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Basic Corporate Taxation

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RECENT BOOKS

BOOK REVIEWS

BASIC CORPORATE TAXATION. 2d Ed. By *Douglas A. Kahn.* Ann Arbor: Institute of Continuing Legal Education. 1973. Pp. xxii, 513; Cloth, $20; Student Paperback, $10.

To those who must work their way through the maze of the corporate income tax laws, the publication of another tax article or book is too often another blind alley. Tax literature proliferates at a rate rivaled only by the revenue laws that it seeks to clarify. For the specialists who can unravel the maze, however, the complexity is a boon—it is little wonder that the Tax Reform Act of 1969,[1] which, for example, introduced the minimum tax for tax preference items[2] and the maximum tax on earned income,[3] has been not-so-humorously referred to as the "Lawyers' and Accountants' Relief Act" of 1969.[4]

Douglas Kahn's *Basic Corporate Taxation* is a refreshing clearing in the labyrinth. Professor Kahn has set himself a difficult goal: To quote from the Preface, "[t]he book is intended for tax students and for the nontax specialist, but hopefully it will also prove to be a useful desk book for specialists" (p. vii). To reach this goal the book must be practical and yet comprehensive, concise but analytical, intelligent and intelligible; in short, the book must be everything that our income tax laws are not. While few authors could attain such a goal, Professor Kahn has done so. This book is a "must" for anyone whose work requires an understanding of the corporate tax laws.

Students will find the book a basic guide in understanding corporate income taxation, which is surely one of the two or three most difficult law school courses. Though the first edition was valuable, the second edition is even better. The practicalities of a given situation are clearly set out and discussed, and extensive examples provide useful learning guides.

The nontax specialist—the lawyer or accountant who is not intimately involved with income taxation—will find the book an essential tool in his practice. It is more important that the nontax specialist recognize tax issues than be able to quickly analyze them in all their complexity. This book will enable him not only to

1. Pub. L. No. 91-172, 83 Stat. 487 (codified in scattered sections of INT. REV. CODE OF 1954).

2. INT. REV. CODE OF 1954, §§ 56-58.

3. INT. REV. CODE OF 1954, § 1348.

4. Eliasberg, *New law threatens private foundations: An analysis of the new restrictions,* 32 J. TAXATION 156, 156 (1970).

recognize problems, but also to make intelligent estimates of the tax specialist's response.

The tax practitioner likewise will find the book of significant value. *Basic Corporation Taxation* is not the most exhaustive book on the subject; that honor must be accorded to Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders*, now in its third edition.[5] However, *Basic Corporate Taxation* provides a succinct explanation of most areas of corporate taxation, and so will prove to be useful both as a "desk book" and as a convenient reference at meetings, in travel, and in client conferences.

The persons who will find the book most valuable, however, are those who most need the tax specialist—businessmen, financial advisors, corporate officers and others whose responsibilities are affected by the tax laws. Substantial legal and accounting fees could be avoided if the client has an understanding of his tax problem *before* he consults a specialist. This is the book that every such client should have. It will enable him more readily to focus upon and understand the problems and issues he faces. In turn, the client will be able to communicate with the tax specialist on a more sophisticated level, saving time and, of course, money.

Technically, the book has a multitude of strong points. Most importantly, it is well-written, concise and easily understood. In the area of corporate divisions, for example, Professor Kahn clearly distinguishes, as many authors and practitioners fail to do, the "spin-off,"[6] the "split-off,"[7] and the "split-up"[8] (pp. 231-34). The book develops the distinction by explaining how each form affects tax incidence. The form of the division, for example, determines the amount and characterization of gain recognized by a shareholder on account of receiving boot (pp. 265-68). A spin-off is also more likely to encounter problems under section 355(a)(1)(B) of the Code,[9] which compels the recognition of gain where the transaction is merely a device to disguise a distribution of earnings and profits, than is a disproportionate split-off or split-up (240-41).

While some difficult issues are not discussed—for example, the

5. B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders (3d ed. 1971).

6. In the spin-off the parent corporation distributes the controlling stock of a subsidiary to one or more of the parent's stockholders, who do not exchange any of their stock in the parent.

7. A split-off is similar to a spin-off except that the stockholders do exchange some or all of their stock in the parent for the stock of the subsidiary. Where the stock of the subsidiary is distributed among the stockholders in the same proportion as their holdings in the parent (a so-called "proportionate split-off"), the split-off is economically identical to a proportionate spin-off.

