THE TAX DILEMMA OF THE ENTERTAINER*

Adrian A. Kragen† and Babette Barton‡

Since the early 1940's there has been an increasing effort on the part of financially successful Americans to avoid the tax impact of a large income from personal services. There has been, of course, no reluctance to accept high remuneration for these services, but rather the individual and his fiscal and legal representatives have been engaged in a constant endeavor to put such remuneration in some category or to receive it in such manner as would lessen the amount to be converted to the support of the government.[1] The progressive tax rate structure of the federal income tax law, which may involve a levy as high as 87% of the income from personal services, coupled with state income tax systems adding their comparatively small but important levies, is, of necessity, an incentive to the development of ingenuity directed toward the reduction of this burden.[2] Congress, in recognition of the onerous nature of the progressive rate and the particularly inequitable impact in the "bunched" income or loss situations, has granted some statutory relief in the Internal Revenue Code.[3] The group of individuals to whom this burden of "bunched" income appears to have the most basic and widely spread deleterious effect are those engaged in

*From a speech delivered by Professor Kragen before the Fourth Annual Program on Legal Aspects of the Entertainment Industry, co-sponsored by the Beverly Hills Bar Association and the University of Southern California School of Law.

†A.B., 1931, University of California, Berkeley; LL.B., 1934, University of California, Berkeley; Professor of Law, University of California School of Law, Berkeley.

‡B.S., 1951, University of California, Berkeley; LL.B., 1954, University of California, Berkeley; Member, California Bar.

[1]Numerous articles have been written on various phases of this subject. For reference purposes the following are noted. Anthoine, *Recent Developments in Collapsible Corporations,* N.Y.U. 14th INST. ON FED. TAX 761 (1956); Ekman, *Arrangements for Deferring Compensation Other Than Stock Options and Pension or Profit Sharing Plans: Contractual Arrangements, Sale of Stock with Purchase Agreement, Etc.,* N.Y.U. 14th INST. ON FED. TAX 1123 (1956); Freeman, *Collapsible Corporations,* N.Y.U. 11th INST. ON FED. TAX 407 (1953); Levin & Mitosky, *Tax Saving Practices of Artists and Entertainers,* 31 TAXES 21 (1953); MacLean, *Collapsible Corporations—The Statute and Regulations,* 67 HARV. L. REV. 55 (1953); Miller, *Capital Gains Taxation of the Fruits of Personal Effort: Before and Under the 1954 Code,* 64 YALE L.J. 1 (1954); Mintz, *Entertainers and the Capital Gains Tax,* 4 TAX L. REV. 275 (1949); Rosenbaum, *Entertainer's Corporations and Capital Gains,* 12 TAX L. REV. 33 (1957); Rudick, *Introduction to Problems in Stock Options and Deferred Compensation,* N.Y.U. 14th INST. ON FED. TAX 1047 (1956); Walker, *Investing in Motion Picture Enterprises,* U. SO. CAL. 1954 TAX INST. 399; Wentz, *Current Developments in the Taxation of Compensation for Services Rendered,* 11 MIAMI L.Q. 175 (1957).

[2]The now classic discussion of the philosophical background and the weakness of a progressive tax system is contained in Blum & Kalven, *The Uneasy Case for Progressive Taxation* (U. OF CHI. PAMPHLET SERIES NO. 11, 1953).

[3]INT. REV. CODE OF 1954 § § 1301-1305 contain the statutory provisions for averaging applicable to lawyers, inventors, writers, etc. (Some brief discussion of these sections will appear later in this paper.) INT. REV. CODE OF 1954 § 172 allows carryback and carryover of net operating losses; INT. REV. CODE OF 1954 § 1341 relates to restoration by the taxpayer of previously reported income; INT. REV. CODE OF 1954 § 453 allows the taxpayer to report gain from certain sale transactions, where payments are received in installments, so as to spread the tax impact over the entire installment period; INT. REV. CODE OF 1954 § 613 provides for percentage depletion as an incentive for those engaged in exploration for natural resources. (There are other relief sections which substantially assist the taxpayer.)

the entertainment industry.[4] Although the plight of these individuals, faced with a comparatively short professional life and a concentration in that brief period of exceptionally high income from personal services, has been frequently brought to the attention of Congress as well as the public by especially difficult situations such as the devastating plight of Joe Louis, there has not been any serious effort in Congress to alleviate to any extent this problem by statutory reforms. The entertainment industry taxpayer and his counsel have been therefore left to the task of reducing the tax load by methods within the, admittedly inadequate for this purpose, sections of the Internal Revenue Code as they have been interpreted by the Commissioner or the courts or in the absence of such official interpretation, as viewed by astute tax counsel.

Three basic avenues of approach will be considered in this paper. There are undoubtedly other roads which have been explored by lawyers for their clients and even in those here reviewed it is not intended that all of the by-ways will have been travelled in the course of this discussion.[5] Relief, in varying degrees, may be obtained, however, from the "curse" of exceptionally high income for a comparatively short period if the income (a) may be deferred to subsequent lower income years, (b) may be spread back over prior lower income years, or (c) may be "converted" into income from the sale or exchange of a capital asset.

I. DEFERMENT OF INCOME

The spreading of income to subsequent periods most frequently has been accomplished by the device of an agreement which, although seen under various designations, will be characterized here generally as a deferred compensation agreement. Under this type of agreement, income from services rendered in a particular year is compensated for by payments made in a subsequent year or years, the year of payment having no relation to the year of service. This type of agreement will sometimes involve part payment in the year of service and allotment of the balance to subsequent years or may involve a deferment of any payment until a period some years after the rendition of the services. The deferment device will, in most cases, be available only to a taxpayer who uses the cash receipts and disbursements method of accounting for federal income tax purposes. Such a taxpayer is obligated on the basis of the time of receipt, and the entire theory of the deferment is that it will postpone receipt. The accrual method taxpayer, required as he is to include income when his right to it becomes fixed even though the payment date is postponed, can only take advantage of a deferment agreement if it is hedged

[4]This term entertainment industry is used in a broad sense to include persons engaged in any area of entertainment of the public, including professional athletes as well as actors, directors, writers, announcers, etc.

[5]For example, no discussion has been included of the tax saving possibilities offered by use of foreign corporations.

about with contingencies as to preclude the presence of any absolute liability to pay. However, a deferred compensation agreement which did not vest liability until the year each payment was made could be useable for an accrual basis taxpayer even though such a forfeitable arrangement would obviously have unsatisfactory aspects and therefore be very rarely used.

In its application the deferred compensation agreement is analogous to the installment method allowed by Internal Revenue Code, Section 453, for as does the latter method, it allows the payment of tax over a period of years subsequent to the transaction allocating the tax liability as the proceeds are received.[6] Unfortunately, in contrast to the installment seller, Congress has not seen fit to spell out a specific, or any statutory formula for affording such treatment in the case of the person rendering personal services and as a result as stated heretofore, the deferred treatment must be justified under the general provisions of the Internal Revenue Code,[7] and the judicial interpretations thereof.[8] This lack of specification of relief has enabled the Commissioner to wage a constant battle to tax compensation provided under a deferment agreement in the year of rendition of the service or some year other than that of actual receipt of the compensation in the normally accepted sense.[9]

Internal Revenue Code, Section 451, clearly states that gross income shall be included for income tax purposes in the "taxable year in which received" unless the taxpayer's accounting method requires a different year of inclusion. On the basis of this statutory mandate, as to inclusion of income, the cash receipts taxpayer who renders services in a particular year, but has no claim to remuneration for those services in the year, would seem not to be required to include such remuneration until received. It is, however, obvious that receipt of cash is not the only method of receiving remuneration. Manifestly the receipt of property in payment for services is income when the property is received and not when it is subsequently sold for cash.[10] Equally, the cash system taxpayer should be considered as receiving income when the compensation is presently available

[6]Rev. Rul. 234, 1953-2 CUM. BULL. 29 (*re* sale by President Truman of memoirs); Estate of Raymond T. Marshall, 20 T.C. 979 (1953).

[7]INT. REV. CODE OF 1954 § § 61, 451(a), 446.

[8]See Fleming v. Comm'r, 241 F.2d 78, 82 (5th Cir. 1957) (deferment prior to due date of proceeds of endowment insurance policy had not constructively been received); Comm'r v. Oates, 207 F.2d 711 (7th Cir. 1953) (involving a substitution for all agents of a deferment system for renewal premiums shortly before Oates' retirement); Weathers v. Comm'r, 12 CCH Tax Ct. Mem. 314 (1953); Veit v. Comm'r, 8 CCH Tax Ct. Mem. 919 (1949) (deferment of the payment of proceeds of a profit sharing agreement prior to the payment date, as part of arrangement for subsequent services). *But see* Sproul v. Comm'r, 194 F.2d 541 (6th Cir. 1952).

