Professional Organization and Unrealized Receivables

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Business organizations are frequently formed with exaggerated emphasis placed upon the potential benefits of the new organization. Consequently, the new association may be well established before troublesome pitfalls surface. The initial determination whether the association should be formed at all and, if so, what form it should take, should thus be made only after considering numerous tax and non-tax factors, and using the best advice available.

Tax problems have recently assumed new importance in establishing professional associations.[1] While the partnership has been the traditional form of organization utilized by the professional community,[2] the adoption of state statutes allowing incorporation,[3] together with corresponding reconsiderations by professional ethics commitees[4]

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1. The principles to be discussed are not confined to professional organizations; they apply equally to the formation of a mercantile or manufacturing entity. This analysis is directed at a service organization, however, as the relative importance of accounts receivable is far greater than with other types of enterprise. Further, problems involving other assets (such as inventory, equipment and real estate) are generally minimal in the professional organization and are beyond the scope of the problems under consideration.

For purposes of this discussion, the term "professional" encompasses any profit-making organization primarily engaged in rendering services where the organization characteristically carries a large portion on unrealized receivables and relatively small amounts of other assets and liabilities.

2. A. Willis, Partnership Taxation § 3.02 (1971).

3. While all states now have professional corporation statutes, only 32 states and the District of Columbia allow all professionals to incorporate. 1 P-H Pension and Profit Sharing ¶ 4038 (1971). See Ariz. Rev. Stat. Ann. § 10-902(5) (Supp. 1972-73) (professional services described as "any personal service which requires as a condition precedent to the rendering thereof the obtaining of a license and which prior to the effective date of this chapter by reason of law could not be performed by a corporation"); Cal. Corp. Code § 13401(a) (West Supp. 1972) (allows incorporation of "any type of professional services which may be lawfully rendered only pursuant to a license, certification or registration authorized by the Business and Professional Code or the Chiropractic Act").

4. Until recently, many professions barred the use of the corporate form of organization because the limited liability of the corporation was inconsistent with the concept of the professional's liability for malpractice. The professional corporation statutes generally retain unlimited liability for professional acts. H. Henn, Handbook of the Law of Corporations and Other Business Enterprises 104-5 (2d ed. 1970); see Frost, *Some Comments as to Professional Corporation Statutes*, 4 Ariz. L. Rev. 169 (1963). As a result, most professions now allow the corporate form of practice. See ABA Comm. on Professional Ethics, Opinions, No. 303, 48 A.B.A.J. 159 (1962).

and the Internal Revenue Service,[5] have led to increased use of the corporate form.[6] Although the Service has finally announced that it will recognize the status of the professional corporation, it has expressly limited its acquiescence to the classification issue.[7] This should warn taxpayers that adequate investigation and tax planning are necessary before selecting this relatively novel, but highly touted, form of professional practice.[8]

Since federal tax considerations are important determinants in the choice of organization, there has been a proliferation of literature on the relative advantages of the corporate form as compared with the individual proprietorship or partnership.[9] This analysis will not attempt to review all of these factors nor recommend one form over another. The purpose is to consider the tax consequences of one part of the organizing transaction: the investment of unrealized receivables in a new or existing partnership or corporation in return for a capital interest in the transferee organization. The Service has indicated only that it will resist the use of such transactions to gain a tax savings from incorporating,[10] but, since the methods of attack available to the Service are potentially applicable to all forms of business, the transaction as used in forming a partnership must also be examined.[11]

BASIC NONRECOGNITION TRANSACTIONS

Upon inception of an association, the practitioner is ordinarily required to contribute a specific amount of capital. Since accounts receivable form the bulk of the working capital in a professional enter-

5. For a review of the Internal Revenue Service opposition to the professional corporation, see CCH PROFESSIONAL CORPORATIONS HANDBOOK §§ 101 *et seq.* (1971); Galvin, *Are Professional Corporations Still Alive,* 18 TUL. TAX INST. 649, 650-59 (1969); Thies, *An Estate Planner's Approach to the Professional Corporation,* 109 TRUSTS & EST. 83, 84-86 (1970).

