid. Spreading out the income over a longer period of time may benefit a taxpayer in a progressive tax regime by causing more of the income to be taxed at lower rates than if it were "bunched up" in one or a few years. These issues will be addressed below: the nonrecognition issue in the discussion of the personal service corporation, and the deferral issue in the discussion of the basketball player hypothetical.

D. *The Personal Service Corporation: A Case of Nonrecognition?*

Although personal service corporations no longer offer the same opportunity for income tax savings as they did a couple of decades ago, they merit study because of the light they shed on the proper reach of the assignment of income doctrine.[178] At the height of their popularity in the

---

178. Immediately before the recent enactment of the Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312 [hereinafter 1993 RRA], the personal service corporation ("PSC") offered little opportunity for tax savings. This was primarily because the highest marginal rate for C corporations, such as a PSC, was then higher than the highest marginal tax rates for individuals and unincorporated businesses (34% vs. 31%). IRC §§ 1(a)-(e), 11. In the 1970s, the situation was reversed. See infra notes 179-80 and accompanying text. Other factors that made operating as a PSC unattractive were:

(1) *Substantial elimination of the preferential tax rates for capital gains*: The substantial preference in tax rates for capital gains formerly in effect made it possible to sell the stock of a PSC or to liquidate a PSC at a very favorable tax rate. In 1970, for example, individuals were subject to a maximum tax rate of 70% on ordinary income, while the maximum tax rate on long-term capital gains was only 35%. IRC §§ 1, 1202 (1970). However, immediately prior to the enactment of the 1993 RRA, the highest individual tax rate on ordinary income (31%) exceeded the highest individual tax rate on long-term capital gains (28%) by only three percentage points. IRC § 1(a)-(e), (h).

(2) *Denial of tax benefits for "personal service corporations" formed to avoid income tax*: Section 269A authorizes the IRS to disallow tax benefits in certain cases where a "personal service corporation" (as defined therein) was formed for the principal purpose of avoiding income tax. IRC § 269A.

1970s, personal service corporations offered the prospect of substantial tax savings. For example, the highest marginal tax rate for individuals in 1970 was seventy percent,[179] while the highest marginal tax rate for corporations was forty-eight percent.[180] A high income taxpayer, by splitting off some of his earned income to his wholly-owned corporation, could take advantage of the lower corporate marginal rates and also a separate graduated tax schedule, all the while retaining complete control over the diverted income. If the individual died owning the stock of his personal service corporation, his estate would receive a stepped-up basis in the stock of the corporation equal to its date-of-death value;[181] this of course would reflect the value of the corporation's accumulated income. The estate could then sell the corpora-

(3) *Flat corporate tax rate of 34% for "qualified personal service corporations"*: Section 11(a), as in effect prior to enactment of the 1993 RRA, taxed a "qualified personal service corporation" (as defined in § 448(d)(2)) at a flat rate of 34%—the highest marginal rate imposed on a corporation. IRC §§ 11, 448(d)(2). This provision deprived a qualified personal service corporation of the benefit of the lower corporate tax rate brackets.

(4) *Double tax regime of Subchapter C*: The double tax regime of Subchapter C subjects corporate earnings to a double tax: first an income tax is imposed on the earnings when the corporation earns them, and then an income tax is imposed on the earnings when the corporation distributes them to the shareholders as dividends. IRC §§ 11, 61(a)(7).

(5) *Repeal of the "General Utilities" doctrine*: Prior to the Tax Reform Act of 1986, the Code made it possible for a corporation to sell its assets and distribute the sale proceeds without the gain being taxed at the corporate level. This mitigation of the double tax regime of Subchapter C was eliminated by the Tax Reform Act of 1986, Pub. L. No. 99-514, § 631, 100 Stat. 2085, 2269.

The 1993 RRA makes the following relevant changes: (1) it increases the maximum individual income tax rate from 31% to 39.6%; (2) it increases the maximum corporate tax rate to 35% but only for corporations whose taxable income exceeds $10,000,000; and (3) it imposes a flat rate of 35% on "qualified personal service corporations." 1993 RRA, §§ 13201, 13202, 13221.

As a result of the changes made by the 1993 RRA, PSCs may become attractive again for high-income individuals, since the maximum individual tax rate for individuals (39.6%) will now exceed the maximum tax rate for corporations (35%, but 34% for corporations having taxable income of less than $10,000,000). Also, the preferential tax rate for capital gains is more significant (28% vs. a maximum tax rate of 39.6% on ordinary income). But PSCs will not be as attractive as they were in the 1970s since taxpayers will now have to deal with § 269A (authorizing the Service to deny tax benefits to personal service corporations formed primarily to avoid tax), § 11(b) (imposing a flat tax rate of 35% on "qualified personal service corporations"), and the repeal of the *General Utilities* doctrine. See generally Leonard Sloane, New Tax Law Limits the Draw of S Corporations, N.Y. Times, Aug. 12, 1993, at D5.

179. IRC § 1 (1970). A special provision, IRC § 1348 (1970), repealed by Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 101(c), 95 Stat. 172, 183, limited the maximum tax rate on earned income to 50%.

180. IRC § 11 (1970).

181. IRC § 1014 (1970).

tion's stock at no taxable gain. If this scenario were followed, the income tax savings effected through the use of the personal service corporation would become permanent. Even if the individual sold or liquidated the corporation before his death, his taxable gain (again reflecting the value of the corporation's accumulated income) would be taxed at preferential capital gain rates.[182]

The personal service corporation thus represented in the seventies an almost perfect case for applying the assignment of income doctrine, as all the necessary elements were present. Consider the following hypothetical case that was posed in Part III:

> *Personal Service Corporation Case*: O was a manufacturers' representative for producers of steel tubing. Operating as a sole proprietor, O netted about $250,000 a year. No more than $5,000 of this amount represented a return on the few assets he used in the business (e.g., his word processor, photocopier, etc.); the balance ($245,000) was solely attributable to O's personal services. On the advice of his attorney, O at the beginning of 1970 formed Newco, Inc. in which he was the sole shareholder and employee. Thereafter, he conducted his business of representing manufacturers through the corporation. O's salary from Newco, Inc. for 1970 was fixed at $100,000 leaving the corporation with a net profit of $150,000. Was O taxable on $245,000 in 1970 under the assignment of income doctrine, since that was the amount of income his services produced?

Here, O is in effect shifting some of the income earned through his personal services, namely, $145,000 out of the $245,000 his services produced, to a related taxpayer, namely, his wholly-owned corporation Newco, Inc., to reduce his overall tax burden. Strangely, the efforts of the Internal Revenue Service to apply the doctrine in these cases met with little success.[183]

---

182. The Code provided individuals with a deduction equal to 50% of the amount by which an individual's net long-term capital gains exceeded his net short-term capital losses. IRC § 1202 (1970), repealed by Tax Reform Act of 1986, Pub. L. No. 99-514, § 301(a), 100 Stat. 2216. Since the highest marginal tax rate on individuals was then 70%, IRC § 1 (1970), this provision effectively capped the marginal tax rate on long-term capital gains at 35%.

