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## Kahn: Basic Corporate Taxation

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## RECENT BOOKS

### BOOK REVIEWS

BASIC CORPORATE TAXATION. By *Douglas A. Kahn*. Ann Arbor: Institute of Continuing Legal Education. 1970. Pp. xxi, 345; 1969 Tax Reform Act Supplement. 1970. Pp. 22. Cloth, \$15; Student Paperback, \$7.50.

#### I. COVERAGE

If during my absence one of our more militant activists were to toss a hand grenade into my office, Douglas Kahn's *Basic Corporate Taxation* would be one of the first of my books that I would replace. On the educational problem to which it is devoted—mainly what every tax planner should know before organizing a closely held corporation—it provides the basic information and guidance needed by both the general practitioner and the tax specialist. For the former, the book should be indispensable; for the latter, it should provide a means of insuring that the particular tax plan has not overlooked an available advantage or is not headed for a pitfall. And for the teacher, the volume provides a valuable addition to the tools<sup>1</sup> that are available for instruction in the highly technical area of subchapter C.<sup>2</sup>

However, *Basic Corporate Taxation* is not designed to assist a judge (or a judge's clerk) in seeking a rationale for the resolution of a refined point of subchapter C tax law on which there is a division of authority. Professor Kahn makes no pretense of providing solutions for or in-depth discussions of a variety of current issues in this area. He does point out and emphasize the critical nature of such gray-area problems as intentional avoidance of section 332 (p. 64), maintenance of control after a section 351 transfer to a controlled corporation (pp. 254-55), intentional avoidance of section 351 (pp. 266-67), and handling of the many items for the proper determination of earnings and profits (pp. 7-10, 26-27). But instead of attempting to provide definite solutions to these problems, he refers the interested practitioner or student to selected critiques in the law review and treatise literature.<sup>3</sup>

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1. *E.g.*, B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* (1966); B. WOLEMAN, *FEDERAL INCOME TAXATION OF BUSINESS ENTERPRISE* (1969).

2. Subchapter C—Corporate Distributions and Adjustments, INT. REV. CODE of 1954, §§ 301-95.

3. There are, for example, frequent references to B. BITTKER & J. EUSTICE, *supra* note 1. For the most part I would not regard the Kahn and the Bittker and Eustice volumes as competitive; I would want both volumes side by side within easy reach for both practice and teaching.

It is a guess that sometime during the late summer or early fall of 1969 someone in Ann Arbor decided that although the monumental 1969 Tax Reform Act<sup>4</sup> had passed the House, it would not materialize until 1970; that the pleas of the new Nixon Treasury for a year's delay would be heeded; and that therefore the Kahn book was a safe go without it. These assumptions, of course, were incorrect, and the heavily laden 1969 Act was promulgated almost simultaneously with the distribution of *Basic Corporate Taxation*. However, the damage done to the book by the 1969 Act has been substantially repaired by a twenty-two-page supplement, which modifies the text to reflect the amendments to subchapter C; the net effect cannot be regarded as anything more than a slight inconvenience in using the book.<sup>5</sup>

In carrying out his thesis that all is prologue to corporate formations, Professor Kahn has found it necessary to eschew the traditional "life cycle" treatment of subchapter C—organization, distributions, reorganization, liquidation—and instead treats distributions, divisions and reorganizations, and the handling of buy-sell agreements before reaching the problems of formal organization and capitalization. I was first prepared to reject this arrangement. But no longer. Given his thesis, logic commands the structure employed, including the internal functional treatment of the problems covered in the four major parts of the book.

The first one third of the book deals with corporate transfers and distributions (chapters I and II), and primarily stresses the tax effects on the shareholders (chapter I). These opening chapters provide a descriptive analysis—replete with understandable examples, with planning aids, and with some considerable emphasis on the Internal Revenue Service's position—of the problems pertaining to dividend distributions, earnings and profits, stock redemptions,<sup>6</sup> partial liquidations, subsidiary and one-month liquidations, complete liquidations (with considerable attention to section 337), and reincorporations. Keeping in mind the book's limited purpose of providing no more than the "basics," I would quarrel only over the light treatment provided on collapsible corporations and the accumulated-

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4. Tax Reform Act of 1969, P.L. No. 91-172, 83 Stat. 487 (codified in scattered sections of 26 U.S.C.)