6. High personal income tax rates coupled with rising incomes for professionals have also spurred the use of the corporate form. Individual income tax rates for 1972 range from a low of 14 percent to a high of 70 percent. INT. REV. CODE of 1954 § 1. Corporate rates, on the other hand, begin at 22 percent and rise to 48 percent. *Id.* § 11. Splitting of income between the corporation and its practitioners, and various tax-free fringe benefits must also be considered. See CCH PROFESSIONAL CORPORATIONS HANDBOOK §§ 115 *et seq.* (1971); C. BROSNAHAN, ATTORNEY'S GUIDE TO CALIFORNIA PROFESSIONAL CORPORATIONS (1969); K. STRONG & K. HOLDSWORTH, PROFESSIONAL CORPORATIONS 20-29 (1970).

7. *See* Rev. Rul. 70-101, 1970-1 CUM. BULL. 278.

8. *See* Egerton, *Reallocation of Income: A New Threat to Professional Corporations?,* 58 A.B.A.J. 979 (1972).

9. For a general guide to the characteristics of corporations and partnerships, see H. HENN., *supra* note 4, at 46, 92. For considerations related to professional corporations, see C. BROSNAHAN, *supra* note 6; K. STRONG & K. HOLDSWORTH, *supra* note 6, at 20-29 (1971).

10. *See* Worthy, *I.R.S. Chief Counsel Outlines What Lies Ahead For Professional Corporations,* 32 J. TAX. 88 (1970).

11. Although investments of unrealized receivables into partnerships have heretofore been relatively unquestioned, success in the corporate area may lead to an attack on the partnership transaction.

prise,[12] one possibility will be to transfer some of the accounts to fulfill the requirement. As most professionals report their income on a cash basis,[13] these receivables are generally "unrealized"[14] for federal tax purposes. The receivables could be collected by the old entity, with the cash being transferred into the new organization, or the receivables could be assigned to the new entity, with subsequent collections to be made by the new entity.

The first option holds no tax advantage for the transferor because the collection of the receivables by the old entity amounts to a realization of income for tax purposes which the transferor will have to report. Moreover, if the new entity is a corporation and salary payments are made to the transferor, his income will be bunched in the year of organization. Not only will a tax advantage have been lost, but a substantially higher tax may result in a year when cash positions are generally critical.

Use of the second option, assigning the accounts receivable to the new entity in return for a capital interest, could result in substantial tax savings if the nonrecognition provisions of sections 721 and 351 of the *Internal Revenue Code of 1954*[15] are applicable. For example, tax planners may consider shifting income from a high income practitioner to a low income partner in the year of organization, splitting income between the corporation and high income professionals, or postponing some of the income taxes for an exceptionally high income year to a low income period by electing a fiscal year differing from that of the investing practitioner. Such plans would be nullified, however, if the nonrecognition provisions do not apply. It is imperative then for the tax planner to consider the possible effects of contrary judicial doctrines and statutory provisions.

To aid the planner in analyzing the tax saving potential of a proposed transaction, the nonrecognition provisions of section 721, relating to partnership formation, and section 351, relating to corporate formation, will be reviewed. The effect of the various "common law" doctrines,[16] judicial interpretations and contravening statutory pro-

12. WILLIS, *supra* note 2, at § 41.04; Greenberg, *Special Problems of the Professional Association,* 20 TUL. TAX INST. 82, 85 (1971).

13. A cash basis method of keeping accounts is a system whereby revenue and expense are recorded on the books when received and paid, without regard to the period to which they apply. See Treas. Reg. § 1.446-1(c)(1)(i) (1970). This method should be distinguished from the accrual basis method of accounting whereby income and expense is identified with specific periods of time, as when earned or incurred. *Id.* § 1.446-1(c)(1)(ii) (1970). For an explanation of these methods, see E. FARIS, JR., ACCOUNTING FOR LAWYERS 66 (rev. ed. 1964).

14. Unrealized receivables are described in Treas. Reg. § 1.751-1(c)(ii) (1971).

15. All citations of section numbers in text are to the INT. REV. CODE of 1954, *as amended* [hereinafter cited as I.R.C.].