8. In the split-up the parent corporation is completely liquidated by the distribution to its shareholders of the stock of two or more subsidiaries.

9. Int. Rev. Code of 1954, § 355(a)(1)(B).

treatment of earnings and profits of the original corporation where a split-up does not qualify for nonrecognition under sections 355-56 —Professor Kahn's discussion of the area is as concise and accurate as any now available.

Second, the book is up-to-date. Cases and Revenue Rulings from 1972 and 1973 are analyzed and discussed in depth, with reference made to some of the best recent law review and journal articles. Consider, for example, the book's treatment of the fascinating area of corporate divisions. The income tax regulations under section 355 of the Code state that a division must be effected for purposes "germane to the business of the corporations."[10] This "business purpose" test has often been overlooked or disregarded, especially since the decision in *Estate of Parshelsky v. Commissioner*.[11] The Second Circuit held in *Parshelsky* that the test was met even where the corporate division was related only to a valid business purpose of the stockholders as opposed to a purpose of the corporation itself; thus the estate planning motives of the stockholders were sufficient to support nonrecognition of gain under section 355.[12] Imagine the surprise of tax specialists when, after *Parshelsky* had been law for almost ten years, the First Circuit decided in *Rafferty v. Commissioner*[13] that stockholders' estate planning motivations are not an adequate business purpose for a corporate division.

Although several articles have discussed the impact of *Rafferty*,[14] very few have touched on the considerations raised by Professor Kahn. He observes that section 355 "was designed to facilitate *commercial* operations by removing tax obstacles to changes . . . in the form in which business is conducted" (emphasis added) (p. 242). Thus, *Rafferty* may have been correct in disallowing section 355 treatment for divisions motivated only by the *personal* concerns of shareholders. As Professor Kahn notes, however, "*Rafferty* did not preclude resort to the shareholders' motives but merely required that there be a nexus between the shareholders' motives and the conduct of the corporation's business" (p. 242).

Professor Kahn's technique of suggesting constructions of the Code that do justice to its policies in spite of difficulties in statutory language is apparent in his discussion of the recent case of *Bongiovanni v. Commissioner*.[15] *Bongiovanni* involved a dispute over the interpretation of section 357(c), which provides that, in the context

10. Treas. Reg. § 1.355-2(c) (1955).

11. 303 F.2d 14 (2d Cir. 1962).

12. 303 F.2d at 17-20.

13. 452 F.2d 767 (1971), *cert. denied*, 408 U.S. 922 (1972).

14. *See, e.g.*, Meyer, *Corporate Strip Tease: Excluding Assets from a Corporate Reorganization*, 51 TAXES 453 (1973).

15. 470 F.2d 921 (2d Cir. 1972).

of a transfer of property to a controlled corporation (a section 351 exchange), the transferor *will* recognize gain to the extent that the sum of the liabilities assumed by the transferee and the liabilities to which the transferred property is subject exceeds the adjusted basis of the property transferred.[16] (This is an exception to section 357(a), which declares that the corporation's assumption or acceptance of liability will generally not constitute boot to the transferor.) The case is interesting because it involved a transfer of accounts payable by a cash method taxpayer. The taxpayer would have had deductions for the payables had he been on the accrual method of accounting, since they represented such items as unpaid salary. Under the cash method, however, they were not deductible until actually paid. Furthermore, because he was on the cash method, the taxpayer had a zero basis in his accounts receivable, work-in-process, raw materials, and tools and supplies, all of which were transferred as well. Nevertheless, the Commissioner contended, the clear language of section 357(c) requires that the taxpayer recognize gain on the transfer of the accounts payable. The court rejected this contention, relying principally on the "inequitable result"[17] otherwise reached and a narrow reading of the legislative history of sections 351 and 357(c).[18] Professor Kahn applauds the result in *Bongiovanni*, but makes the interesting point that the rationale of the case must be refined. All accounts payable need not be excepted; the principle should rather be "that a transfer of liability will not be treated as a receipt to the transferor unless the benefits previously acquired by virtue of the liability have been *recognized* by the transferor for tax purposes—e.g., where the liability represents: a debt for cash received by the transferor; or a debt or property in kind received by the transferor where the liability was included in the transferor's basis in the property; or a debt for which a tax deduction was allowed to the transferor" (p. 347).