[9]*Supra* note 8. In a number of attempted deferment cases some special fact situation was the basis of the court holding that there was an actual receipt. These are discussed hereafter in the text, but noted here. Morse v. Comm'r, 202 F.2d 69 (2d Cir. 1953); Renton Brodie, 1 T.C. 275 (1942); Ward v. Comm'r, 159 F.2d 502 (2d Cir. 1947).

[10]Musselman Hub-Brake Co. v. Comm'r, 139 F.2d 65 (6th Cir. 1943).

to him and he fails or refuses to take it. It would be extremely easy from an administrative standpoint to consider as income to a cash receipts and disbursements method taxpayer only the amount of actual receipts. The test would be simple, but it is obvious that it would be harmful to the effectiveness of any income tax system. This concept of actual receipt, upon which the large majority of cash receipts taxpayers in fact report because of the nature of their receipt of income, if embodied as a part of the law would enable the clever or well-advised taxpayer to have complete control over the year in which he would report income, regardless of the availability of such income and its economic use by him. There is no serious contention against the proposition that the taxpayer should be required to include in taxable income that income over which he has unfettered control.[11] Any conflict between the taxpayer and the Internal Revenue Service arises in the determination of whether this unfettered control is present; the Commissioner at one extreme urging that an act which postpones the receipt of income is the exercise of control regardless of whether it is before, during or after the rendition of services, and the taxpayer, at the other extreme, urging that until actual cashing of the check there is no such control.[12]

To avoid the obvious tax evasion aspects of this type of situation, two rules have evolved. The first is that the cash system taxpayer has income when he has received the equivalent of cash. It is comparatively simple to determine the application of the "equivalent of cash" doctrine when an item of physical property or an intangible, transmutable into physical property, is received. There is not such ease of determination where the item is an intangible benefit such as the satisfaction of some desire for future security. In such cases do we come within the economic benefit doctrine of such cases as *Helvering v. Horst*[13] so that it should be taxed, at its value, to the one having this intangible benefit? Although there has been substantial expansion of the "equivalent of cash" concept beyond its original meaning of receipt of property having a fair market value, there does not appear to have been any case holding that a simple promise to pay in the future could be treated as a cash equivalent. In fact, the courts in considering contracts of sale have generally held that where the only document evidencing the deferred payment is the contract of sale, the payments are included in income as cash is actually received.[14] Although the judicial opinions appear to preponderate in favor of non-taxability in

[11]Corliss v. Bowers, 281 U.S. 376 (1930); Ross v. Comm'r, 169 F.2d 483 (1st Cir. 1948); Nangle v. U.S., 145 F. Supp. 900 (Ct. Cl. 1956); Richard Deupree, 1 T.C. 113 (1942).

[12]See Rev. Rul. 58—162, 1958, INT. REV. BULL. No. 15 at 12 which seems to accept the concept of deferment.

[13]Helvering v. Horst, 311 U.S. 112 (1940).

[14]Estate of Clarence Ennis, 23 T.C. 799 (1955); Nina J. Ennis, 17 T.C. 465 (1951); Bedell v. Comm'r, 30 F.2d 622 (2d Cir. 1929); C. W. Titus, Inc. 33 B.T.A. 928, 935 (1936); Mertens, *Law of Federal Income Taxation* § 11.05.

the pure contract cases, each case must be considered on its facts. Mertens has expressed the view that if the contract has a fair market value, then it should be considered as the equivalent of cash and taxed when the contract is executed at its fair market value.[15] However, this view would not appear to be supported by the cases which would distinguish between normal negotiability and documents which do not ordinarily pass in commerce.[16] Although the language in some of the cases somewhat loosely includes "with no readily ascertainable market value" in the criteria for non-taxability it appears that this factor was not really considered by the courts. Where the taxpayer received an item, intended as payment, which could be valued he would of course be subjected to income inclusion in the year of receipt.[17] Thus, a negotiable promissory note given as payment for services would be income to the extent of its value when received, even though the recipient held the note until the maker made payments.

The second rule is that of constructive receipt which arises where income is credited or set apart for the taxpayer without any substantial limitation or restriction and which may be drawn upon by him at any time. Income falling into this category is considered as gross income to the taxpayer when it is so available regardless of the time of actual receipt. The constructive receipt rule has been the one most relied upon by the Commissioner in the effort to destroy the efficacy of deferred compensation agreements.

Originally the doctrine of constructive receipt was somewhat frowned upon by the courts and applied only in quite obvious instances.[18] In recent years, however, there has been an increasing tendency to apply the doctrine in proper cases, both for and against the government.[19] This trend makes it extremely important that a deferred compensation agreement, which the writers of this paper believe to be a legitimate device, be drafted so as to clearly avoid the application of the constructive receipt concept. Inasmuch as the question whether there is a present right to receive is substantially a question of fact, it is vital that the facts as stated in the agreement and as acted upon by the parties negative a present right to receive.[20]

In determining what is the best way to draft a deferred compensation agreement, the attorney must be certain to avoid any provisions which would allow the Commissioner to assert that the agreement is susceptible to the application of either rule. The courts have repulsed the Commis-

[15] *Id.* at § 11.06.

[16] Nina J. Ennis, 17 T.C. 465, 470 (1951); Harold W. Johnston, 14 T.C. 560 (1951); Dudley T. Humphrey, 32 B.T.A. 280 (1935); *Cf.* Arthur E. Wood, 25 T.C. 468, 475 (1955).

[17] Frederick J. Wolfe, 170 F.2d 73 (9th Cir. 1948).

[18] Travelers Ins. Co. v. Comm'r, 161 F.2d 93 (2d Cir. 1947); Moran v. Comm'r, 67 F.2d 601 (1st Cir. 1933).

[19] McEuen v. Comm'r, 196 F.2d 127 (5th Cir. 1952); Weil v. Comm'r, 173 F.2d 805 (2d Cir. 1949); Ross v. Comm'r, 169 F.2d 483 (1st Cir. 1948).

[20] Mertens v. Rogan, 56 F. Supp. 450 (S.D. Cal. 1944); James G. Cozzens, 19 T.C. 663 (1953).

sioner in his effort to invoke the doctrine of constructive receipt in deferment cases generally, unless in the particular instance there was a showing of an actual "turning his back" on income by the taxpayer after it was due and payable. Where the taxpayer, prior to such time, entered into a deferment arrangement, the courts have denied constructive receipt even though the amount was determined and the services to which the income related had been rendered. For example, in *Howard Veit*,[21] the taxpayer was to be paid, in 1942, $87,000 as his share of 1940 profits. As part of a new employment contract, executed late in 1941, at the request of the employer, it was agreed that this 1940 profit share should be paid in five equal installments, covering the years 1942 to 1946. In *Oates v. Comm'r*,[22] Oates agreed less than thirty days before retirement to a new arrangement for deferment of renewed commissions so that they would be evenly spread over a substantial period rather than paid as received under the prior agreement.

Although the *Veit* and *Oates* cases sustained, in essence, modifications of old agreements, the validity of a deferred compensation agreement would be less susceptible to the contention that there was a constructive receipt of the income, if the agreement were entered into as an integral part of the original agreement for the rendition of services. This would constitute an effective insulation against the contention that the taxpayer "turned his back on income" as that phrase has been used in the constructive receipt cases.

The doctrine of constructive receipt has been held applicable to any instance where the contract understanding was that payments were to be deferred, but that the employee had a unilateral option to request and receive payment.[23] However, where the contract provided that no advance payment was to be made, the fact that there was an indication by the employer that he would make payment if requested has been held not to be the basis for invoking the doctrine of constructive receipt,[24] since the employee had no present right to the income.