16. The phrase "common law" is taken from Brown, *The Growing "Common Law"*

visions that can be asserted to defeat the nonrecognition statutes will then be examined. In determining the effects of these various proscriptions on a particular situation, it must be remembered that these doctrines and statutes may be pleaded in the alternative by the Commissioner to attack the application of the nonrecognition provisions.

Nonrecognition Statutes—Partnerships

Section 721 provides that no gain or loss is recognized by a partnership or any of its partners upon a transfer of property to either a newly formed or existing partnership[17] if the sole consideration is an interest in the partnership.[18] By operation of section 722, the contributing partner's basis in the property contributed is transferred to his partnership interest. The partnership assumes the contributing partner's basis in the transferred property,[19] and any gain or loss on subsequent disposition of the property is reportable by the partnership.[20] Other than his proportionate share of partnership profits, the contributing partner is not required to recognize upon subsequent disposition any precontribution increase in the value of property transferred.[21]

Applying these rules, no income would be recognized by a cash basis transferor upon his contribution of unrealized accounts receivable to a partnership.[22] Since under the cash basis method of accounting the unrealized receivables had not been recognized as income, the transferor has a zero basis in the receivables.[23] By transferring the zero basis with the receivables, he effectively shifts the income recognition to the partnership.[24] Although the basis of his partnership interest is correspondingly less, that portion attributable to the

of Taxation, 34 S. CAL. L. REV. 235 (1961), where the author maintains that, although tax law is purely statutory in origin, the role of the courts has, in certain instances, become so important as to reshape the content of the Code. The substance of this analysis exemplifies that proposition.

17. I.R.C. § 708 provides that an existing partnership shall continue for tax purposes except when the entire business of the partnership is terminated, or when, during a 12-month period, there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits. See 6 J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 35.71 (1968).

18. When the contributing partner receives cash or other property, or when the partnership assumes liabilities in excess of the basis contributed, gain may be realized. See Treas. Reg. §§ 1.721-1(a) (1956), 1.752-1(b)(2) (1956).

19. I.R.C. § 723.

20. Treas. Reg. § 1.704-1(c)(1) Exs. (1)-(3) (1964).

21. *Id.*

22. Frank A. Logan, 51 T.C. 482, 487 (1968); WILLIS, *supra* note 2, at 80; Whitman, *How a Partner Whose Primary Contribution is Services May Achieve Capital Gain*, N.Y.U. 22ND INST. ON FED. TAX. 653, 656 (1964).

23. James M. Wilson, 23 CCH Tax Ct. Mem. 462, 465 (1964).

24. *See* Frank A. Logan, 51 T.C. 482 (1968); U.S. CODE CONG. & ADM. NEWS 4722-23, 5319 (1954); 4 CCH 1972 STAND. FED. TAX REP. ¶ 3918.012; 6 MERTENS, *supra* note 17, § 35.30, at 119-20; Dixon, Barnett, Evall, Geller & Kalish, *Partnerships & Subchapter S: A Comparison of Tax Advantages, A Panel Discussion*, N.Y.U. 25TH INST. ON FED. TAX. 151, 169 (1967).

accounts receivable being zero,[25] income recognition on his part may be postponed until he disposes of his partnership interest.[26] As the interest may be held for many years, a postponement could result in a substantial tax benefit to the transferor.

The partnership, on the other hand, having assumed the transferred basis of zero,[27] must report the income resulting from subsequent collection of the receivables.[28] This income must be reported by each of the partners according to his distributive share of partnership profits.[29] No special treatment is afforded income realized which is attributable to the difference between the partner's tax basis and the value of the property at the time of the contribution.[30] That one or more of the partners may receive a tax benefit is immaterial.[31]

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25. Frank A. Logan, 51 T.C. 482, 487 (1968); James M. Wilson, 23 CCH Tax Ct. Mem. 462, 465 (1964); I.R.C. § 722.

26. Helvering v. Walbridge, 70 F.2d 683 (2d Cir.), *cert. denied*, 293 U.S. 594 (1934); U.S. CODE CONG. & ADM. NEWS 4723 (1954). *But see* text accompanying notes 27-29 *infra*.