5. The most important changes made by the 1969 Act affecting subchapter C involved *INT. REV. CODE* of 1954, §§ 305 (stock dividends), 311(d) (realization by corporation upon distributions of certain appreciated property), 312 (earnings and profits), and limitations imposed on charitable gifts of appreciated property and § 306 stock. I have keyed my copy of the text to the supplement; the publishers should provide a sheet of gummed labels for this purpose.

6. The decision of the Supreme Court in *United States v. Davis*, 397 U.S. 301 (1970),—on certiorari when the book went to press—has rendered much of the analysis pertaining to the Code's treatment of distributions in redemption of stock in *INT. REV. CODE* of 1954, § 302(b)(1) moot, since the Court rejected the "flexible net effect" test (corporate business purpose) as a justification for capital treatment under this provision.

earnings tax, and over the almost complete lack of attention to the personal-holding-company tax.

The second portion of the volume (chapter III) consists of a sixty-page analysis of the highly technical rules governing tax-free corporate divisions, changes in form, recapitalizations, and acquisitions. As in the case of the first part, this material is basically descriptive, but well illustrated with examples and planning suggestions. The author has performed his task well here, and I found his analysis of the corporate-division single-business rule to be exceptionally well handled (pp. 127-29).

In one sense the volume reaches its focal point—or climax if a book on subchapter C can have a climax—in chapter IV, which consists of a solid treatment of the basic close-corporation planning document: the mandatory buy-out agreement.<sup>7</sup> With the major emphasis—forty of seventy pages—on funding the redemption price, this unique chapter treats the variables that should be considered in drafting either an entity purchase or a cross-purchase mandatory agreement that provides for the buy-out of a deceased shareholder. Avoiding dogmatism—but sometimes indicating a preference—Professor Kahn, in a clear and concise manner, delineates here the range of both the tax and nontax factors that should be considered by the tax planner.

The final portion of the book—which can hardly be characterized as a denouement since close-corporation tax planning hardly admits of definite and final resolutions—carries the planning thrust of the previous parts into the tax and nontax factors involved in formal organization and capitalization. Chapter V devotes forty pages to the requirements of Internal Revenue Code section 351 (tax-free transfers to controlled corporations),<sup>8</sup> a brief but excellent coverage of the subchapter S election, and a short treatment of section 1244 stock. Chapter VI consists of a twenty-page treatment of the relative advantages of the use of debt and preferred stock.

Given this basic over-all structure of the volume's informational content, *Basic Corporate Taxation* is worth examining for its utility as a tax-planning guide and as a teaching tool.

## II. TAX PLANNING

The preparation of a subchapter C tax-planning (which the late Professor Charles Loundes so aptly characterized as but a euphe-

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7. Chapter IV was previously published as Kahn, *Mandatory Buy-Out Agreements for Stock of Closely Held Corporations*, 68 MICH. L. REV. 1 (1969).

8. The discussion in the text (pp. 257-58) of the lower-court conflict on whether a bad-debt reserve must be recovered as ordinary income when accounts receivable of a cash basis taxpayer are transferred under INT. REV. CODE of 1954, § 351, was resolved by the Supreme Court in favor of the taxpayer: the Court held that when the accounts were exchanged for stock equal in value to the value of the accounts—as measured by the face value less the reserve—the balance in the reserve did not have to be recovered under the tax benefit doctrine. *Nash v. United States*, 398 U.S. 1 (1970).

mism for tax avoidance) guide can hardly be an easy task, even when the focus is limited to the factors that should be considered in forming a close corporation. Few areas of the tax law present so many technical rules covering so many areas that require segmentation to make them manageable; few areas of the tax law present so many intricate problems in managing clients with respect to their conflicting business, family, and tax objectives. As a result, in preparing a short work there will be repeated confrontations with masses of material, both tax and nontax, that call for decisions on when to stop and let some other work carry the details.

But *Basic Corporate Taxation* comes out more than quite well as a planning guide. For example, the treatment of mandatory buy-out agreements in chapter IV serves as a guidance aid by extensively considering the factors that favor the execution of a buy-out agreement—*i.e.*, providing liquidity, handling the risk of continuing the business, and avoiding estate tax valuation disputes with the Internal Revenue Service (pp. 180-87). Particularly helpful in this area is the discussion of the funding of an entity buy-out plan; this discussion includes both a suggestion for the inclusion of a restriction in designating a beneficiary when insurance proceeds are payable to an individual rather than to a trustee (p. 212) and a sampling of the considerations involved in choosing between a trustee and the settlement options provided in the life insurance policy (pp. 213-16). Other examples of planning guides deal with the liquidation of a subsidiary under section 332 followed by the liquidation of the parent (p. 98), the limited usefulness of section 333 (p. 77), the handling of dissenting minority shareholders under the "solely voting stock" requirement in a "B" reorganization (pp. 167-68), and the care that should be taken to exclude an insured corporate officer from participating in corporate decisions concerning the insurance on his life (p. 206).