An extremely important item in the formulation of a deferred compensation agreement is the complete elimination of any form of security to insure ultimate payment to the deferee. The basic premise upon which it can be contended that there is no immediate tax liability on the amounts to be paid in the future on a deferred compensation agreement is that the agreement to pay cannot be considered to be the equivalent of cash, and that there is nothing of value which can be considered as actually or constructively received. Fundamentally, the potential payee is gambling that when the time arrives for payment, he, as a general creditor of the

[21] 8 CCH Tax Ct. Mem. 919 (1949).
[22] 207 F.2d 711 (7th Cir. 1953).
[23] Burns v. Comm'r, 31 F.2d 399 (5th Cir. 1929).
[24] James G. Cozzens, 19 T.C. 663 (1953).

payor, will be able to collect the amounts specified in the agreement. The gamble is, of course, motivated and justified by the fact that the major portion of the loss, if any, will be borne by an involuntary participant, the United States Government. However, the taxpayer must retain that contingency of eventual nonpayment to retain the tax benefits of the deferment. In the event the agreement provides for some type of security or escrow which makes for certainty of payment, the agreement to pay is "tainted" with value which to that extent is an immediate payment, taxable in the year the agreement is executed and the security deposited.[25] Victory has also been obtained by the government where the taxpayer has received an item capable of valuation even though the actual receipt of the cash was delayed until a subsequent year.[26] It is vital to the achievement of the primary purpose of a deferment agreement that all semblance of receipt of payment, either actual or constructive, be avoided.[27] Although the Commissioner has had difficulty in sustaining the application of the doctrine of constructive receipt, in instances where contingencies were present, even though somewhat ephemeral, he has been successful where the court could see a "turning his back" on something of value presently available, even though not physically delivered.[28]

The need for, or value of, contingencies as a factor in upholding the theory upon which deferred compensation agreements are based has led to the suggestion that there should be, in the agreement, provisions preventing vesting or causing forfeiture in the case of non-fulfillment. Generally, the provisions suggested have been in the nature of advisory or consultant services or "on call" requirements. It cannot be denied that in the case of a cash receipts method taxpayer a recognized bona fide provision for such continuing services as a condition for receipt of the deferred compensation would be a strong added factor in the sustaining of the position that the income had not been received at the time the basic services were rendered. However, it is not reasonable to assume that in the majority of cases the payee would consent to substantial burdens, after the primary

[25]Williams v. U.S., 219 F.2d 523 (5th Cir. 1955) (deferment placed in escrow in bank); see also Kuehner v. Comm'r, 214 F.2d 437 (1st Cir. 1954).

[26]Lavery v. Comm'r, 158 F.2d 859 (7th Cir. 1946); Cherokee Motor Coach Co. v. Comm'r, 135 F.2d 840 (6th Cir. 1943); Charles F. Kahler, 18 T.C. 31 (1952). See McEuen v. Comm'r, 196 F.2d 127 (5th Cir. 1952) (check issued in Ohio on December 30, 1943, and mailed to Florida where it was received in January 1944, was constructively received as contended by taxpayer in 1943); Anderson v. Bowers, 170 F.2d 676 (4th Cir. 1948) (executrix drew check in 1941 for fee allowed by court but did not cash it pending determination of estate tax, which was closed in 1943 disallowing deduction of part of fee of executrix; held constructively received in 1941).

[27]Richards' Estate v. Comm'r, 150 F.2d 837 (2d Cir. 1945) (lawyer refused to settle as to one of two defendants until 1 year after receipt due to income tax impact; held taxable in year received); J. D. Amend, 13 T.C. 178 (1949) (farmer in selling produce provided for payment in year following sale held as usual practice not constructively received).

[28]Weil v. Comm'r, 173 F.2d 805 (2d Cir. 1949); Aramo-Stiftung v. Comm'r, 172 F.2d 896 (2d Cir. 1949); Loose v. United States, 74 F.2d 147 (8th Cir. 1934); *Cf.* James G. Cozzens 19 T.C. 663 (1953).

services had been rendered, the failure to perform which would forfeit his right to payment for such primary services, or that the payor, at least where the deferment is for a long period, would actually desire or intend to avail itself of such services. The bona fide nature of such provisions in the normal personal service contract, particularly in the entertainment industry, is, in the opinion of the writers, extremely dubious. Furthermore, it is the position of the writers of this paper that such provisions are only makeweights, if, as they believe, the theory on which agreements are based is valid.[29] The fundamental premise on which the annual accounting principle rests is that income is received, for a cash receipts taxpayer, when it is actually or constructively received. The taxpayer has not received an income where he, as a part of his contract of employment, makes an arrangement for payment in a subsequent period any more than if he had sold a desk, or a wheat crop in one year and was paid in the next.[30] The deferred compensation agreement properly executed appears to be a partial answer for the actor, director, professional athlete and others in the entertainment industry who are faced with the problem of "super colossal" earnings and equally fantastic tax burdens. In contrast to many of the ingenious ideas that are formulated to meet the problem of these individuals, this one does not skirt the edge of the statute, but we believe is directly within the spirit and the letter of the income tax law.

A recent item in *Time* magazine re William Holden illustrates some of the advantages and disadvantages of the deferred compensation agreement. *Time* states: "For His Dotage. Actor-Businessman William Holden, who handcuffed Columbia Pictures to what seemed a historically profitable contract for his part in 'The Bridge on the River Kwai,' last week felt the contract's manacles snapping around his own wrists. Signing on for 10% of the gross, Holden, to keep taxes down, forced Columbia to add a clause providing payment in sums not exceeding $50,000 a year. So far, so shrewd—but 'Kwai' has already grossed $8,500,000, is expected to end up with at least $25,000,000; 40-year old Bill Holden will not be fully paid until he is 90 . . . Columbia can earn $90,000 a year by investing Holden's money." It would appear that *Time* has some doubts as to the astuteness of Mr. Holden and his advisors in agreeing (probably insisting) to a program of payment which will require his survival to age 90 for a complete fulfillment, and which ostensibly is so exceptionally advantageous to the employer. The obvious results as stated by *Time* are true, but the implications do not have the same verity. If Mr. Holden had negotiated for 10% of the gross receipts, payable as received, he would certainly have had out of a gross income to him of $2,500,000 a net return, after taxes, of $325,000 because he is today in the top period of

[29]Of course, bona fide provisions preventing vesting are essential to the use of a deferred compensation agreement for an accrual method taxpayer.

[30]James G. Cozzens, 19 T.C. 663 (1953); J. D. Amend, 13 T.C. 178 (1949).

earning power, and, as a result, in the top bracket for federal income tax purposes. Under the agreement for payment of $50,000 a year, Holden, or his heirs, will have a net return that may be more than $1,500,000.[31] Holden, in effect, has purchased an annuity for 50 years for himself and his family, yielding approximately $30,000 a year after payment of taxes. It is certain that $325,000 would not have purchased any such amount. It is true, of course, that the employer has the use of Holden's profit share for an extended period, but this was undoubtedly a factor in the negotiating of the original contract and without specific statement was, or should have been, taken into account in the determination of the amount of Holden's percentage of the gross receipts.[32]

Under the Code and cases as they presently exist, the writers believe that a deferred compensation agreement properly negotiated and executed would not be vulnerable to successful attack by the Commissioner and would be a proper method of timing the taxable receipt of income.[33] It should be realized, however, that the Commissioner has never completely conceded such validity to deferment and that the taxpayer using this method must be certain not to allow any variance which would justify a determination that there had been receipt of something of value.

II. Spreading Income to Prior Years

The spreading back of income to lower income years is not of major interest to performers in the entertainment industry. The provisions of the Internal Revenue Code which cover this area are available generally only to writers, producers and persons similarly situated and to their lawyers, agents and business managers. The sections do not allow for that voluntary timing which is an integral part of the deferred compensation agreement and even where they fit into the earnings picture they may be taxwise of little or no advantage. The theory of these sections is that an individual engaged in employment, writing a story or making an invention, the compensation for which is largely bunched in a single year, should not bear a heavier tax burden than he would have borne if the income were received in equal installments over the period en-

[31]These computations are based on the assumption that Mr. Holden would receive the $2,500,000 in the absence of deferment in years in which his net income from other sources exceeded $200,000 and that the agreed deferment is not to start earlier than 1960 and will continue over a long period of small income from other sources. If Mr. Holden's income from other sources continues to be large, the deferment will, of course, be of little or no value to him taxwise except in the case of the unlikely eventuality of substantial reduction of the rate in the top tax brackets.

[32]Time, Vol. LXXI, No. 22 p. 84, June 2, 1958.

[33]In this regard it should be noted that under INT. REV. CODE OF 1954 § 404 (a) (5) an accrual method employer is not allowed to deduct amounts payable under a plan deferring the receipt of compensation until the date of actual payment. If an agreement for one employee can be considered to be a "plan" this section would, of course, be a substantial deterrent to employers seeking current deductions for the accrued liability.

compassed in the rendition of services, the writing or the rewriting.[34] Thus, if a writer takes a period of over twenty-four months and receives in one year at least 80 percent of the total income received in the preceding taxable years, and the 12 month period following the close of the taxable year, he may spread the income received over the period preceding the close of the taxable year, but not in excess of 36 months, ending with the close of the taxable year in which the income was received.[35] He is, in such cases, given the option of paying the lesser amount of (a) the tax computed by spreading the income over the prior period or (b) the tax computed by including the entire amount in the income for the year of actual payment. This affords the writer, who suddenly finds his story a best seller, with the attendant rewards of that position, the opportunity to spread back to some of the earlier years of struggle, for tax computation purposes, a portion of his sudden riches. Similar provisions in principle are provided in Section 1301 for the employee or independent contractor, with some comparatively minor differences in the mode of application.[36]

---

[34]INT. REV. CODE OF 1954 § 1301. Compensation From An Employment.