The amount of income postponed, if any, would depend on the relative percentage of unrealized receivables contributed by the incoming partner as compared with his percentage of partnership income. In the example in the text accompanying notes 32-38 *infra*, Able contributed 100 percent of the unrealized receivables, but only had a 50 percent distributive share of partnership profit. He was, therefore, able to postpone tax on 50 percent of the receivables. Beginner, on the other hand, had contributed no unrealized receivables, but was obligated to report 50 percent of the income realized upon collection.

27. James M. Wilson, 23 CCH Tax Ct. Mem. 462 (1964); I.R.C. § 723.

28. Frank A. Logan, 51 T.C. 482, 483 (1968); Dixon, Barnett, Evall, Geller & Kalish, *supra* note 24, at 169-70.

29. Lewis L. Culley, 29 T.C. 1076, 1086 (1958), *acquiesced in*, 1958-2 CUM. BULL. 4; I.R.C. §§ 704(a), (c)(1); Treas. Reg. § 1.704(c)(1) Ex. (1) (1964); Gelband, *Allocation of Income and Deductions Among Partners*, N.Y.U. 21st INST. ON FED. TAX. 997, 998 (1963).

30. This result may be avoided by inserting a special provision in the partnership agreement governing precontribution gains or losses. Treas. Reg. § 1.704-1(c)(2) (1964). In the absence of such a provision, however, the regular profit and loss ratio will govern.

31. U.S. CODE CONG. & ADM. NEWS 4723, 4725 (1954); R.I.A. TAX COORDINATOR ¶ B-1107 (1972).

The effect of these sections is to treat the partnership as an entity for these types of exchanges. Prior to the passage of the *Internal Revenue Code of 1954*, the tax consequences of partnership formation were determined by numerous court decisons, regulations and revenue rulings. Faced with various proposals to provide a statutory pattern for partnership formation, Congress debated the "entity" and "aggregate" theories of partnership taxation. The entity theory attempts to treat the partnership as a whole, making no distinction between contributed property and purchased property in recognizing gains and losses. The aggregate theory contemplates taxing each partner for his precontribution gain at the time of realization. Congress adopted the entity theory because of its "extreme simplicity." The aggregate approach was intended as an optional method that could be elected by the partners by inserting special provisions in the partnership agreement providing for the recognition of precontribution changes in value by the contributing partner. U.S. CODE CONG. & ADM. NEWS 4091-92, 4722-23, 5319 (1954). For further descriptions of the entity and aggregate approaches, see 6 MERTENS, *supra* note 17, at § 35.30 (1968); Jackson, Johnson, Surrey, Tenen & Warren, *The Internal Revenue Code of 1954: Partnerships*, 54 COLUM. L. REV. 1183, 1204, 1208 (1954).

Notwithstanding the existence of section 721, the entity-aggregate theory debate has contemporary implication generated by the assignment of income doctrine. See text and notes 80-95 *infra*.

Although the actual advantages to be gained through the application of section 721 are determined by the facts underlying each proposed association, the possible effect of these rules may be illustrated by the following example. Assume that "Able," a long time practitioner looking toward retirement, and "Beginner," a recent graduate seeking an association, form a partnership,[32] each agreeing to contribute $50,000 to the partnership capital and to share profits on a 50-50 basis. Able, in fulfilling his capital requirement, transfers $50,000 of unrealized receivables to the partnership, together with equipment and other assets with a basis equal to liabilities transferred.[33] Beginner invests $1,000 cash, promising to pay the balance of his required capital contribution from cash generated by future profits.[34] Able is not required to report any gain on the contribution either at the time of the contribution[35] or at the time the receivables are collected.[36] When collected, the $50,000 is reported as income by the partnership, of which $25,000 is includable on Able's return and $25,000 on Beginner's. Able, whose professional and other income has placed him in the 50 percent tax bracket, has reduced his tax by a minimum of $12,500 in the year of organization. Beginner, being in a much lower tax bracket, absorbs the income at a substantially lower tax cost. Because Able assumed a zero basis for his partnership interest, the portion of the income recognized by Beginner in the transferred receivables will ultimately be reflected in Able's income upon disposition of his interest. Assuming that Able does not plan to retire for ten years, however, this potential tax liability will be postponed for that period.[37] In addition, not only will Able's tax bracket probably be substantially lower after retirement, but he can further postpone recognition by allowing Beginner to make installment payments in purchasing Able's partnership interest.[38]