Professor Kahn's resolution of the *Bongiovanni* problem is no doubt equitable. However, I question whether the language of the statute is as flexible as he implies. Section 357 speaks in terms of "liabilities," and the term may simply be inadequate to bear the weight of Professor Kahn's interpretation. The recent Tax Court decision in *David Rosen*[19] should be considered in this light. That case held that section 357(c) applies even where the taxpayer remains at all times personally liable for the liabilities transferred to the

16. ". . . if the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred . . . then such excess shall be considered . . . a gain . . . ." INT. REV. CODE OF 1954, § 357(c).

17. 470 F.2d at 924.

18. 470 F.2d at 924-25.

19. CCH Tax Ct. Rep. Dec. 32,530 (April 8, 1974).

corporation. The court stated: "It must be conceded that the transaction comes within the specific language of the statute. . . . While the [taxpayer] nevertheless remained personally liable for the payment of such liabilities, and the creditors never looked to [the corporation] for payment, there is no requirement in section 357(c)(1) that the transferor be relieved of liability."[20] Thus, in spite of difficulties such as those Professor Kahn sets forth, the courts are apparently unwilling to give a strained interpretation to the word "liabilities" in section 357(c). In fairness, it should be noted that Professor Kahn does not predict that his analysis will be adopted or even that *Bongiovanni* will be followed; he specifically states that "[t]he question whether the *Bongiovanni* principle will be adopted and restructured will have to await future developments" (pp. 347-48). In my view, however, a piecemeal and strained treatment in the courts of the *Bongiovanni* problem will be ineffective and, in the long run, counterproductive. The approach suggested by Professor Kahn, though it is clear and equitable, must be implemented by Congress, rather than by the courts.

Although I might easily note other examples of the timeliness and practicality of Professor Kahn's contributions, enough has been said to allow me to comment briefly on the minor insufficiencies of the book.

At least from the perspective of a practicing tax attorney, the book might have been more profitably organized. Experience shows that the key question to consider before incorporation is whether incorporation compares favorably with other forms of enterprise organization, such as the proprietorship, the general partnership, the limited partnership, and the subchapter S corporation, taking into account factors such as the transfers of assets and liabilities to the corporation, the reasonableness of officers' salaries, any double taxation of corporate distributions, and the issuance of stock or debt. As the book is presently organized, discussion of corporate organization is postponed until chapter five, and analysis of the tax attributes of small businesses (subchapter S and section 1244) and partnerships occupies chapters six and seven. Chapters one and three, on the other hand, discuss corporate distributions, reorganizations, and divisions. While the consequences of dissolving or terminating the entity, for instance, are very significant, and often inadequately examined or understood at the time of entity formation, they are secondary in importance to the choice of entity. Fortunately, the book's reversal of perspective is not a substantial problem because each chapter is self-contained, and the book easily lends itself to per-chapter use.

20. CCH Tax Ct. Rep. Dec. 32,530, at 2505.

Professor Kahn has also omitted materials that deserve at least brief mention. The book includes virtually nothing about the impact on intercorporate dealings of section 482, which allows the Internal Revenue Service to reallocate income, deductions, credits, and allowances among "two or more organizations, trades, or businesses . . . owned or controlled directly or indirectly by the same interests."[21] Section 482 has been a highly effective tool in combatting the artificial allocation of income and deductions between entities.[22] Any corporate tax planning must include consideration of section 482, yet it is mentioned only in passing.

The book also does not cover the use of foreign corporations[23] or western hemisphere trade corporations.[24] The omission is surprising in this age of multinational corporations, international trade and investment, decreasing domestic profitability, and increasing foreign profitability.

Yet, these quibbles with the book's organization and coverage are just that—"quibbles." They do not detract from its value to the tax specialist as a desk reference: Indeed, the general practitioner would probably find them advantageous. There is no question that from the point of view of the student, the nontax specialist, and the businessman, or anyone who needs a working knowledge of basic corporate taxation, Professor Kahn has written the best book on the market today.

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21. INT. REV. CODE OF 1954, § 482.

22. *See, e.g.*, Ballentine Motor Co. v. Commr., 321 F.2d 796 (4th Cir. 1963); Marc's Big Boy-Prospect, Inc. v. Commr., 52 T.C. 1073 (1969), *affd. sub nom.* Wisconsin Big Boy Corp. v. Commr., 452 F.2d 137 (7th Cir. 1971); Hamburgers York Road, Inc., 41 T.C. 821 (1964).

23. INT. REV. CODE OF 1954, §§ 951-64.

24. INT. REV. CODE OF 1954, §§ 921-22.