(a) Limitation on Tax. If an individual or partnership

(1) engages in an employment as defined in subsection (b); and

(2) the employment covers a period of 36 months or more (from the beginning to the completion of such employment); and

(3) the gross compensation from the employment received or accrued in the taxable year of the individual or partnership is not less than 80 percent of the total compensation from such employment,

then the tax attributable to any part of the compensation which is included in the gross income of any individual shall not be greater than the aggregate of the taxes attributable to such part had it been included in the gross income of such individual ratably over that part of the period which precedes the date of such receipt or accrual.

(b) Definition of an Employment. For purposes of this section, the term "an employment" means an arrangement or series of arrangements for the performance of personal services by an individual or partnership to effect a particular result, regardless of the number of sources from which compensation therefor is obtained.

§ 1302 (a) Limitation on Tax.—If—

(1) an individual includes in gross income amounts in respect of a particular invention or artistic work created by the individual; and

(2) the work on the invention or the artistic work covered a period of 24 months or more (from the beginning to the completion thereof); and

(3) the amounts in respect of the invention or the artistic work includible in gross income for the taxable year are not less than 80 percent of the gross income in respect of such invention or artistic work in the taxable year and the 12 months immediately succeeding the close of the taxable year,

then the tax attributable to the part of such gross income of the taxable year which is not taxable as a gain from the sale or exchange of a capital asset held for more than 6 months shall not be greater than the aggregate of the taxes attributable to such part had it been received ratably over, in the case of an invention, that part of the period preceding the close of the taxable year or 60 months, whichever is shorter, or, in the case of an artistic work, that part of the period preceding the close of the taxable year but not more than 36 months.

(b) Definitions. For purposes of this section—

(1) Invention. The term "invention" means a patent covering an invention of the individual.

(2) Artistic Work. The term "artistic work" means a literary, musical, or artistic composition or a copyright covering a literary, musical, or artistic composition.

[35]Robertson v. United States, 343 U.S. 711 (1952).

[36]The period involved in the work is 36 months, and the amount received in the year must be at least 80 percent of the total compensation from the employment.

Under Section 1301, it is vital that the income be from "an employment." This is defined by the Code as an arrangement or series of arrangements for the performance of personal services to effect a particular result. Thus the question will not be for whom the services were rendered or the nature generally, but rather the result achieved or intended to be achieved. This code definition is intended to eliminate the possibility of averaging employment over a period of years for a client on a variety of matters, but with a lump sum payment in one year. This latter use would vitiate the purpose of the section, and instead of a provision for relief of bunched income, could be a voluntary device for adjustment of income tax liability. In addition, the section requires the employment to cover at least 36 months from beginning to end. This, of course, does not require continuous activity under the employment.[37] Finally, 80% of the total compensation must be received in a single taxable year. It would be an extremely unusual occasion when a performer would have the extended period of employment without continuing receipt of compensation required under Section 1301.[38]

In planning under Sections 1301 and 1302, it is important to be certain of the "beginning" date and the "completion" date. The record keeping aspect is vital to meet the problem of proof. A court in one case held that the commencement of a work "connotes more than the germinating of an idea."[39] In another decision the Tax Court held that a mural containing a number of figures developed prior to the undertaking of the mural was not commenced until the actual work on the finished product was begun.[40] On the other hand, the keeping of a diary of war experiences by an individual for the purpose of eventually using them in a book was a "commencement" within the meaning of the predecessor to Section 1302.[41] Everyone who can fit within this category should clearly record the facts incident to the first conception of the entire idea so as to minimize the problem of proof to which we have previously referred.[42]

III. "CONVERSION" OF INCOME

Although averaging devices offer some relief to the high bracket taxpayer, far greater tax savings can be effected by shifting potential earnings not from one year to another but rather from the category of ordinary income to the comparative haven of capital gain. A simple comparison

[37]The burden to prove the 36 month period is on the taxpayer. Englar's Estate v. Comm'r, 166 F.2d 540 (2d Cir. 1948).

[38]Financial or legal problems of a motion picture producer might possibly bring a performer into a situation where § 1303 would be useful.

[39]Beardsley v. United States, 140 F. Supp. 541 (D.C. Conn. 1956).

[40]Jean De Marco, 9 T.C. 1188 (1947).

[41]Iliff D. Richardson, 14 T.C. 547 (1950; see also Blum v. Comm'r, 11 CCH Tax Ct. Mem. 612 (1952); see Morgan v. Comm'r, 16 CCH Tax Ct. Mem. 262, 266 (1957), holding that work was "completed" when application filed for patent.

[42]Smart v. Comm'r, 152 F.2d 333 (2d Cir. 1945); Curtis Dall, 23 T.C. 580 (1954), *aff'd* 228 F.2d 526 (2d Cir. 1955).

of the maximum 25%[43] rate attributable to capital gains with the 87% maximum rate[44] on ordinary income reveals in itself the spectacular tax savings promised by conversion of ordinary income to capital gain. Unfortunately, far less readily apparent is the means by which to accomplish this "conversion."[45]

Meeting the challenge of "conversion" was not exceptionally difficult to achieve at a time when the definition of capital assets[46] was broad enough to include literary works, radio programs, musical compositions and like concrete products of a taxpayer's creative efforts. Under such circumstances, the author, entertainer, composer or other artist who relied on his personal services for a livelihood could embody his talents in tangible property form and by the straightforward device of a sale[47] thereof realize the preferential capital gain rate.[48] This relatively simple plan for converting the fruits of personal efforts into capital assets and reaping the financial harvest as capital gain was denied only to those who were deemed professionals holding the tangible products of their personal efforts primarily for sale to customers[49] in the ordinary course of business.[50]

The adoption in 1950[51] of the present rule found in Internal Revenue Code Section 1221 (3)[52] removes the disparity in taxation of amateurs

---

[43]INT. REV. CODE OF 1954 § 1201.

[44]INT. REV. CODE OF 1954 § 1(c).

[45]For a comprehensive detailing and evaluation of instances of capital gains taxation of the fruits of personal efforts, see Miller, *Capital Gains Taxation of the Fruits of Personal Effort: Before and Under the 1954 Code,* 64 YALE L.J. 1 (1954).

[46]Prior to 1950, the INT. REV. CODE of 1939 defined the term capital assets in § 117(a)(1) to mean "property held by the taxpayer (whether or not connected with his trade or his business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation . . . or real property used in the trade or business of the taxpayer."

[47]See text at notes 69-70 *infra* for discussion of the "sale" requirement.

[48]Herwig v. United States, 105 F. Supp. 384 (Ct. Cl. 1952) (sale of motion picture rights to "Forever Amber"); Estate of Douglas Chandor, 28 T.C. 721 (1957) (sale of portrait of Winston Churchill); Richard W. TeLinde, 18 T.C. 91 (1952) (sale of copyright to medical treatise); see also Mintz, *Entertainers and the Capital Gains Tax,* 4 TAX L. REV. 275 (1949) for a discussion of the capital gains treatment accorded the sale of the radio program "Amos 'n Andy" by its creators, Mr. Freeman Gosden (Amos) and Mr. Charles Correll (Andy).

[49]See note 46 *supra.* The property was excluded from the defintion of capital assets because of the purpose for which it was being held.

[50]Rider v. Comm'r, 200 F.2d 524 (8th Cir. 1952) (sale of books by math teacher); Fields v. Comm'r, 189 F.2d 950 (2d Cir. 1951) (sale of motion picture rights to several plays); Goldsmith v. Comm'r, 143 F.2d 466 (2d Cir. 1944), *cert denied,* 323 U.S. 774 (1944) (sale of exclusive motion picture rights to play). *But cf.* Irving Berlin, 42 B.T.A. 668 (1940) (motion picture rights to musical compositions).

[51]INT. REV. CODE OF 1939, § 117(a)(1)(C). This was the so-called Eisenhower amendment, designed to plug the "loophole" which permitted the then General, now President, Eisenhower and other amateurs to realize capital gains on the products of person efforts.

[52]INT. REV. CODE OF 1954 § 1221: "For purposes of this subtitle, the term 'capital asset' means property held by the taxpayer (whether or not connected with his trade or business), but does not include . . .