32. The rules under section 721 apply to contributions made to a "partnership in the process of formation or to a partnership which is already formed and operating." Treas. Reg. § 1.721-1(a) (1960). Therefore, the advantages also exist when an established partnership takes in a new partner.

33. Care should be taken to transfer property with a basis in excess of any liabilities assumed by the partnership; otherwise, taxable gain may result. See Treas. Reg. §§ 1.752-1(b)(2), 1.731-1(a)(1) (1960); Willis, *supra* note 2, at § 10.03-.04.

34. If Beginner receives nothing more than the credit for the $1,000 cash invested plus an interest in future partnership profits, he realizes no income at the time of contribution. See Willis, *supra* note 2, at § 9.01. He will be taxed on his distributive share of partnership profits whether he reinvests the cash distributed or allows his capital interest to accumulate by not withdrawing his share. *Cf.* I.R.S. § 702(a); Treas. Reg. § 1.702-1(a) (1966).

35. Generally, income is taxed when received. Helvering v. Horst, 311 U.S. 112 (1940); Sol C. Siegel Productions, Inc., 46 T.C. 15, 24 (1966).

36. Frank A. Logan, 51 T.C. 482, 483 (1968); Dixon, Barnett, Evall, Geller & Kalish, *supra* note 24, at 169. The facts of the example in the text are similar to those in *Frank A. Logan.*

37. *See* authorities cited note 26 *supra.*

38. Gain attributable to unrealized receivables is taxed as ordinary income upon

Planners can use the nonrecognition provisions of section 721 in many situations since few restrictions have been placed upon its application. For example, the Regulations under section 721 specifically provide that transfers to both newly formed and existing partnerships are allowed by the section.[39] In addition, the contributing partner is not required to have control of the partnership after the contribution, as is necessary in an incorporation under section 351.[40] Therefore, section 721 would apply equally if Able were a 20-man partnership admitting a junior partner.

Two major qualifications to the applicability of section 721 should be noted. First, the Regulations specifically exclude granting a capital interest to a partner in return for services rendered to the partnership.[41] Thus, if Beginner had agreed to contribute services to the new partnership for a specified time without salary in return for a paid-up capital interest, he would have realized ordinary income in the amount of the interest received.[42] By excluding services rendered to the partnership and neglecting to mention receivables from services rendered to third parties, the Regulations seem to imply that the latter qualify for nonrecognition treatment.[43] Second, if the primary purpose of any of the distribution provisions of the partnership agreement is the avoidance of tax, the Commissioner has authority to disregard those provisions.[44] Consequently, special allocations of depreciation, nontaxable income or losses to high income taxpayers should be avoided, unless it can be clearly shown that the allocations were not made principally for tax avoidance purposes.

Nonrecognition Statutes—Corporations

Section 351 provides that no gain or loss is to be recognized by the transferor when property is transferred to a corporation solely in exchange for its stock or securities.[45] The transferor receives his stock

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disposition. I.R.C. §§ 735, 751. *See also id.* § 736 relating to payments made to a retiring partner or a deceased partner's successor in interest. Taxation problems upon disposition of a partner's interest are beyond the scope of this discussion. Tax planners should, however, consider the effects of disposition in framing the organizing transaction. See Frank A. Logan, 51 T.C. 482 (1968).

39. Treas. Reg. § 1.721-1 (1960); *see* Helvering v. Archbald, 70 F.2d 720 (2d Cir.), *cert. denied*, 293 U.S. 594 (1934).

40. *See* text accompanying notes 51-53 *infra*.