183. Foglesong v. Commissioner, 621 F.2d 865 (7th Cir. 1980) (rejecting application of assignment of income doctrine, since its application conflicted with the policy of recognizing a corporation as a separate legal person and economic actor), on remand, 77 T.C. 1102 (1981), rev'd, 691 F.2d 848 (7th Cir. 1982); Rubin v. Commissioner, 429 F.2d 650 (2d Cir. 1970) (rejecting application of assignment of income doctrine to a personal service corporation

Professor Manning has argued that the doctrine should *not* apply to an assignment of earned income to a wholly owned corporation.[184] He argues as follows: the assignment of income doctrine can properly be applied only to a *gratuitous* assignment of income;[185] an assignment to a wholly-owned corporation is *not gratuitous* since the "value of the stock received or the increase in the value of stock already owned, of necessity, equals the value of the income transferred";[186] therefore, the doctrine cannot be applied to an assignment to a wholly-owned corporation.

Professor Manning confuses the purpose of the assignment of income doctrine. It is true, as he points out, that the shareholder-employee suffers no diminution of wealth in these cases. But the assignment of income doctrine is not concerned about diminution of wealth but with tax avoidance. In the seventies, a person by utilizing a personal service corporation could achieve an unwarranted reduction in taxes in just the manner proscribed by the assignment of income doctrine: the splitting of earned income among related taxpayers thereby defeating the graduated tax system. That the taxpayer could accomplish this without experiencing a diminution in wealth *strengthens*—rather than *weakens*—the case for applying the doctrine. Recall in *Clifford* the emphasis Justice Douglas placed on the fact that the purported transfer in that case left the husband's economic status unchanged: "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 substantial change in his economic position."[187] That the earner can still control and enjoy income that he has purportedly assigned strengthens the case for taxing him on that income. In *Clifford*, Justice Douglas *assumed* the existence of a harmonious family unit in finding no change of economic position. How much stronger is the case for taxation when the absence of economic change is not based on the vagaries of inter-family relations but on unfettered legal control of a wholly-owned corporation.

The question remains whether the proper result in these cases can be obtained within the framework of the approach outlined above, or whether that approach needs to be modified. No modification is necessary. If we accept Professor Manning's characterization of the transaction as an assign-

---

because such application tended to undermine policy of treating corporation as a taxable entity distinct from its shareholders, and because § 482 was available to deal with the problem).

184. Elliott Manning, The Service Corporation—Who Is Taxable on Its Income: Reconciling Assignment of Income Principles, Section 482, and Section 351, 37 U. Miami L. Rev. 657, 669 (1983). Professor Manning would, however, apply § 482 to a shareholder-employee who works exclusively for his wholly-owned corporation. Id. at 676-80.

185. Id. at 668.

186. Id. at 669 (footnote omitted).

187. Helvering v. Clifford, 309 U.S. 331, 335-36 (1940).

ment for *value*, then under the established rules the shareholder-employee is taxable on the amount of consideration received. This amount, to use Professor Manning's words, is the "value of the stock received or the increase in the value of stock already owned, [which,] of necessity, equals the value of the income transferred."[188]

In the above hypothetical, O's rendering of services to Newco, Inc. for an inadequate consideration may be viewed as a transaction governed by section 351 of the Code. O, of course, did not receive any stock in return for selling his services to Newco, Inc. at a bargain price, and thus the transaction would not at first blush seem to be governed by section 351. But the courts have held that issuance of additional stock to a 100% shareholder is an "meaningless gesture," and that transactions involving a sole shareholder should be analyzed *as though* additional stock had been issued.[189] Thus, O may, and should, be viewed as though he received stock from Newco, Inc. having a value equal to the difference between the fair market value of his services and the salary he actually received. However, even when the transaction is cast in this form, O does not qualify for the nonrecognition rule of section 351.[190] O is not contributing "property" to the corporation, but rather his "services" which do not qualify for nonrecognition under section 351.[191] In response, it might be argued—weakly I think—that O is not transferring services but the income which the services produce; that therefore he is transferring "property" which qualifies for nonrecognition under section 351.[192] Even acceptance of this dubious argument will not enable O to avoid taxation. Both the courts and the Service hold that assignment of income principles override the nonrecognition rule of section 351 where, as here, the assignment is tax motivated and results in an artificial fragmentation of income.[193]

---

188. Manning, supra note 184, at 669 (footnote omitted).

189. See, e.g., Lessinger v. Commissioner, 85 T.C. 824, 831-36 (1985), rev'd on another issue, 872 F.2d 519 (2d Cir. 1989), and authorities cited therein.

190. IRC § 351(a).

191. IRC § 351(d).

192. The courts and the Service have recognized that the transfer to a newly-formed corporation of accounts receivable arising from services performed for the predecessor business constitutes a transfer of "property" and not of "services." See Hempt Bros. v. United States, 490 F.2d 1172, 1175-76 (3d Cir.), cert. denied, 419 U.S. 826 (1974); Rev. Rul. 80-198, 1980-2 C.B. 113. In these situations, the services were performed before the transfer to the corporation took place; hence, there were no "services" left to transfer but only a chose in action. Moreover, the services were performed for a predecessor business, not for the new corporation. However, in the case posed in the text, the services are being performed for the corporation. Clearly, the performance of services on behalf of a corporation for a less than fair market salary represents a contribution of "services" to the corporation.

193. Brown v. Commissioner, 40 B.T.A. 565 (1939), aff'd, 115 F.2d 337 (2d Cir. 1940); Rev. Rul. 80-198, 1980-2 C.B. 113.

Other objections to applying the assignment of income doctrine to personal service corporations include: (1) applying the doctrine undermines the tax principle that a corporation is a separate and distinct taxpayer from its shareholders;[194] (2) applying the doctrine is a crude, sledgehammer solution to a problem requiring a more delicate treatment;[195] and (3) the presence of a specific code provision (section 482) dealing with the problem precludes resort to general judicial doctrines.[196] The first two arguments are without merit while the third requires modification.