Nor does the volume, short as it is, ignore the relevant nontax factors involved in the planning tasks in this area. For instance, in its treatment of entity buy-outs, the book outlines the major corporate-law factors (pp. 228-34) as well as the insurance law and practice considerations (pp. 218-21). Similarly, the chapter on corporate capitalization includes a substantial discussion of the nontax considerations relevant to the use of preferred stock (pp. 297-312).

### III. TAX EDUCATION

I have long been possessed of two related "hang-ups,"<sup>9</sup> the factual basis for which I regard as more than a little evidence of the present-day somewhat low state of legal education: (1) the inadequate training received by most LL.B. and J. D. graduates in the tax problems

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9. These are "hang-ups" in the sense of preoccupations or fixations rather than psychological blocks, I hope. See RANDOM HOUSE DICTIONARY 600 (college ed. 1968).

that will be encountered in general practice; and (2) the lack of development of meaningful training in tax policy formulation.<sup>10</sup>

The first of these problems logically should admit of easy solution: a stiff required course in the law school curriculum that will include sufficient drill in the subchapter C area so that the student will at least recognize the tax issues that he will encounter in forming corporations, drafting wills and trusts, negotiating contracts, and performing other run-of-the-mill tasks in general practice. Few law schools can contend that their graduates are so trained; the elective system guarantees that such training is being received by only a handful of students, and that most graduates have had only a limited exposure to the critical tax problems in the business area.

On the other hand, it is just possible that the current ferment in legal education, with its concern for meaningful clinical training,<sup>11</sup> may provide a new opportunity for the tax teacher to mount a fresh attack on this basic deficiency in the law school curriculum. His argument could run like this: clinical training is basically concerned with training in such skills as interviewing, counseling, fact-gathering, research, decision-making about alternative strategies, negotiating, and "packaging" business arrangements;<sup>12</sup> while not all of these skills can be reached when treating the subchapter C area in a large class, some of them can and others cannot be simulated.

It may further be argued that, in any event, the study of subchapter C—with planning-oriented course material such as *Basic Corporate Taxation*—is well suited as a vehicle for introducing students to many of the skills now associated with clinical training. When funding for the handling of small groups is available, material such as Professor Kahn's volume, supplemented with imaginative problems that would parallel and expand on the examples and illustrations in the text and that would force the student into the Treasury Regulations and legislative history, could provide a foundation for more meaningful clinical work.

Logic seems to compel the need for such preclinical training, since a sound informational background in subchapter C is a prerequisite for any clinical effort designed to expose the student to the multiple skills required in business and family legal planning. How, for example, could a student participating in a conference with the proposed owners of a close corporation acquire any meaningful insights with respect to the interviewing skill if he lacks at least top-of-the-head knowledge of such matters as Internal Revenue Code sec-

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10. See Chommie, *Federal Income Taxation of Corporations and Shareholders and the Tax Trained Lawyer of Today and Tomorrow*, 116 U. PA. L. REV. 358 (1967).

11. See CLINICAL EDUCATION AND THE LAW SCHOOL OF THE FUTURE (E. Kitch ed. 1970).

12. See Ferren, *Goals, Models and Prospects for Clinical-Legal Education*, in E. Kitch, *supra* note 11, at 94.

tions 351, 357, and 358; of the basics of a buy-sell agreement; of the problems of capitalizing a corporation; or of the existence of the tax distinctions between current and accumulated earnings in handling subchapter S distributions?<sup>13</sup> It can hardly be argued that such highly technical legislation as is embraced in subchapter C can be quickly assimilated by even the brightest student either in a preliminary reading assignment for participating in a client conference, or in backup classroom discussions when the student is at work on a live problem. Subchapter C is just not that easily absorbed.