41. Treas. Reg. §§ 1.721-1(b)(1)-(2) (1960); *see* United States v. Frazell, 335 F.2d 487 (5th Cir. 1964); Harry W. Lehman, 19 T.C. 659 (1953); WILLIS, *supra* note 2, at §§ 9.02, 41.03.

42. Regarding the effect of restrictions placed upon the paid-up capital account and their effect on realization of income, see WILLIS, *supra* note 2, at § 9.01-.17; Whitman, *supra* note 22, at 657-63.

43. *See* Whitman, *supra* note 22, at 656.

44. I.R.C. § 704(b)(2); Treas. Reg. § 1.704-1(b)(2) (1964); *see* Stanley C. Orrisch, 55 T.C. 395 (1970).

45. The purpose behind the nonrecognition is to prevent the taxing of unrealized

with a basis attributable to the contributed property.[46] The corporation assumes a carry-over basis for the property received, reporting the entire gain or loss realized upon subsequent disposition of the contributed property.[47]

Consequently, when a corporation receives unrealized receivables in a section 351 exchange, it assumes the transferor's zero basis,[48] and the income is taxable to the corporation upon subsequent collection.[49] The transferor recognizes no income upon the transfer of the receivables or upon collection by the corporation. Theoretically, the unrecognized gain transferred is ultimately recaptured in the gain reportable by the transferor upon disposition of his stock,[50] since the prior contribution of the receivables increased the value of the stock without increasing the transferor's basis. The postponement of this recognition, however, together with the capital gain treatment accorded gain on the sale of capital stock, could result in a substantial tax benefit to the transferor.

Unlike the partnership provisions, section 351 requires that the transferor "control" the corporation immediately after the transfer. Control is defined in terms of ownership; the transferor must own at least 80 percent of the voting power of the corporation and 80 percent of every class of stock issued.[51] Although the transferor may consist of one or more persons,[52] as a practical matter the control requirement limits the use of the nonrecognition provisions to the original incorporation of a professional organization. It would be rare for an

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gains when the transaction is merely a change in the form of ownership. Helvering v. Cement Investors, 316 U.S. 527, 533 (1942); Portland Oil Co. v. Commissioner, 109 F.2d 479, 488 (1st Cir. 1940); Peter Raich, 46 T.C. 604, 607-08, 611 (1966); Worthy, *supra* note 10, at 90, 91; Eaton, Jr., *Professional Corporations and Associations*, 17 BUS. ORG. 12-21 (1971).

46. I.R.C. § 358(a).

47. *Id.* § 362(a).

48. P.A. Birren & Son, Inc. v. Commissioner, 116 F.2d 718, 720 (7th Cir. 1940); Paul H. Travis, 47 T.C. 502 (1967), *aff'd in part, rev'd in part as to other issues*, 406 F.2d 987 (6th Cir. 1969); Peter Raich, 46 T.C. 604, 610 (1966); Ezo Products Co., 37 T.C. 385, 393 (1961); Greenberg, *supra* note 12, at 87; Pennell & O'Byrne, *Incorporating the Partnership—Federal Income Tax Considerations*, 17 PRAC. LAW. 51, 56 (Feb. 1971); Worthy, *supra* note 10, at 91.

49. P.A. Birren & Son, Inc. v. Commissioner, 116 F.2d 718, 720 (7th Cir. 1940); Matchette v. Helvering, 81 F.2d 73, 74 (2d Cir.), *cert. denied*, 298 U.S. 677 (1936); Wobbers, Inc., 26 B.T.A. 322 (1932); Dauber, *Accounts Receivable in Section 351 Transactions*, 52 A.B.A.J. 92 (1966).

50. P.A. Birren & Son, Inc. v. Commissioner, 116 F.2d 718 (7th Cir. 1940); Arthur L. Kniffen, 39 T.C. 553 (1962), *acquiesced in*, 1965-2 CUM. BULL. 5; Thomas W. Briggs, 15 CCH Tax Ct. Mem. 440 (1956).

51. I.R.C. § 368(c). This control should be distinguished from the actual control required by section 482, discussed in text accompanying notes 121-42 *infra*. *See id.* § 482; Treas. Reg. § 1.482-1(a)(3) (1968).