The Supreme Court did not impugn the viability of Mrs. Earl as a separate taxpayer when it applied the assignment of income doctrine to her husband's salary.[197] Likewise, applying the doctrine to a personal service corporation does not impugn the corporation's viability as a separate and distinct taxpayer. Indeed, the assignment of income doctrine presupposes the existence of a separate viable taxpayer. A finding that all or a portion of the corporation's income should be taxed to the shareholder-employee does not mean that the corporation's existence is being disregarded; it simply means that the value of the shareholder-employee's services exceeds the salary he has elected to take, and that such excess constitutes earned income which the shareholder-employee has assigned to the corporation. If the corporation owns other assets, either tangible or intangible (including goodwill), which contribute to the profitability of the corporation, a reasonable portion of the corporation's profits should be attributed to those assets and not the shareholder-employee's services. Application of the doctrine is thus completely compatible with the notion of a personal service corporation as a separate income-generating taxpayer. Of course, if the corporation has no assets apart from its right to the personal services of its shareholder-employee, as sometimes occurs in the case of a personal service corporation, the corporation will have no taxable income after paying its shareholder-employee a fair price for his services.

Moreover, the assignment of income doctrine need not—and should not—be applied in a sledgehammer manner. Statements to the effect that applying the assignment of income doctrine is like "crack[ing] walnuts with a sledgehammer"[198] or represents an "all-or-nothing approach"[199] suggest

194. *Foglesong*, 621 F.2d at 868-69; *Rubin*, 429 F.2d at 652-53.

195. *Foglesong*, 621 F.2d at 872 (comparing application of assignment of income doctrine to "crack[ing] walnuts with a sledgehammer"); *Rubin*, 429 F.2d at 653 (describing the assignment of income doctrine as an "all-or-nothing approach").

196. *Rubin*, 429 F.2d at 653 (stating common law doctrines like the assignment of income doctrine "have no place where, as here, there is a statutory provision [i.e., § 482] adequate to deal with the problem presented").

197. Lucas v. Earl, 281 U.S. 111 (1930).

198. *Foglesong*, 621 F.2d at 872.

that application of the doctrine to a personal service corporation inevitably results in all of the corporation's income being taxed to the shareholder-employee. But as shown above, the only portion of a corporation's income properly taxable to the shareholder-employee under the assignment of income doctrine is the amount by which the fair value of his services exceed his salary: this is the amount that the shareholder-employee has assigned to the corporation. If the corporation, for example, uses its own physical assets in its business, a portion of the corporation's income represents a return on those assets and should properly be taxed to the corporation. Application of the doctrine therefore requires a refined and delicate analysis of the portion of the firm's profits properly allocable to the services of the shareholder-employee and the portion properly allocable to its other assets.[200] Depending on the circumstances, a substantial portion of a corporation's profits properly could be taxed to it notwithstanding application of the assignment of income doctrine.[201]

The principle stated above that a shareholder-employee should be taxed on the fair value of his services to his corporation is subject to one limitation: the amount of compensation deemed paid to him should not exceed the income he would have recognized had he not incorporated. Consider the case of an unsuccessful personal service corporation that earned $10,000 in revenues and paid $8,000 in secretarial salary before it ceased

---

199. *Rubin*, 429 F.2d at 653.

200. Requiring the parties to determine the fair value of a shareholder-employee's services to his personal service corporation does not seem unduly burdensome. Taxpayers and the Service already confront a similar task in applying § 162(a)(1) which limits a taxpayer's deduction to a "reasonable allowance" for compensation paid. Moreover, taxpayers and the Service must make similar determinations in applying the "arm's-length" standard under § 482.

201. It is unclear whether the courts realize the need to make the refined analysis called for in the text. The Tax Court, in sustaining the Commissioner's allocation of 98% of the corporation's net commission income to Mr. Foglesong under § 482, stated:

> The touchstone for determining whether the financial relations between the petitioner and the corporation reflected those of unrelated parties dealing at arm's-length is the extent to which the total remuneration to the petitioner from the corporation for the services he performed . . . was essentially equivalent to that which he would have received absent incorporation.

Foglesong v. Commissioner, 77 T.C. 1102, 1105-06 (1981), rev'd, 691 F.2d 848 (7th Cir. 1982). This test is too crude, since it fails to recognize that a sole proprietor's net taxable income from the conduct of his unincorporated business may reflect a return on his physical and intangible assets (including goodwill and going concern value) as well as remuneration for his personal services. The case, however, may simply reflect a failure of proof on the part of the taxpayer, since the decision makes no reference to any contention by the taxpayer that the Commissioner's allocation failed to allow a reasonable return on the corporation's physical and intangible assets.

operations. Assume that the fair value of the shareholder-employee's services during the corporation's existence was $20,000. If the $20,000 were deemed paid to the shareholder-employee, he would be taxed on $20,000 of compensation income, and the corporation would recognize a taxable loss of $18,000 [$10,000 of revenues - $8,000 of secretarial salary - $20,000 of salary deemed paid to shareholder-employee]. This result does not further the policy of the assignment of income doctrine. The purpose of the doctrine is to prevent a taxpayer from *shifting* taxable income from himself to related taxpayers thereby avoiding the higher rates prescribed by the progressive tax rate schedule. If the shareholder-employee had *not* incorporated, he would have recognized taxable income of $2,000 [$10,000 of revenues - $8,000 of secretarial salary]. Consequently, the shareholder-employee has *shifted* only $2,000 of income from himself by operating through a corporation; and this is the only amount he may properly be taxed on under the assignment of income doctrine. Taxing him on this amount will cause the corporation to break even [$10,000 of revenues - $8,000 of secretarial salary - $2,000 of compensation paid to the shareholder-employee]. Other doctrines or statutory provisions may cause the shareholder-employee to recognize more than $2,000 of compensation income;[202] but the assignment of income doctrine, being concerned solely with the amount of taxable income a taxpayer shifts to another party, should tax him only on this amount.

Where section 482 and the assignment of income doctrine produce the same result, it becomes something of a quibble whether that result is produced under the statutory provision, the judicial doctrine, or both. However, one court has held that section 482 does not apply to a shareholder-employee who works exclusively for his personal service corporation.[203] A

---

202. If § 482 applies to a shareholder-employee who works exclusively for his personal service corporation, see infra note 203 and accompanying text, the shareholder-employee will be taxed on the fair value of his services even if this causes the corporation to recognize a loss. Regs. § 1.482-1A(d)(4) (as amended in 1993) (applicable to taxable years beginning on or before April 21, 1993); Regs. § 1.482-1T(d)(1)(ii) (1993) (applicable to taxable years beginning after April 21, 1993). The validity of this rule has been sustained over the objection that § 482 authorizes only the allocation of income, not the "creation of income." Fitzgerald Motor Co. v. Commissioner, 508 F.2d 1096 (5th Cir. 1975); Kerry Inv. Co. v. Commissioner, 500 F.2d 108 (9th Cir. 1974); Kahler Corp. v. Commissioner, 486 F.2d 1 (8th Cir. 1973); B. Forman Co. v. Commissioner, 453 F.2d 1144 (2d Cir.), cert. denied, 407 U.S. 934 (1972); Latham Park Manor, Inc. v. Commissioner, 69 T.C. 199 (1977) (overruling prior inconsistent Tax Court decisions), aff'd, 618 F.2d 100 (4th Cir. 1980).