(3) a copyright, a literary, musical, or artistic composition, or similar property, held by—

and professionals and now treats these two groups on a par, and in an equally harsh manner.[53] This section specifically excludes from the definition of capital assets "a copyright, a literary, musical, or artistic composition, or similar property" held by the creator or by a taxpayer, such as a donee[54] with the cost basis of the creator.[55] However despite this restrictive statutory treatment there are many in the entertainment industry who may continue to enjoy the blessings of capital gains in dealings involving properties of a creative nature.[56]

True, Messrs. Gosden and Correll, the ingenious creators of the radio show "Amos 'n Andy,"[57] could not expect today the preferential capital gain treatment accorded them several years ago upon the sale of the rights in their radio show,[58] but it does not follow that subsequent owners of the show or the characters therein portrayed[59] would be denied the capital asset categorization. Capital gain potentials from the sale of properties, which would not qualify as capital assets to their creators, are well illustrated by the frequently reported instances of literary properties purchased by actors,[60] directors[61] and producers[62] with the intent of resale to a studio for exploitation in a motion picture in which the seller can perform his usual services as a star, producer or director. To the persons making such purchases and resales, there are two major stumbling blocks

---

(A) a taxpayer whose personal efforts created such property, or

(B) a taxpayer in whose hands the basis of such property is determined, for the purpose of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of the person whose personal efforts created such property".

[53]See Pilpel, *Developments in Tax Law Affecting Copyrights in 1954,* 33 TAXES 271 (1955), which points up the unjustifiable discrepancy between the tax treatment of patents and copyrights.

[54]Before the 1950 amendment, donees of professional writers were able to obtain capital gain treatment upon the sale of a professional artist's creation. See Cory v. Comm'r, 230 F.2d 941 (2d Cir. 1956), *cert denied* 352 U.S. 828 (1956) (donee of autobiography by Santayana denied capital gains only because the transfer was a mere license). It should be noted that, unlike donees, estates of deceased professional authors and artist have a stepped up basis for the deceased's works and can thus still realize capital gains upon sale. Gershwin v. United States, 153 F. Supp. 477 (Ct. Cl. 1957) (sale of rights in inherited musical compositions).

[55]INT. REV. CODE OF 1954 § 1231, which permits capital gain treatment in situations involving non-capital assets, contains a similar exclusion.

[56]The basic reason offered for according capital gain treatment to creators of patents and copyrights is the need to provide an incentive to these persons. Yet, "it is difficult to see how any concession to the only two groups of people who can today claim capital gains treatment for copyrights (that is, purchasers of such property and estates of deceased authors) can in any way operate as an incentive to living authors except perhaps as an incentive in the direction of giving up working—or living—entirely." Pilpel, *Developments in Tax Law Affecting Copyrights in 1954,* 33 TAXES 271 (1955).

[57]See Mintz, *Entertainers and the Capital Gains Tax,* 4 TAX L. REV. 275 (1949).

[58]A radio program is a type of "similar property" excluded from the definition of capital assets. H.R. Rep. No. 2319, 81st Cong., 2d. Sess. 92 (1950).

[59]For a discussion of the severable property rights existing in radio shows such as "Amos 'n Andy," see Mintz, *supra* note 57.

[60]See Fred MacMurray, 21 T.C. 15 (1954); Jose Ferrer, No. 70957, T.C. filed Dec. 4, 1957.

[61]See Anatole Litvak, 23 T.C. 441 (1954); Fred MacMurray, 21 T.C. 15 (1954).

[62]See Pat O'Brien, 25 T.C. 376 (1955); Fred MacMurray, 21 T.C. 15 (1954).

to be overcome before capital asset categorization for the proceeds is assured. First, since "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" does not qualify as a capital asset, the problem arises of how many such purchases and resales can be effected before the actor, director or producer is considered to be in the business of consummating such sales.[63] Apparently the Commissioner will contend in the future that it takes very few transactions to establish that the taxpayer is in such a business.[64] Second, there is the almost inevitable argument by the Commissioner that the consideration agreed upon is not in payment for a capital asset (the literary property) but in reality constitutes a disguised payment for services to be rendered by the seller, and to that extent is reportable as ordinary income.[65] That the Commissioner means to continue this type of attack will no doubt be substantiated by the position taken in the recently filed Jose Ferrer case.[66] The facts there disclose that Ferrer contracted to sell the motion picture rights he had acquired to the novel "Moulin Rouge" for a fixed percentage of the profits of the resulting motion picture, and under other provisions of the same contract agreed to star in the film. Apparently the Commissioner's position is that part of the amount designated in the contract as payable to Ferrer, the seller, is really added compensation payable to Ferrer, the star.[67] Although in the Ferrer case, the lumping of the personal service contract and the sale of the motion picture rights into a single contract acted as a red flag to the Commissioner, suggesting in itself the interdependency of the prices agreed upon for each commodity, separation of the contractual items will certainly not obviate the government attack. It is probable that the success or failure of the taxpayer's contention that there was remuneration from the sale of capital asset and not additional compensation for the personal services rendered will depend largely on the ability of the taxpayer to show a "reasonable" amount for the personal services rendered or the asset involved or at the least that the amounts resulted from arms length negotiation.[68]

---

[63]See cases cited in notes 48, 50, 60, 61, 62, *supra*. *Cf.* Fidler v. Comm'r, 231 F.2d 138 (9th Cir. 1956) (columnist—news commentator); Gershwin v. United States, 153 F. Supp. 477 (Ct. Cl. 1957) (widow of composer).

[64]The commissioner has recently withdrawn his prior acquiescence in the *MacMurray* and *Litvak* cases. P-H 1958 FED. TAX SERV. ¶ 54—752.

[65]Fred MacMurray, 21 T.C. 15 (1954); *Cf.* Julius Marx, 29 T.C. 88 (1957) (sale of partnership interest); Jack Benny 25 T.C. 197 (1955), *dismissed* May 24, 1956 (sale of corporation stock), both discussed *infra* in text at notes 117-19. This argument is also posed by the Commissioner in cases where the seller's services antedated the sale. Pat O'Brien, 25 T.C. 376 (1955); *cf.* Finney v. Comm'r, P-H 1958 FED. TAX SERV. ¶ 58—577; Comm'r v. Gross, 236 F.2d 612 (2d Cir. 1956).

[66]CCH TAX CT. REP. ¶ 5011.

[67]The commissioner may also be urging that the transaction was a licensing arrangement only, as evidenced by the agreement that the consideration be based on profits from the picture. See *infra*.

[68]See note 65, *supra*. In the *MacMurray* case the argument of disguised compensation was rebutted "indirectly" by concentration on evidence to show the value of the literary property rather than the value of the services. A similar "indirect" approach is followed in

Even after the hurdle of capital asset classification is successfully scaled, capital gain treatment will not be forthcoming unless the property is disposed of in a transaction which qualifies as a sale. Basically the problem is how many rights (such as motion picture rights, television rights, etc.) can be retained by the person disposing of the property without having the transaction treated as a mere licensing arrangement.[69] The current position taken by the Commissioner[70] is that a grant of the exclusive right to exploit a copyrighted work in a particular medium of publication or expression for the life of the copyright transfers a property right which is subject to sale; a grant of less confers a license only. Furthermore, the consideration is treated as proceeds of a sale rather than rents or royalties if the consideration received for the grant is not based upon a percentage of the receipts, number of performances given or exhibitions made of a work, and is not payable periodically over a period generally coterminous with the grantee's use of the copyrighted work. The validity of this position appears questionable. If a copyright is divisible as the Commissioner admits and the courts have repeatedly declared, how can the Commissioner say that a transfer for a period less than the life of the copyright of all of a divisible portion is not a transfer of property? Further, in view of all of the patent cases how is it possible to contend that a transfer based upon some measure is not a sale for Internal Revenue Code purposes? However, litigation with some uncertainty of result would be a necessary correlative to a transfer which was not within the circumscribed rules laid down by the Commissioner.

Although artists can no longer achieve capital gains by a sale of the tangible products of their creative endeavors, they need not despair that as to them capital gains are a tantalizing mirage. Rather, their tax counselors are simply presented with the challenge of resolving the seemingly paradoxical dilemma of converting personal efforts to capital assets and ultimately capital gains within a statutory framework which denies capital asset classification to products of one's own personal efforts.

To date the solution most generally seized upon has been to secure for the taxpayer a proprietary interest in a business (whose value is based at

---

the *Benny, Finney* and *Gross* cases. In the *O'Brien* case, the court held in favor of the taxpayer since a "reasonable salary" "under the circumstances" was agreed upon, even though the Commissioner argued this salary was considerably less than the taxpayer's "normal" salary. In the *Gross* case, the court rejected the Commissioner's attempt to tax some of the corporate distributions as added salaries, and observed in 236 F.2d at 618 that the taxpayers (officers of the corporation) "are not compelled to take salaries for the services they render. They may donate their services to the corporation if they choose to do so."

[69]The issue of license versus sale was specifically considered in the following cases: Cory v. Comm'r, 230 F.2d 941 (2d Cir. 1956), *cert denied*, 352 U.S. 828 (1956); Fields v. Comm'r, 189 F.2d 950 (2d Cir. 1951); Gershwin v. United States, 153 F. Supp. 477 (Ct. Cl. 1957); Herwig v. United States, 105 F. Supp. 384 (Ct. Cl. 1952); see Goldsmith v. Comm'r, 143 F.2d 466 (2d Cir. 1944) *cert denied*, 323 U.S. 774 (1944).