52. I.R.C. § 351(a). The phrase "one or more persons" includes individuals, trusts, estates, partnerships, associations, companies or corporations. Treas. Reg. § 1.351-1(a)(1) (1967).

existing professional corporation to gain an associate with sufficient unrealized receivables to acquire such a high percentage of stock.[53]

Although the exact benefits to be derived by nonrecognition are determined by the fact situation, another example involving Able and Beginner will illustrate the potential of section 351. Instead of entering a partnership, Able, who holds the unrealized receivables, forms a professional corporation, exchanging all of his receivables for 100 percent of the stock issued. Since Able "controls" the corporation after the investment,[54] the corporation takes the receivables with a zero basis and reports the income upon collection, which is subject to the lower corporate tax rate. Able is not only relieved of reporting the income at his higher tax rate, but the rate for his other income may be lowered. The corporation can then sell stock to Beginner as his cash position improves. Ten years from the date of organization when Able retires, he can sell his stock to Beginner, reporting the proceeds as capital gain. If he desires, he may further defer his income by electing to collect his payments in installments or by selling his shares over a period of time.

A major qualification to the operation of section 351 is that stock issued for services rendered to the corporation is specifically excluded. Although the *Code* states broadly that "stock or securities issued for services shall not be considered as issued in return for property,"[55] the Regulations confine the definition of services to those "rendered or to be rendered to or for the benefit of the issuing corporation."[56] While stock issued in return for the investment of unrealized receivables for services rendered to third parties might conceivably be excluded under the *Code* language, the narrower definition in the Regulations seems to indicate that the receivables will be accorded nonrecognition treatment. Moreover, stock which is issued in exchange for services rendered to the corporation does not count in determining

53. The simultaneous contribution by the existing members of the corporation of a nominal amount of property in an attempt to afford nonrecognition benefits to the incoming professional is specifically prohibited. Treas. Reg. § 1.351-1(a)(1)(ii) (1967).

54. Alternatively, both Able and Beginner could form the corporation. If this were done, the requisite control would still be present, as the total stock issued to Able and Beginner would be used to measure control. For example, if stock worth $50,000 were issued to Able for the unrealized receivables and stock worth $1,000 issued to Beginner for cash, the transferors would still have 100 percent of the stock issued after the transfer, and the control requirement would be fulfilled. Other alternatives are available, encompassing stock options to Beginner or the issuance of a preferred stock to Able. Discussion of these alternatives is beyond the scope of the unrealized receivables problem.

55. I.R.C. § 351(a).

56. Treas. Reg. § 1.351-1(a)(1)(i) (1967); *see* Treas. Reg. §§ 1.351-1(a)(2) Ex. (3), -1(b)(2) Ex. (2) (1967). Note that a substantial and disproportionate shift in interest may also be regarded as compensation. *Id.* § 1.351-1(b)(1) (1967); U.S. CODE CONG. & ADM. NEWS 4064, 4681 (1954).

control for purposes of section 351. Thus, if Beginner had been an incorporator and had received half of the stock issued in exchange for his promise to render future services to the corporation without compensation, section 351 would not have applied. In that case, Able would have to recognize income in the amount of the receivables transferred,[57] and Beginner would have to recognize income to the extent of the value of the stock received,[58] even though the receivables remained uncollected.

Although both sections 721 and 351 appear to encompass receivables due for services rendered, there has been a lack of judicial interpretation supporting this result. *Thomas W. Briggs*[59] seems to be the leading case holding that the nonrecognition provisions apply to unrealized receivables. Despite the explicit language of the nonrecognition sections and *Briggs*, however, some tax practitioners doubt that the provisions will be universally applied because they run afoul of certain long standing judicial interpretations and statutory provisions.[60] The remainder of the discussion, therefore, will center upon an analysis of those doctrines and provisions in order to determine the applicability of sections 721 and 351.