203. Foglesong v. Commissioner, 691 F.2d 848 (7th Cir. 1982) (refusing to apply § 482 to a shareholder-employee who worked exclusively for his wholly owned corporation because the "two or more organizations, trades, or businesses" requirement was not met). The Service announced in Rev. Rul. 88-38, 1988-1 C.B. 246, that it would not follow this holding in *Foglesong*, and the Tax Court in post-*Foglesong* cases has continued to apply § 482 in these situations. E.g., Haag v. Commissioner, 88 T.C. 604 (1987).

court following this ruling should have no hesitancy in applying the common law assignment of income doctrine. If anything, section 482 should encourage the courts to apply the doctrine to cases not falling within the section's literal language, since the section represents Congressional endorsement of the general philosophy of the doctrine: income should be taxed to the party that earns it and not artificially split among related parties to produce tax benefit.[204]

E. *The Basketball Player: A Case of Deferral*

As mentioned above, a person who assigns his earned income for valuable consideration may still derive a tax benefit if the consideration is paid out over a longer period than the earned income was scheduled to have been paid. By stretching out the payments, instead of "bunching" them in one or a few years, more of the income will be taxed in lower brackets. This was the tax plan in the "basketball player" hypothetical posed in Part III:

> *Basketball Player Case*: B, a basketball player, is acutely aware that the professional life of an athlete is short. He wishes to spread out the income he earns during his "good years" over his lifetime to reduce his overall tax burden. On the advice of his attorney, he enters into an agreement with an *unrelated* corporation, X Corp., to provide all his services in professional sports to X Corp. for six years in return for $18,000 a year for the rest of his life. B's attorney then attempts to negotiate an agreement between Hawks, a professional basketball club, and X Corp. under the terms of which X Corp. would provide the Hawks with B's services as a basketball player for the next three years for $100,000 a year. However, because of the Hawks' adamant insistence that it will only deal directly with B, B enters into an agreement

---

204. In Philipp Bros. Chems. v. Commissioner, 435 F.2d 53 (2d Cir. 1970), the court made the following observation regarding the policy of § 482: "The statute rests on the well-settled policy that income is taxable under Section 61 of the 1954 Code to the party who earns it and that it is economic reality rather than legal formality which determines who earns income." Id. at 57.

In Keller v. Commissioner, 77 T.C. 1014, 1034 (1981), aff'd, 723 F.2d 58 (10th Cir. 1983), the court observed that "Section 482, and the regulations pursuant thereto, provide a detailed mechanism to deal with the tax-avoidance problems which spur the assignment of income doctrine. Section 482 and the assignment of income doctrine, therefore, should not lead to different results in this case." See also Olla State Bank v. United States, 77-1 U.S. Tax Cas. (CCH) ¶ 9455, at 87,148-49, 40 A.F.T.R.2d (P-H) 5073, 5073-74 (W.D. La.) ("§ 482 only provides a method for making the determination allowed by § 61").

with the Hawks to play basketball for it for the next three years for $100,000 a year, and then assigns his rights to this pay to X Corp. Is B taxable on $100,000 a year under the assignment of income doctrine, or only on the $18,000 a year he receives from X Corp.?

Note first what is not occurring here. B is not attempting to shift income to another party; he was dealing at arm's-length with an unrelated party to maximize his earnings; and he fully expected to receive back a dollar of income for each dollar of income he assigned to X Corp. Under the analysis employed above—that one who assigns his earned income for value should be taxed only on the consideration received—B would only be taxed on the payments received from X Corp. But another element is present here: B is achieving a substantial tax saving by deferring his income. Since the assignment of income doctrine is a remedial device to carry out basic tax policy, the question becomes whether there is a compelling public policy against achieving tax savings through deferral that justifies applying the doctrine in these cases.

In fact, there seems to be no policy against it at all. Persons selling property are free to structure the sale to qualify for the installment sale provisions in the Internal Revenue Code and thereby spread out recognition of their gain.[205] Employees and independent contractors desiring to stretch out or defer their compensation to reduce their tax burden may negotiate deferred compensation agreements.[206] Case law permits an employee who has already deferred his income once to defer it again, even if already earned, provided the agreement to further defer is made before the income was scheduled to be paid.[207] The attitude of the law is that if a taxpayer is willing to accept delayed payment of his income he will be taxed accordingly.

Tax policy thus provides no warrant for using the assignment of income doctrine to prevent tax savings through deferral. Not surprisingly then, courts have declined to invoke the assignment of income doctrine to prevent the deferral of income.

This was demonstrated in Rushing v. Commissioner[208] where two corporations owned by the taxpayers adopted plans to liquidate within twelve months of the day the plans were adopted.[209] The reason for adopting these

205. IRC §§ 453, 453A, 453B.

206. Rev. Rul. 60-31, 1960-1 C.B. 174, modified by Rev. Rul. 64-279, 1964-2 C.B. 121 and Rev. Rul. 70-435, 1970-2 C.B. 100.

207. See Veit v. Commissioner, 8 T.C. Memo (CCH) 919 T.C. Memo (P-H) ¶ 49,253 (1949).

208. 441 F.2d 593 (5th Cir. 1971).

209. Id. at 593-94.

plans was to qualify under old section 337 which permitted a corporation to avoid recognition of gain on the sale of its assets if it completely liquidated within twelve months of the adoption of a plan of liquidation.[210] Shortly after the adoption of these plans, the corporations sold all their assets.[211] A few days before the deadline for liquidating, the taxpayers sold their stock in the corporations to two trusts they had established for their children in exchange for notes payable over a number of years.[212] The taxpayers elected to report the gains on the sales of their stock on the installment sales method.[213] Thereafter, the corporations were timely liquidated and the proceeds paid to the trusts.[214] Had the taxpayers retained their stock and received the liquidation proceeds, they would have had to recognize the entire gain on the liquidations in a single year, that is, the year in which the liquidation proceeds were distributed. The Commissioner asserted that the taxpayers were taxable on the liquidation proceeds under the assignment of income doctrine and consequently were required to report their entire gains in the year of the liquidations.[215] His argument was that the liquidations were foregone conclusions at the time of the stock sales; that the taxpayers in selling their stock were merely assigning to the trusts the gains that had already been earned on the liquidations; and that the taxpayers were thus taxable on the gains under the assignment of income doctrine.[216]

The Court of Appeals for the Fifth Circuit affirmed the Tax Court's holding in favor of the taxpayer.[217] In an opinion by Judge Goldberg, the court first found the assignment of income doctrine inapplicable:

> At the outset we feel compelled to state what this case is not about. . . . [T]his is not a case where one taxpayer has attempted to shift the gain to a second taxable entity in

---

210. Id. at 593 n.2 (quoting IRC § 337 (1970), amended by Tax Reform Act of 1986, Pub. L. No. 99-514, § 631(a), 100 Stat. 2269).