[70]Rev. Rul. 54-409, 1954-2 CUM. BULL. 174; See also Rev. Rul. 54-409, 1954-2 CUM. BULL. 52.

least in part on the taxpayer's personal efforts), which interest can ultimately be disposed of at capital gain rates. Common illustrations of this are found in independent production companies formed by combinations of actors, producers or directors;[71] companies organized by entertainers to produce their radio and television shows;[72] or corporations formed by cartoonists to furnish drawings to cartoon syndicates.[73] The taxpayer is free to choose that form of business organization which best serves his ends, even though tax minimization is a motivating factor in his choice.[74] The possibilities range from a simple sole proprietorship, through partnership, corporation, complex multiple corporate structures[75] or a combination of any of the foregoing.[76]

After election of the desired business form, a contract for rendition of the taxpayer's personal services is entered into with the entity, or perhaps in the case of entertainers, the personal service contract is executed with the sponsor or network for whom the company has contracted to produce the show.[77] To the taxpayer in the entertainment industry who "enjoys" a high income bunched in relatively few years, the "tax appeal" of the independent company is founded, not on the earnings to be realized under these personal service contracts (which of course must be reported as ordinary income), but rather in the two-fold expectation that (1) some earnings can be channeled through the business and taxed at the lower business rate, and (2) at least part of the increment in the value of the business can be realized at capital gain rates.

In general, the desired tax savings can best be achieved through use of the corporate form. First, the corporation is a distinct taxable entity[78] which pays a comparatively low maximum tax of 52%[79] on corporate income as earned, the shareholders becoming directly taxable on corporate

[71]See Taubman, *Motion Picture Co-Production Deals and Theatrical Business Organization,* 11 TAX L. REV. 113 (1956); Walker, *Investing in Motion Picture Enterprises,* U. SO. CAL. 1954 TAX INST. 399.

[72]See Julius Marx, 29 T.C. 88 (1957); Jack Benny, 25 T.C. 197 (1955), *dismissed* May 24, 1956. Rosenbaum, *Entertainers' Corporations and Capital Gains,* 12 TAX L. REV. 33 (1957).

[73]See Comm'r v. Fisher and Fisher, Inc., 84 F.2d 996 (1936). Reynard Corp., 37 B.T.A. 552 (1938), *dismissed,* Aug. 8, 1938.

[74]*E.g.,* Herbert v. Riddell, 103 F. Supp. 369 (S.D. Cal. 1952), *dismissed,* Aug. 18, 1952. Julius Marx, 29 T.C. 88 (1957).

[75]The tax advantages from use of multiple corporations may be sacrificed because of reallocation of income and deductions among the corporations, or disallowance of deductions, credits, or other allowances. INT. REV. CODE OF 1954 §§ 61, 269, 482, 1551. The Commissioner is currently waging numerous attacks against multiple corporations by exercise of these statutory weapons.

[76]For a discussion of the complexities in classifying the business forms available to independent production companies, see Taubman, *Motion Picture Co-Production Deals and Theatrical Business Organizations,* 11 TAX L. REV. 113 (1956).

[77]A contract between the entertainer and one other than his own company has the advantage of minimizing the chances of either personal holding company classification or an argument of disguised compensation. See *infra* text at notes 94-102, 116-121.

[78]For an important qualification of this, see *infra* text at notes 103-05.

[79]INT. REV. CODE OF 1954 § 11.

income only when it is distributed to them, or indirectly when they dispose of their corporate stock (to the extent the income is reflected in an appreciated value for their stock). In contrast, the yearly income of a sole proprietorship or partnership is reportable by and taxable to individual owners of these businesses[80] at their own high surtax rates on their yearly returns.[81] Second, a recent ruling,[82] suggests the possibility that the corporation could ultimately dispose of some produced property, such as motion pictures, at capital gain rates, which property in the hands of a proprietorship or partnership could not qualify as a capital asset because the personal efforts of the owners were important in the creation of the property. Finally, capital gain taxation of both realized income (retained earnings) and unrealized income (such as goodwill, uncollected fees, and appreciation of the assets of the business) is possible by use of the corporate form.[83] Specifically, since corporate stock qualifies as a capital asset,[84] an increase in the value of corporate stock can be realized at capital gain rates by sale or exchange[85] of that stock, so that in effect capital gain would result on any realized and unrealized income to the extent these items were responsible for an increased value of the stock and hence reflected in gain from sale of the stock. In comparison, the sale of the owner's interest in a proprietorship is treated as the sale of the individual assets of the business rather than the sale of a single capital asset;[86] whereas the sale or exchange of a partnership interest is treated as the sale or exchange of a capital asset[87] except as to that part of the consideration received which is attributable to unrealized receivables and substantially appreciated inventory items of the partnership.[88]

Tax savings do not, however, flow automatically from the use of a corporate entity. Adequate planning and control are necessary to prevent the entity from becoming a Frankenstein to plague its creator.

---

[80]INT. REV. CODE OF 1954 § 701: "A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities."

[81]INT. REV. CODE OF 1954 § 1361 provides for an election by certain partnerships and sole proprietorship to be treated as domestic corporations. But see the qualification in § 1361(b)(4) which requires the electing enterprise to be one in which capital is a material producing factor.

[82]Rev. Rul. 55-706, 1955-2 CUM. BULL. 300.

[83]Capital gain taxation of *unrealized* income is obviously advantageous where it substitutes the 25% capital gain rate for the higher ordinary income rate. Capital gains taxation of *realized* income is also advantageous to high bracket taxpayers since, exclusive of penalty taxes, the maximum tax payable on that income will be 60¼% (47% maximum corporate income tax plus 25% capital gain tax on the corporate net) as compared with an 87% maximum tax had the income been earned directly by the shareholder and not channeled through the corporation.

[84]Corporate stock qualifies as a capital asset except when held as stock in trade by a securities dealer. INT. REV. CODE OF 1954 § 1236.

[85]A corporate distribution is treated as payment in "exchange" for stock if made in complete or partial liquidation (§ 331, 346) or in certain redemptions (§ 302).

[86]Williams v. McGowan, 152 F.2d 570 (2d Cir. 1945).

[87]INT. REV. CODE OF 1954 § 741.

[88]INT. REV. CODE OF 1954 § 751.

One inroad on the tax advantages anticipated from the use of a corporation might result from the assessment of additional taxes. For example, an accumulated earnings tax is imposed on any corporation formed or availed of for the purpose of avoiding the surtax on shareholders by permitting earnings and profits to accumulate in the corporation beyond the reasonable needs of the business.[89] This tax[90] is a particular threat to small closely held corporations[91] since it is patently obvious that such corporations can easily be used by shareholders for the proscribed purpose. The threat of the tax has been somewhat alleviated by revisions in the 1954 Code which make the tax inapplicable to a corporation whose accumulated earnings are less than $60,000,[92] and which permit the taxpayer to shift to the Commissioner the burden of proof as to the unreasonableness of the accumulations.[93] Although the new provisions enhance the ability to accumulate, temperance must surely be exercised to avoid overstepping the permissible bounds.

Another penalty tax of particular significance in the type of corporation here considered is the exceedingly high personal holding company tax,[94] which, unlike the accumulated earnings tax, does not rest on the presence of tax avoidance motives by the shareholders. Rather, the statute sets up two objective conditions which, if met, subject the company to the tax. Under one test,[95] which relates to stock ownership, five or less persons must own, directly or indirectly,[96] more than 50% of the corporate stock. The other condition[97] is concerned with corporate income and requires that at least 80% of the corporation's gross income must be "personal holding company income" as defined in the statute.[98] Such income may be described in brief as non-operating income, such as dividends, interest, royalties, and rents. However, also within the definition of personal holding company income, and of special importance in the entertainment industry, are amounts received by corporations from certain personal service contracts.[99]

---

[89]INT. REV. CODE OF 1954 § 531-537.

[90]The rate of tax is 27½% of the first $100,000 of "accumulated taxable income" and 38½% of the excess.

[91]See Comm'r v. Cecil B. DeMille Productions 90 F.2d 12 (9th Cir. 1937), *cert. denied*, 302 U.S. 713 (1937); Comm'r v. Fisher & Fisher, Inc., 84 F.2d 996 (1936). Reynard Corp., 37 B.T.A. 552 (1938), *dismissed*, Aug. 8, 1938.

[92]INT. REV. CODE OF 1954 § 535 (c) (1), (3).

[93]INT. REV. CODE OF 1954 § 534.

[94]The tax is 75% of the first $2000 of undistributed "personal holding company income" and 85% of the excess.