Finally, clinical training is still largely at a preliminary experimental stage in the law school curriculum. Published data indicates that only a small portion of the students at a small number of the nation's 175 law schools are being exposed to it at all; that little or no progress has been made in the business area, where most law students will eventually find their niche; and that the present prospects for funding programs that do not deal with indigent clients are bleak indeed.<sup>14</sup> It therefore can be concluded that clinical training in the business and family legal-planning areas must be accepted at present as an ideal, but that meaningful progress toward this ideal can be achieved with problem courses in subject areas such as subchapter C, and with the use of such materials as *Basic Corporate Taxation*. With this type of program, attention can be focused on the development of such lawyer skills as the handling of raw legislation, problem-solving, the selection of alternatives in reaching tax objectives, and fact-gathering.

#### IV. TAX POLICY ISSUES AND THE PUBLIC

I suppose that I have established that I like Douglas Kahn's book, and that I expect to find it most useful as a teaching and practice aid. But I have a number of remaining questions about subchapter C that neither this book, nor any other that I know of, makes any pretense of answering. These questions should probably be directed especially to the more articulate subchapter C experts. One such question involves the amount of knowledge that the general public should have with respect to the tax avoidance aspects of this corner of the Internal Revenue Code. I take it to be axiomatic that the general public in a democratic order is entitled to know who pays the taxes, but that the subchapter C policy issues and kindred technical tax issues are hardly the subject of dinner table conversation in the average American home. Any congressman, for example, who attempted to inject a sophisticated discussion of tax policy into a political campaign would be faced with a most bewildered electorate.

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13. See, e.g., Professor Kahn's discussion at pp. 270-77.

14. See *Panel Discussion: Financing Student Clinical Programs*, in E. Kitch, *supra* note 11, at 34.

On the other hand, the feeling persists that more could be done to lay before the general public what is at stake in the technical areas of the tax law, and the tax experts, by virtue of their special knowledge, have a special responsibility to explain to the public, in terms that can be understood, the basic policy decisions and proposals that have been made. It seems to me that the general public is entitled to some knowledge about such matters as why the tax system is complex, why simplicity is a myth, what competing considerations are involved in making decisions in the technical area, and how these decisions are made. It is also arguable that, unless this task is done and done well, the risk is substantial that public faith in the delicately balanced federal tax structure could deteriorate rapidly, and that therefore, at the very least, general exposure of the technical tax policy issues is important to the functioning of a complex democratic order.

Would the task of explaining these issues be a fruitless waste of time? Could they be explained in understandable terms? These two questions, of course, suggest the nature of the challenge.<sup>15</sup> But why, for example, could not the basic policy structure of subchapter C be explained adequately in terms of the considerations involved in taxing corporations as separate entities and then taxing shareholders on the balance of the corporate income when it is distributed? Could it not be made clear that there would be serious revenue and tax avoidance effects in eliminating the corporate tax? Why could it not be further explained that this sometimes extra tax factor is greatly ameliorated by the availability of the corporate form as a shelter from the personal income tax, and by the treatment of gain realized upon the termination of an investment in a corporation at bargain basement capital gains rates; and that Congress has determined that certain changes in the form of a corporate investment—a formation and reorganization of a corporation—do not justify the imposition of a tax?

With basic subchapter C policy positions explained and illustrated, why should it then be so difficult to explain some of the more perplexing technical issues—issues such as the scope of the “F” reorganization, the reincorporation bailout, stock dividends, partial collapsible bailouts, and the interests at stake in dividing a single corporate business?

Should any tax teacher, lawyer, or accountant feel a calling in the

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15. The late Randolph Paul, in relating the history of progressive taxation in England, indicates that in 1906 there was some objection to a progressive tax based on a fear of lack of public understanding. To this objection Paul quotes the reaction of Francis Edgeworth: “Cannot the general public read the dial of a town clock without going behind to inspect the works?” R. PAUL, *TAXATION IN THE UNITED STATES* 719 (1954).

foregoing respect, he will find much of the grist for his labors in *Basic Corporate Taxation*,<sup>16</sup> especially on the technical issues. He may discover something else: that the general public is capable of understanding more than it is generally given credit for, and that, even if his efforts do not stimulate a taxpayer revolt against inequity, public understanding will have been advanced. And this is its own reward.

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16. Professor Surrey, after eight years at the focal point of federal tax policy-making as Assistant Secretary of the Treasury for Tax Policy, has recently suggested that one of the vital needs in the tax policy formulation process is the need for communicating knowledge revealed by study of the tax policy issues "to the general public, and here in a form and manner that permits adequate comprehension. We need for this process publicists interested in tax matters who can work with the academicians and others engaged in the basic analysis." Surrey, *Federal Tax and Fiscal Policy—Some Aspects of Future Developments*, 48 TAXES 49, 57-58 (1970).