211. *Rushing*, 441 F.2d at 593-94.

212. Id. at 594.

213. Id. at 595 n.4.

214. Id. at 595.

215. Rushing v. Commissioner, 52 T.C. 888, 896-97 (1969), aff'd, 441 F.2d 593 (5th Cir. 1971).

216. Id.

217. *Rushing*, 441 F.2d at 598. The Tax Court found for the taxpayers on the dubious ground that "the trusts [as sole shareholders] could have voted to rescind the resolutions of liquidation." *Rushing*, 52 T.C. at 897. This is highly unrealistic. Had the liquidations not been completed within the 12-month period specified in the plans because of the trustees' actions, the corporations would needlessly have incurred a huge tax on the gains they realized on the sale of their assets; this would have injured the trusts' beneficiaries and subjected the trustees to personal liability for their dereliction of duty.

> order to reap the benefits of the second entity's lower tax rate. The price the trusts paid the taxpayers for the stock was the full value of the stock, including the appreciation in value which would be realized upon liquidation. *We therefore find the Commissioner's reliance upon the anticipatory assignment of income theory entirely misplaced simply because no income was assigned.*[218]

The only question was "whether they must pay taxes on the entire amount of the gain in the year the corporations were liquidated or . . . over a period of years as the installment payments are received from the trusts."[219] The answer to this question simply turned on whether the taxpayers had retained any direct or indirect control over the proceeds or any economic benefit therein.[220] Since "[a]n autonomous entity [i.e., trust] controlled the proceeds, and no right of recapture inured to the benefit of the taxpayers," and since the "taxpayers retained no effective benefit or control over the liquidation dividend," the taxpayers were not taxable on the liquidation proceeds and were permitted to recognize the gains on their stock sales under the installment sales method.[221]

Significantly, many courts have applied the assignment of income doctrine in cases virtually identical to *Rushing* except for the fact that taxpayers gave away rather than sold their stock. That is, the courts have found in cases where the taxpayers gave away their stock that the gain on the liquidation had already been earned at the time of the gift and thus was taxable to the assignor.[222] But in *Rushing*, where the stock was sold, the court refused to treat the gain as already earned at the time of the sale. These contrasting results demonstrate the basic premise of this article: the assignment of income is not a metaphysical truth but a pragmatic device to carry out basic tax policy. The courts will apply the doctrine when the taxpayer is

---

218. *Rushing*, 441 F.2d at 597 (emphasis added).

219. Id.

220. Id. at 598.

221. Id.

222. Jones v. United States, 531 F.2d 1343 (6th Cir. 1976); Kinsey v. Commissioner, 477 F.2d 1058 (2d Cir. 1973); Hudspeth v. United States, 471 F.2d 275 (8th Cir. 1972); Allen v. Commissioner, 66 T.C. 340 (1976). In the earlier cases, the courts relied in part on the fact that the donees lacked the power to block unilaterally the scheduled liquidations. *Kinsey*, 477 F.2d at 1063; *Hudspeth*, 471 F.2d at 279. The later cases, however, held this factor was not decisive and found that under the "realities and substance" test the liquidations were virtually certain to occur in those cases even though the donees possessed sufficient stock to prevent the liquidations had they so desired. *Jones*, 531 F.2d at 1345-46 (donees together with shareholders, other than donor, could stop liquidation); *Allen*, 66 T.C. at 347-48 (donee received controlling stock interest).

attempting to shift income to a lower tax bracket taxpayer through a gratuitous assignment but decline to apply it where the taxpayer sells his stock for full value in an attempt to spread out recognition of his gain.[223] Although the courts have not articulated their reason for refusing to apply the doctrine in the latter case, it is undoubtedly due to their perception—perhaps unconscious—that no vital tax policy is at stake where the taxpayer merely attempts to achieve a tax savings through deferring the receipt of his income.

The Treasury succeeded in having the *Rushing* result legislatively modified in the Installment Sales Revision Act of 1980.[224] The Treasury was not concerned that taxpayers could transform an immediately recognizable gain into a deferred gain, but that a group comprising a single economic unit (such as a family) could enjoy immediate receipt of the proceeds while recognizing the gain on a deferred basis.[225] Thus, the statute was amended to provide that where a taxpayer sold property on an installment sales basis to a "related person," and the "related person" resold the property within two years, the taxpayer would recognize his gain at the time the "related person" realized his gain (if that resulted in earlier recognition of the gain).[226] "Related person" was defined to include, among others, members of the same family and trusts for the benefit of family members.[227] Thus the result in *Rushing* under the current law would be different: the taxpayers would have recognized gain at the time the trusts for the benefit of their children

223. In *Hudspeth*, the court noted that the failure to apply the assignment of income doctrine in *Rushing* only permitted the taxpayers to defer recognition of their gain and had "no effect on the character or total amount of gain eventually recognized" whereas a failure to apply the doctrine where the taxpayers gave the stock to charity would enable the taxpayers to avoid recognition of the gain on liquidation entirely. *Hudspeth*, 471 F.2d at 278.

224. Pub. L. No. 96-471, 94 Stat. 2247 (codified as amended in scattered sections of 26 U.S.C.).

225. The installment method is currently abused by taxpayers who sell appreciated property to related persons (for example, a trust set up for the benefit of the seller's children), who immediately resell the property to a third party as a part of a prearranged transaction. The original seller defers recognition of gain. The related person receives the full sale proceeds tax free because the tax basis of the property in the hands of the related person is its purchase price. Thus, the economic unit comprised of the two related persons has cash equal to the value of the property while deferring taxation of the gain which would have been immediately recognized had the initial sale been for cash.

Installment Sales Revision Act of 1980 and Minor Bills: Hearings on H.R. 6883, H.R. 5616, H.R. 5729, H.R. 6039, H.R. 6140, H.R. 6247, H.R. 6824, and H.R. 7009 Before the Subcomm. on Select Revenue Measures of the House Ways and Means Committee, 96th Cong., 2d Sess. 25, 27 (1980) (statement of Harry L. Gutman, Deputy Tax Legislative Counsel, Treas. Dep't).

226. IRC § 453(e).

227. IRC § 453(f)(1).

recognized their gain, that is, at the time of the liquidations. Note, however, that the statute applies only when the taxpayer sells to a "related person"; it has no application to a sale to an unrelated person. Congress did not revise, nor did the Treasury seek to revise, the rule dealing with sales to unrelated parties. Thus, in sales to unrelated parties, the statute left intact the reasoning of *Rushing* that the assignment of income doctrine has no application where a party sells his right to income for fair consideration on a deferred basis.