[95]INT. REV. CODE OF 1954 § 541 (2).

[96]Indirect ownership of stock refers to the constructive ownership rules in INT. REV. CODE OF 1954 § 544 which attribute to one individual the stock owned directly by his corporation, partnership or partners, family members, etc.

[97]INT. REV. CODE OF 1954 § 541(1).

[98]INT. REV. CODE OF 1954 § 543.

[99]INT. REV. CODE OF 1954 § 543(a) (5) provides in part: "Personal service contracts. (A) Amounts received under a contract under which the corporation is to furnish personal services; if some person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or if the individual who is to

This inclusion acts to curb those "incorporated talent" arrangements in which a high bracket entertainer made his services available at a low fee to his closely held corporation, which in turn contracted with an outsider to provide these services at their higher true value, the effect being to tax this difference at the corporate income tax rate in substitution for the higher individual rates.[100] Under the present statutory scheme, income from a personal service contract is treated as income subject to the personal holding company tax only if at some time during the taxable year the artist involved in the contract owns, directly or indirectly, at least 25% of the corporate stock.[101] Thus, one obvious way of avoiding the personal holding company tax would be to place a 24% ceiling on stock ownership by the performer, taking care not to overlook the potential trap of attribution of ownership of another's stock under constructive ownership rules. Another means of circumventing the statute is to engage the corporation in sufficient non-personal holding company activities, such as the manufacture of sunglasses or facial disguises, so that personal holding company income does not exceed 79% of the gross income. The most direct way to avoid the personal holding company sections is for the artist personally to contract with the outsider for the rendition of his services, as where an actor contracts directly with a major studio rather than having his closely held corporation contract to "loan" his services, or, where an entertainer contracts directly with a sponsor or network to perform on a show produced by his company.[102] This, of course, is a cautious approach which avoids disastrous collisions with personal holding company sections, but likewise minimizes opportunities for tax savings from channeling some income through the corporation.

The expectation of tax savings from use of a corporation likewise may fail to materialize because of reallocation and direct taxation of corporate income to the shareholders. Small closely held companies are particularly vulnerable to this threat, either on the grounds that the corporation is a mere sham to be disregarded for tax purposes,[103] or that the income was in reality earned by and attributable to the shareholders and hence should be taxable to them.[104] In general, the Commissioner has been unsuccessful in his efforts to disregard the corporate entity where the corporation does in fact engage in activity or serve some business purpose.[105] Yet the reserve powers of the Commissioner to reallocate income serve to emphasize the

perform the services is designated (by name or by description) in the contract; and (B) amounts received from the sale or other disposition of such a contract."

[100]See *e.g.*, Comm'r v. Laughton, 113 F.2d 103 (9th Cir. 1940).

[101]INT. REV. CODE OF 1954 § 543(a)(5).

[102]See Jack Benny, 25 T.C. 197 (1955), *dismissed*, May 24, 1956.

[103]The leading case is Higgins v. Smith, 308 U.S. 473 (1940); *accord*, Comm'r v. Laughton, 113 F.2d 103 (9th Cir. 1940).

[104]INT. REV. CODE OF 1954 § 61, 482.

[105]The leading case is Moline Properties, Inc. v. Comm'r, 319 U.S. 436 (1943); see also Herbert v. Riddell, 103 F. Supp. 369 (S.D. Cal. 1952), *dismissed* Aug. 18, 1952.

need for permitting the corporation maximum power and opportunity to act in its own behalf.

The danger that ordinary income rather than capital gain will be realized ultimately upon disposition of the stock is a contingency which must be faced early in the planning stages. Particularly is this true in the motion picture and entertainment industry corporations where the threat of forfeiture of the preferred capital gain treatment is a very real and potent one. The section of the IRC dealing with "collapsible corporations"[106] presents one obvious reason for a very careful examination of the statutory restrictions in the corporate area.

Prior to the adoption of any restraining provisions, it was possible to convert large amounts of ordinary income to capital gain through the expedient of what is now known as a collapsible corporation. In its simplest form,[107] it was a corporation organized for the purpose of producing a single motion picture. Upon completion of production, and before the corporation realized any substantial taxable income from the film, the shareholders would dissolve or "collapse" the corporation, valuing the picture at the time of distribution, and report any gain therefrom as a capital gain. Since this gain was largely attributable to the income potentials of the property produced, which income would have been reported as ordinary income had there been no dissolution, the perfectly executed collapse plan avoided nearly all ordinary income tax, both corporate and individual, in favor of taxation at capital gain rates. The statutory solution to this plan was to deny capital gain upon the sale or exchange of stock of a "corporation formed or availed of principally for the . . . production of property . . . with a view to . . . the sale or exchange of stock by its shareholders . . . before the realization by the corporation . . . of a substantial part of the taxable income to be derived from such property . . . ."[108] This statute is rather unique in posing almost as many traps for the counselled as for the unwary. The reason for this rests in the general ambiguity of the statutory terms.[109] For example, the undefined use of such

[106]INT. REV. CODE OF 1954 § 341.

[107]See Pat O'Brien, 25 T. C. 376 (1955); Freeman, *Collapsible Corporations,* N.Y.U. 11th INST. ON FED. TAX 407 (1953): "Here is how the device operated in the film industry: A producer, director, writer and stars, organized a corporation for the production of a moving picture. The services of these stockholders were engaged by the corporation which made the picture, arranged for its distribution and then liquidated, before realizing any income from the transaction. The shareholders received undivided interests in the film distribution contract and reported the difference between the cost of their stock and the fair market value of the contract as long-term capital gain. The fair market value of the picture was then amortized over the estimated life of the film and only the excess of the distribution receipts over the amortization deductions was taxed at ordinary income rates."

[108]INT. REV. CODE OF 1954 § 341 (b) (1) (A).

[109]For more extended discussions of the inadequacies and uncertainties in the statutory terminology, see Anthoine, *Recent Developments in Collapsible Corporations,* N.Y.U. 14th INST. ON FED. TAX 761 ((1956); DeWind and Anthoine, *Collapsible Corporations,* 56 COLUM. L. REV. 475 (1956); Freeman, *Collapsible Corporations,* N.Y.U. 11th INST. ON FED. TAX 407 (1953); MacLean, *Collapsible Corporations—The Statute and the Regulations,*

basically indefinite terms as "principally" and "substantial" produces certainty only of conjecture. Again, the corporation must be formed or availed of "with a view" to the action described, yet this vague phraseology could mean anything from a bare recognition by any shareholders of the possibility of an early collapse to the necessity of a real intent by the shareholders in question to collapse the corporation.[110] There is also the problem of determining what constitutes a "substantial part of the taxable income to be derived from [produced] property."[111] This breeds speculation because, even assuming that the total income from the property can be accurately estimated (a far-fetched assumption in light of the extended periods over which a movie may be exhibited profitably, residual television rights, etc.), a further guess is necessary as to what constitutes a "substantial" part of that income. Then too, the term "property" is ambiguous in that it may be used in a singular sense to refer to a single motion picture or television show, or to all films which compose a series, or in the broadest sense to designate all the unrelated properties produced by the corporation.[112]

The somewhat unclear term, "property," appears also in the statutory limitations[113] on the application of the collapsible corporation section. These limitations offer very restricted exceptions to the near fatal application of Section 341. The first limitation applies to a shareholder who owns, directly or indirectly, less than 5% of the corporate stock any time after commencement of production of the property. The section also fails to apply unless more than 70% of the gain recognized during a year is attributable to the produced property. The final limitation excludes from the section's application gain realized more than three years after completion of production.

In addition to these specific statutory limitations, the definition itself of a collapsible corporation suggests ways of avoiding the statute. For

67 HARV. L. REV. 55 (1953); Walker, *Investing in Motion Picture Enterprises*, U. SO. CAL. 1954 TAX INST. 399.

[110]See Weil v. Comm'r, 252 F.2d 805 (2d Cir. 1958); Raymond Burge, 28 T.C. 246, 261-262 (1957), *appeal pending*. The extreme position adopted by the Commissioner is that this requirement is satisfied in any case in which the described action was contemplated by those persons in a position to determine the policies of the corporation, whether such action was contemplated unconditionally, conditionally, or as a recognized possibility. Treas. Reg. § 1.341-2(a)(2)(1958).

[111]See Levenson v. United States, P-H 1957 FED. TAX SERV. ¶ 58—339.

[112]Treas. Reg. § 1.341-2(a)(4)(1958): "The property referred to in section 341(b) is that property or the aggregate of those properties with respect to which the requisite ever existed. In order to ascertain the property or properties as to which the requisite ever existed, reference shall be made to each property as to which, at the time of the sale . . . there has not been a realization by the corporation . . . of a substantial part of the taxable income to be derived from such property. However, where any such property is a unit of an integrated project involving several properties similar in kind, the determination whether the requisite view existed shall be made only if a substantial part of the taxable income to be derived from the project has not been realized at the time of sale . . . and in such case the determination shall be made by reference to the aggregate of the properties constituting the single project."