Some additional support for the proposition that the assignment of income doctrine should not be applied where the taxpayer merely seeks to defer receipt of his income may be found in Keller v. Commissioner.[228] There the taxpayer carried on his pathology practice as an employee of his wholly owned professional service corporation.[229] The Commissioner asserted that the taxpayer was taxable on all earnings arising from his practice under the assignment of income doctrine, and not merely his salary.[230] The Tax Court recognized that the doctrine would apply if his total compensation were less than what he would have received absent incorporation.[231] The court found, however, that his salary *plus* the amount the corporation contributed to the qualified retirement plan on his behalf *plus* the value of the corporation's medical reimbursement plan approximated what he would have received absent incorporation,[232] and therefore the doctrine did not apply. During the years in question, the amount of income that could be deferred through a qualified plan was much greater in the case of an employee than in the case of a self-employed individual.[233] Dr. Keller's arrangement thus resulted in a much greater deferral of income than would have been possible absent incorporation. The court's refusal to apply the assignment of income doctrine under these circumstances suggests that it did not view mere deferral of income as justifying application of the doctrine.

---

228. 77 T.C. 1014 (1981), aff'd, 723 F.2d 58 (10th Cir. 1983).

229. Id. at 1020-21.

230. Id. at 1021, 1029. The Commissioner relied on § 482 and the doctrines of lack of business purpose and substance over form as well as the assignment of income doctrine. Id.

231. Id. at 1025. The court, in making this observation, was explaining the application of § 482, rather than the assignment of income doctrine, to Dr. Keller and his wholly-owned corporation. However, the court later stated that the assignment of income doctrine produced the same result as § 482. Id. at 1029, 1033-34. Therefore, it seems fair to conclude that the court's observation with respect to § 482 was equally applicable to the manner in which the doctrine was to be applied.

232. Id. at 1028.

233. See, e.g., 1 Michie's Federal Tax Handbook 1977 ¶ 537, at 211 (Joseph E. Gibson ed. 39th ed., 1977) (stating that "tax advantages obtainable by a sole proprietor or partner from a pension, profit-sharing or annuity plan are not so spectacular as those granted a regular employee, including the stockholder-officer of a corporation").

Return now to the "basketball player" hypothetical. It has been shown that neither policy nor precedent justifies applying the assignment of income doctrine where the taxpayer merely defers receipt (and therefore recognition) of his income. Certainly no warrant would exist for applying the doctrine to B had the Hawks contracted directly with X Corp. rather than with B. Should the result change merely because the Hawks, in the hypothetical, contracted directly with B who then assigned his rights under that contract to X Corp. pursuant to his pre-existing agreement with X Corp.? Reaching different results in these cases would exalt form above substance. All relevant factors are the same: in both cases, the payments made by the Hawks end up in the hands of X Corp.; in both cases, B will receive the same amount; and in both cases, B performs the same personal services. Therefore, the same result should prevail and B should be taxed only on the amounts received from X Corp.[234]

A more difficult question would be presented if B had been under no obligation to assign his contract rights to X Corp. when he contracted with the Hawks. In that case, it could be asserted that B's right to income from the Hawks vested in him when he signed with the team, and thereafter it was too late for him to disavow that income. Suppose the sequence of events had

---

234. B's initial agreement with X Corp. may be viewed as a sale or other disposition of the right to his services giving rise to a taxable event under § 1001. A question might arise as to whether B must immediately recognize a taxable gain equal to the difference between the present value of his right to receive $18,000 a year for life (say, $220,000) and B's basis in his services, zero. This is unlikely. If X Corp.'s obligation to B is unfunded and unsecured, B will probably be taxed only when and as the $18,000 annual installments are paid to him. See Rev. Rul. 60-31, 1960-1 C.B. 174, Examples (1) and (2). This is especially so, since B's right to the payments is contingent upon his performing his obligations under the contract. The subsequent transfer of the right to B's services to the Hawks should not cause B any tax liability. First, the transfer should be treated as made by X Corp. and not by B. X Corp. owned the right to B's services, and only it could lawfully dispose of such right. Second, B should not realize any gain on the transfer of his services to the Hawks, since X Corp. is entitled to receive all amounts realized on such transfer.

The above analysis is premised on the assumption that the agreement with X Corp. and the subsequent agreement with the Hawks are separate and distinct events, and that X Corp.'s $18,000-a-year obligation is fixed and independent of the agreement ultimately reached with the Hawks. However, if the fact finder determines that both events are integral steps of the same transaction and that the Hawks is the real employer of B, the result may be different. The Service may argue that Hawks by making payments (either directly or indirectly) to X Corp. is, in effect, funding its obligation to B and protecting B against the claims of the Hawks's creditors. When an employer funds its obligation to an employee in a way that immunizes the employee against the claims of the employer's creditors (for example, by funding an escrow account or buying an annuity in the employee's name), the cases hold that the employee receives an economic benefit which he must immediately recognize as income. United States v. Drescher, 179 F.2d 863 (2d Cir.), cert. denied, 340 U.S. 821 (1950); Rev. Rul. 60-31, 1960-1 C.B. 174, Example (4).

been as follows: (1) B enters into a player's contract with the Hawks under which he is entitled to annual salary of $100,000 for three years; and (2) B thereafter enters into an agreement with X Corp. under which he assigns his rights under the contract to X Corp. in return for its promise to pay him $18,000 a year for life. Unlike the hypothetical above, B at the time of his contract with the Hawks was free to receive and *keep* those payments himself. B's subsequent assignment of his rights under the Hawks contract to X Corp. clearly constitutes a "sale or other disposition" of his contractual rights triggering recognition of gain under section 1001. B (whose basis in his contractual rights is probably zero) would therefore be taxed immediately on the full present value of the right to receive $18,000 a year for life, *unless* he could either avail himself of the installment sales method or successfully argue that he should be taxed on the $18,000 payments only when and as he receives them since he is a cash basis taxpayer. It is unclear under present law whether B would prevail on either the cash basis argument or the installment sales approach.[235] In view of the great freedom that employees

235. *The cash method argument*: Where there is a taxable sale or exchange, § 1001 requires that the seller recognize as the "amount realized" the cash received plus the fair market value of any other property received. IRC § 1001(b). In the case of cash basis taxpayers, like B, the cases have varied greatly in deciding whether an unfunded promise to make future payments must be valued and taxed immediately under § 1001 or whether recognition of income may be delayed until actual receipt of the payments. Some cases have held that such obligations need be valued and taxed immediately only if they possess the necessary element of negotiability while others have held they must be taxed immediately if they can be sold by the taxpayer at any price. 4 Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income, Estates and Gifts ¶ 105.3.2 (2d ed. 1992). The Service takes the position that Congress in enacting the comprehensive revision of the installment sales provisions in 1980 intended to make the installment sales method the exclusive method of deferring gain where the amount of the payments is fixed. Id.