[113]INT. REV. CODE OF 1954 § 341(d).

example, by deferring liquidation of a "single shot" corporation until after "the realization by the corporation of a substantial part of the income" to be derived from its sole production, the balance of the income from that property can be realized at capital gain rates. Similarly, once a "multiple shot" corporation has realized a substantial amount of income from all the films produced by it, capital gains will probably be allowed even though as to one particular motion picture the corporation had not as yet realized much, if any, ordinary income.[114]

With the substantial uncertainty which surrounds the interpretation of Section 341, good planning dictates that the proceeds from the sale or exchange of the stock of a production corporation be paid on an installment plan basis so as to spread the realization of income over several years.[115] This provides a hedge against the dangers of a large concentration of ordinary income in the year of sale which could materialize should the corporation be classified as collapsible or should the proceeds from some purported sale be viewed as compensation for personal services of the seller. The argument of disguised compensation most certainly has great practical merit when cast in a setting of a sale of stock coupled with an agreement by the seller to render personal services for the buyer. It takes little imagination to visualize the temptatiton facing a taxpayer in the 87% bracket to inflate the price of his stock and reduce the personal service payments correspondingly, since for every dollar so shifted the taxpayer's pockets bulge with another sixty-two cents.[116] The surprising element lies in how successful the taxpayer has been in refuting the contention that he has engaged in such maneuverings. In the very recent Groucho Marx case,[117] Marx, star of the television show "You Bet Your Life," and Guedel, the originator-producer of the show, sold to the National Broadcasting Company their respective interests in the partnership which owned the show, and in addition separately contracted for a considerable additional amount to continue performing their services in connection with the show. The Commissioner argued that much of the purchase price represented compensation for services, but the court concluded that the issue was essentially one of fact and that the million dollars received for the sale of their partnership interests represented the fair market value. The significant facts in this record are that the two major broadcasting networks, completely independently of one another, arrived at the million dollar valuation for the partnership, and that under the employment contract executed contemporaneously with the sale of the

[114]Treas. Reg. § 1.341-5(d)(4),(5)(1958).

[115]The contract of sale would be analogous to a deferred compensation agreement, with like tax results of deferred taxation. See *supra*.

[116]That is, the taxpayer's share of the stock proceeds is 75¢ on the dollar after paying the 25% capital gain tax, whereas his slice of each dollar from the personal service contract is only 13¢, making 62¢ difference in his profits from the two contracts.

[117]Julius Marx, 29 T.C. 88 (1957).

partnership interest, Marx and Guedel received more than they had been receiving for their services under the pre-sale arrangements. In an earlier decision involving very similar facts,[118] Jack Benny had set up a corporation to produce his radio show, the corporation contracting with the sponsor to produce the show and Benny likewise contracting with the sponsor to star in the show. The unusual feature in this case was that Benny was under contract personally to the sponsor so that his stock was sold separate and apart from any agreement to render personal services. Although realistically it must be conceded that the Columbia Broadcasting System would not have bought the stock unless it felt confident that Benny would continue to perform as star in the show, the fact remains that there was no employment relationship entered into between the buyer and seller, and the court concluded that no part of the price paid was for services. Perhaps this absence of an actual employer-employee relationship accounts for the rather unrealistic result in the case.[119] By analogy, in those cases where the seller's services antedated the sale, the poor showing made in general by the Commissioner[120] may rest on the fact that the argument of disguised compensation is less convincing *per se* in that the services had already been completed for an amount fixed and agreed upon quite independently from the terms of the sale. In any event, the argument of disguised compensation, like that of corporate sham, is basically one of fact requiring in negation a factual showing to substantiate that the corporation was a separate and valuable entity.[121]

In assessing the value of the independent production company, the tax savings focussed upon heretofore should not blind one to the many remaining advantages of both tax and non-tax significance in the small closely-held corporate entity. For example, the independent production company can conceivably make advantageous use of the qualified pension and profit sharing plans of the Internal Revenue Code[122] for the benefit of high-priced employees, in contrast to larger companies[123] for whom the statutory requirement of nondiscrimination in employee coverage and benefits[124] poses a serious restriction. Furthermore, stock options[125] and

---

[118]Jack Benny, 25 T.C. 197 (1955), *dismissed*, May 24, 1956.

[119]See Rosenbaum, *Entertainers' Corporations and Capital Gains*, 12 TAX L. REV. 33 (1957).

[120]Finney v. Comm'r, P-H 1958 FED. TAX SERV. ¶ 158—577; Comm'r v. Gross, 236 F.2d 612 (2d Cir. 1956).

[121]See note 68, *supra*, for other relevant considerations.

[122]INT. REV. CODE OF 1954 §§ 401, 402, 403, 404.

[123]The use and benefits of the qualified plans in the Internal Revenue Code are also denied a high bracket taxpayer self employed in his own proprietorship or partnership since the plans are restricted to employees.

[124]For references covering qualified pension and profit sharing plans, and other compensatory devices, see Rice, *Incentives for Executives of Small Corporations*, 32 TAXES 222 (1954); Wentz, *Current Developments in the Taxation of Compensation for Services Rendered*, 11 MIAMI L.Q. 175 (1957).

[125]For the tax treatment of "restricted stock options," see INT. REV. CODE OF 1954 § 421 under which no taxable income results until sale of the stock acquired pursuant to the

stock bonuses reach a peak of effectiveness as compensatory and incentive devices in small newly organized companies in which the growth potential and the share of each person therein is large.[126] Certainly deserving of comment is the function a small closely-held corporation serves as a stimulus to further production of motion pictures, television shows, and legitimate theater presentations, furnishing as it does an expedient for amassing and accumulating the large amounts of capital necessary for these productions, and providing an effective outlet for those artists who find their creative endeavors throttled or distorted by employment in large companies in which they have no managerial voice.[127]

IV. CONCLUSION

The foregoing discussion has considered some of the more obvious methods for alleviating the impact of our steeply progressive tax rates on individuals engaged in momentarily lucrative personal services in the entertainment industry. Tax advisors have originated and their clients are using many other methods which are more devious and intricate than those mentioned in this paper. Lost sleep and ulcers are the only certain results of these plans which are compiled with the hope of giving the taxpayer some financial benefit from his "moment" of success. Yet the principle of relief from the inequitable burden of bunching of income has been accepted by Congress specifically and there appears to be no adequate reason why the certainty which the "averaging" provisions have brought to the lawyer, writer and inventor faced with bunched income should not be extended to the entertainer. It is, of course, obvious that the present inequitable differentation between copyright and patent should be eliminated. It is the belief of the writers that Congress could and should, consistently with the policies expressed in Sections 172 and 1301 to 1305 of the Internal Revenue Code adopt provisions giving any individual having an exceptional "bunching" of income the right to elect to spread such income for any tax year over an extended period. It is the suggestion of the writers that the carry back-carry over provisions relative to net operating losses could be effectively adapted in principle to this area of necessary tax relief. Thus, if we allowed a determination of tax based upon the tax that would have been paid if the income was received in the previous five-year period the sudden impact of high earnings would in many cases be made substantially less burdensome. This would assist the

option. The taxability of other stock options occurs at the date the employee exercises the option (Comm'r v. LoBue, 351 U.S. 243 (1956)) or at the date of issuance of the option, when the option itself is deemed to have value and to constitute the compensation. (McNamara v. Comm'r, 210 F.2d 505 (7th Cir. 1954); Comm'r v. Stone's Estate, 210 F.2d 33 (3d Cir. 1954)).

[126]See note 124 *supra;* Rudick, *Income Taxes and Deferred Compensation Agreements,* U. So. CAL. 1949 TAX INST. 163.

[127]See Herbert v. Riddell, 103 F. Supp. 369 (S.D. Cal. 1952), *dismissed,* Aug. 18, 1952.

new star in the entertainment firmament but of course it obviously would not meet the problem of the Gary Coopers or Clark Gables who have high earnings over an extended period. It is the suggestion of the writers that in addition to the provision mentioned above two others be adopted. One would be the specific provision for deferred compensation agreements following the general format of Section 453 in principle. The other would be a provision similar in idea to that proposed in the Jenkins-Keough bill for self-employed, allowing the individual to purchase long-term government bonds up to a specific percentage of net income and to exclude such amount from taxable income until such time as the bonds were cashed. These provisions, applicable to any individual, would cause some minor reduction of revenue to the government but would substantially eliminate an inequitable burden and the resultant tax avoidance devices which encumber the operation of our tax system.