The installment sales approach: In Realty Loan Corp. v. Commissioner, 54 T.C. 1083 (1970), aff'd, 478 F.2d 1049 (9th Cir. 1973), both the Tax Court and the Ninth Circuit held that a contract to perform services constituted "property" and therefore a sale of such a contract could qualify for the installment sales method. This holding seems to cover B's sale of his contractual rights with the Hawks to X Corp. But see Sorensen v. Commissioner, 22 T.C. 321 (1954). However, the Service can make a strong counterargument. A primary reason for enactment of the installment sales method was to relieve a taxpayer of the hardship of immediately paying the tax on the full gain when he had received cash in the year of the sale for only a small portion of the sales price. Commissioner v. South Tex. Lumber Co., 333 U.S. 496 (1948). In this case, B was originally entitled to receive annual payments of $100,000 over a three-year period; he thereafter converted this right into a right to receive annual payments of $18,000 over his lifetime. The hardship to B of paying a tax in a single year (or in three years) on income that he will receive over a lifetime is self-inflicted. The Service might argue that the installment sales method was not meant to enable a taxpayer to defer recognition of income beyond the time when he would have received all of his cash payments under his original contract. This argument seems implicit in the holding in *Realty Loan Corp.* where the Tax Court upheld use of the installment sales method where its use did not extend the period

and sellers of property have in deferring recognition of income, it is difficult to discern how tax policy would be subverted by either allowing B to use the installment sales method or allowing him to defer recognition of income until actual receipt of the annual payments. But whatever the answer to that question, there is no warrant for applying the assignment of income doctrine here. There is simply a deferral of income, and that is not a concern of the assignment of income doctrine.

F. *A Loose End: Should* Schneer *Have Been Taxed on the Fee that Was Fully Earned at the Time of the Assignment?*

All the judges in *Schneer* agreed that Schneer was taxable under the assignment of income doctrine on the one fee, amounting to $1,250, which had been fully earned before he left the first firm.[236] This conclusion is almost surely wrong.

Since this fee had been fully earned when Schneer assigned it to the second firm, it was in effect an account receivable.[237] Accounts receivable are "property"[238] and thus are subject to the partnership basis rule of section 723. Pursuant to that rule, the second partnership took over Schneer's basis in the account receivable,[239] that is, zero. Section 704(c)(1), as in effect during the time in question, provided that in allocating gain or loss with respect to the contributed property, the property was to be treated "as if [it] had been purchased by the partnership."[240] The purpose and effect of this

---

for recognizing gain beyond the time when the taxpayer would have received and recognized income under the original service contract. *Realty Loan Corp.*, 54 T.C. at 1097-98. The Tax Court distinguished *Sorensen*, which had disallowed the use of installment sales, on the ground that its use in that case would have extended the time for recognizing gain beyond the time the taxpayer would have otherwise received and reported his gain. Id. at 1097 (stating that the sale of contract rights "could not change . . . the time at which the amount was includable in income").

236. *Schneer*, 97 T.C. at 651-52.

237. The opinion does not indicate whether the $1,250 was billed prior to Schneer's departure from the first firm. However, the court found that it had accrued prior to his departure from the first firm and it recognized that income would only accrue when all events have occurred which fix the right to receive the income and the amount in question could be determined with reasonable accuracy. Id. at 649-50. In any event, it is clear that Schneer was at least contributing a chose in action, and a chose in action is "property" and not services.

238. Hempt Bros. v. United States, 490 F.2d 1172, 1175-76 (3d Cir.), cert. denied, 419 U.S. 826 (1974); see also Rev. Rul. 80-198, 1980-2 C.B. 113.

239. IRC § 723.

240. IRC § 704(c)(1) (1982). Section 704(c)(1) was amended by the Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 71, 98 Stat. 589, to provide that gain on property contributed to the partnership was to be shared among the partners, pursuant to regulations issued by the Service, to take account of the difference between the basis of the

language was to assure that the entire gain or loss realized with respect to the contributed property was reported by the partnership instead of by the contributing partner.[241] The gain or loss would then be allocated among the partners in accordance with the ratios specified in the partnership agreement for sharing gains or losses.[242] If they preferred, the partners could have agreed pursuant to section 704(c)(2), as then in effect, to share the gain from the collection of the receivable so as to take account of the difference between the partnership's basis in the receivable and the receivable's fair market value at the time of the contribution.[243] However, in *Schneer* there was no such agreement.

Thus, under the statutory scheme then in effect, collection of the $1,250 fee by Schneer's second firm was reportable by it (and not by Schneer), and Schneer should have been taxed on this fee only to the extent of his distributive share in it. The question is whether this statutorily mandated scheme was overridden by the assignment of income doctrine.

In Hempt Bros. v. United States,[244] the court was confronted with deciding whether section 351 and related provisions were overridden by the

---

property to the partnership and its fair market value at the time of the contribution. This meant that the contributing partner would be required to recognize the "built-in gain" that existed on the contributed property at the time of the contribution (i.e., the difference between the property's fair market value and its basis at the time of the contribution) when the partnership sold or otherwise realized gain upon the contributed property. Thus, under the new rule, Schneer would have been required to recognize all or a substantial part of the $1,250 when his partnership collected this fee since Schneer's "built-in gain" in the fee was its fair market value at the time of contribution *less* his basis in the fee (presumably zero).

However, the new rule applies only to "property contributed to the partnership after March 31, 1984." Id. § 71(c), 98 Stat. at 589. Although the published opinion of the Tax Court does not so state, a review of the Record in the case shows that a check from the first firm to Schneer for the fee in question was dated January 30, 1984 and was endorsed and deposited in the second firm's bank account on January 31, 1984. Record at Petitioners' Exhibit 22, *Schneer* (No. 31804-88) (ledger of first firm showing payment of $1,250 forwarding fee to Schneer on January 30, 1984); id. at Joint Exhibit 5-E (front and back of check no. 2331, dated January 30, 1984, drawn by first firm and made payable to Stephen Schneer in the amount of $1,250); id. at Joint Exhibit 10-J (deposit slip of second firm showing deposit on January 31, 1984 of $1,250 received from first firm); id. at Joint Exhibit 12-L (second firm's bank statement showing deposit of $1,250 on January 31, 1984). Thus, whether the date of the contribution is deemed to be the date on which Schneer became a partner in the second firm, or the actual date on which the fee was paid over to the second firm, it is clear that the contribution occurred prior to April 1, 1984, and that the old rule applied.

241. 1 Arthur B. Willis et al., Partnership Taxation § 108.03 (4th ed. 1993).

242. IRC § 704(a) (1982); Willis et al., supra note 241, § 108.03.

243. IRC § 704(c)(2) (1982).

244. Hempt Bros. v. United States, 490 F.2d 1172, 1175-76 (3d Cir.), cert. denied, 419 U.S. 826 (1974).

assignment of income doctrine.[245] In that case, a cash basis partnership had transferred its accounts receivable to a corporation upon its formation.[246] Under the statutory scheme, the corporation would be taxed on the accounts receivable when it collected them; however, the corporation argued this result was precluded by the assignment of income doctrine which taxes income to the person who earns it.[247] The court rejected the corporation's claim, holding that judicially created assignment of income doctrine "must give way . . . to the broad Congressional interest in facilitating the incorporation of ongoing businesses" as evidenced by its enactment of section 351.[248]

Similar considerations are present here. Congress in enacting in section 704(c) expressly recognized and sanctioned the ability of a contributing partner to shift taxable gains and losses on the contributed property to the other partners.[249] This scheme was consistent with the underlying objectives of Congress in enacting Subchapter K in 1954: simplicity, flexibility and equity as between the partners.[250] The rule of section 704(c)(1), which allocates all gain or loss to the partnership, has the virtue of simplicity[251] and is far simpler than the present rule which mandates that the gain or loss be allocated between the contributing partner and the other partners in a manner that takes account of the difference between the partnership's basis in the property and its fair market value at the time of contribution.[252] Moreover, the rule of section 704(c) furthered the Congressional purpose of flexibility since it permitted the partners to determine among themselves their respective tax burdens.[253] Under section 704(c), as in effect during the period in question, the partners could either have followed the rule of section

---

245. Id. at 1173.

246. Id. at 1174.

247. Id. at 1176.

248. Id. at 1178.

249. Willis et al., supra note 241, § 108.03.

250. H.R. Rep. No. 1337, 83d Cong., 2d Sess. 65 (1954), reprinted in 1954 U.S.C.C.A.N. 4025, 4091; S. Rep. No. 1622, 83d Cong., 2d Sess. 89 (1954), reprinted in 1954 U.S.C.C.A.N. 4629, 4721.

251. Willis et al., supra note 241, § 108.03, at 108-7 (stating that "§ 704(c)(1) had the attribute of simplicity").

252. For an insight into the complexity of the present rule, see Prop. Regs. §§ 1.704-1(b)(1)(vi), 1.704-1(b)(2)(iv), 1.704-1(c), 1.704-3, 57 Fed. Reg. 61345 (1992). These proposed regulations set forth three alternative methods to make the adjustments mandated by IRC § 704(c); the proposed regulations result from Congressional concern that the regulations under the formerly elective method might be inflexible and overly burdensome for taxpayers in situations where there was little potential abuse.

253. See Foxman v. Commissioner, 41 T.C. 535, 551 (1964), aff'd, 352 F.2d 466 (3d Cir. 1965) ("Accordingly, one of the underlying philosophic objectives of the 1954 Code was to permit the partners themselves to determine their tax burdens *inter sese* to a certain extent, and this is what the committee reports meant when they referred to 'flexibility.' ").

704(c)(1) of allocating all gain or loss to the partnership, or have agreed under section 704(c)(2) on an allocation that took into account the difference in the property's basis and its fair market value at the time of contribution. The objective of equity was also advanced since it gave the partners the opportunity to adopt the alternative approach of section 704(c)(2)—probably the more equitable approach[254]—while allowing them to use the section 704(c)(1) approach if section 704(c)(2) proved too burdensome. Here, as in *Hempt Bros.*, the assignment of income doctrine must yield to the broad Congressional purposes in enacting the statutory scheme.

Indeed, it was widely recognized by commentators that in non-abuse situations, section 704(c), as in effect during the time in question, overrode the assignment of income doctrine.[255] This is shown by the following excerpt from a leading treatise on partnership taxation:

> Problem
> A and B form an equal partnership to engage in the practice of accountancy. A contributes $10,000 in money and B contributes unrealized receivables which are valued at $10,000 arising out of B's previous accounting practice. Assuming the partnership reports on the cash method of accounting, will the receipt of income from the collection of the $10,000 of unrealized receivables contributed by B be allocable for income tax purposes one-half to A and one-half to B?
>
> The famous case of Lucas v. Earl established at an early date that a taxpayer may not assign earned income to another taxpayer. . . . [However,] when the cash method AB partnership collects the unrealized receivables and thereby realizes taxable income, it is allocable 50% to A and 50% to B. Thus, § 721(a) sanctions the assignment of income to a

---

254. See Willis et al., supra note 241, § 108.03 for possible inequities resulting to partners under the § 704(c)(1) approach.

255. Arthur B. Willis et al., Partnership Taxation § 22.03 (3d ed. 1982); 1 William S. McKee et al., Federal Taxation of Partnerships and Partners ¶ 4.02[2] (1st ed. 1977) (stating that in non-abuse cases, "the nonrecognition policy of § 721 should generally prevail over assignment-of-income restrictions in order to facilitate the transfer of going businesses to partnerships" referring specifically to contribution by accountants of accounts receivable from their prior practices to new partnership); [1993] Partnership Tax Plan. & Prac. (CCH) ¶ 1595 (June 1993) (stating that under old § 704(c) "IRS rarely, if ever, asserted that the transfer of earned but uncollected income . . . by a partner to a partnership . . . was an anticipatory assignment of income" even though the result under the statute was "an assignment of a portion of the income from the contributing partner to the other partners").

> partner where there is a transfer to the partnership of unrealized receivables as a part of a genuine business transaction.[256]

Since the Tax Court found that Schneer's agreement with his second firm was a genuine transaction with "no apparent attempt to avoid the incidence of tax by the formation or operation of the partnership,"[257] it should have taxed the account receivable to the partnership and not to Schneer.

VI. Conclusion

Despite its venerable pedigree, the assignment of income doctrine as applied to personal service contracts is still beset by confusion and uncertainty. The key to resolving these questions is an understanding of the origin and purpose of the doctrine: It is a judicially created device designed to preserve the integrity of the graduated tax system by preventing taxpayers from splitting their income among lower income tax bracket taxpayers.

This understanding in turn leads to further insights: (1) the doctrine does not apply where the income earner has assigned his right to income for consideration in an arm's-length transaction since this does not result in any shifting of income; (2) the doctrine does not apply where the taxpayer merely attempts to defer his income since there is no strong policy against reducing one's tax burden through the deferral of income; and (3) when applying the doctrine in connection with a nonrecognition section, one must determine whether the policies Congress intended to implement by providing for nonrecognition outweigh the policy of the doctrine in the case under consideration.

A constant recognition of the purpose of the doctrine and its resulting limitations as developed in this article will resolve many of the puzzles currently encountered in its application.

---

256. Willis et al., supra note 255, § 22.03, at 22-3 to 22-4 (footnotes omitted).
257. *Schneer*, 97 T.C. at 663.