ARGUMENTS AGAINST NONRECOGNITION

Few laws are self-explanatory, and federal income tax laws are no exception. The nonrecognition sections[61] are subject to a number of contravening doctrines and statutory exceptions not evident in the language of sections 721 and 351. Foremost among the judicial doctrines are those relating to "sham" transactions and assignment of income. The primary statutory obstacles to nonrecognition are found in the matching of income and expenses[62] and reallocation provisions[63] of

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57. *Cf.* Treas. Reg. § 1.351-1(a)(2) Ex. (2) (1967).
58. *See id.* § 1.351-1(b)(2) Ex. (2) (1967).
59. 15 CCH Tax Ct. Mem. 440 (1956).
60. *See e.g.*, Dauber, *supra* note 49, at 92; Eaton, *supra* note 45, at 12-18; Greenberg, *supra* note 12, at 85.

Both Thomas W. Briggs, 15 CCH Tax Ct. Mem. 440 (1956), and Peter Raich, 46 T.C. 604 (1966), were "clean" cases, in that all of the elements of bona fide business purpose, lack of dominant tax motive, no shift of ownership, and consistency of accounting method were present. But if some of these elements were not present, as for instance, if the corporation elects a different method of accounting than that used by the transferor, the result might not only be to shift income from transferor to transferee, but also to provide a complete escape from taxation. Eaton, *supra* note 45, at 12-19. *But see* P. A. Birren & Son, Inc. v. Commissioner, 116 F.2d 718 (7th Cir. 1940). Obviously, the Service would be opposed to this result. So far, all agreements by the Service to the nonrecognition of income by the transferor have been conditioned upon recognition of income by the corporation. Worthy, *supra* note 10, at 90; *Points To Rember*, 24 TAX LAW. 601, 608 (1971).

61. The phrases, "nonrecognition statutes" and "nonrecognition provisions" refer to both I.R.C. § 721 (partnership formation) and to *id.* § 351 (corporations).
62. *Id.* § 446.
63. *Id.* § 482.

the *Code*. If any one of these contradictions prevail, the tax planner will have failed to reach his objective.

Sham Transactions

Taxpayers are generally free to transact their business in whatever legal form they prefer, and the desire to minimize taxes is a legitimate consideration in making that choice.[64] When a transaction is framed for the sole purpose of avoiding taxes, however, with the entire transaction a sham designed to conform to the formalities required by a particular tax statute, the Service has successfully attacked the tax effects.[65] Thus, the nonrecognition provisions will not apply if the form of business organization is chosen without a legitimate business purpose or is primarily for tax avoidance reasons.[66] For example, the Commissioner may conceivably attack an incorporation just prior to the receipt of an exceptionally large fee, maintaining that the corporation was formed primarily to take advantage of income splitting between the professional and the corporation. This in turn raises a question of larger scope. Admittedly, the potential for tax savings is a prevalent factor behind the popularity of the professional corporation. Whether this reason will be construed as "primarily for tax avoidance" and be fatal to corporate tax treatment for the small professional organization is still undetermined.

In deciding whether a particular transaction should be sustained, courts have failed to formulate reliable guidelines.[67] When declining to recognize the form adopted by the taxpayer, courts look to the substance of the transaction, holding that if it is a "fiction"[68] or a "sham,"[69] it "lies outside the plain intent of the statute."[70] When upholding the taxpayer's choice of form, courts emphasize the legitimacy of tax

64. *See, e.g.*, Knetsch v. United States, 364 U.S. 361 (1960); Gregory v. Helvering, 293 U.S. 465 (1935); Peter Pan Seafoods, Inc. v. United States, 417 F.2d 670 (9th Cir. 1969); Chisholm v. Commissioner, 79 F.2d 14 (2d Cir. 1935).

65. *See, e.g.*, Knetsch v. United States, 364 U.S. 361 (1960); Commissioner v. P.G. Lake, Inc., 356 U.S. 260 (1958); Commissioner v. Court Holding Co., 324 U.S. 331 (1945); Helvering v. Clifford, 309 U.S. 331 (1940); Griffiths v. Commissioner, 308 U.S. 355 (1939).

66. *Cf.* Gregory v. Helvering, 293 U.S. 465 (1935); Commissioner v. Montgomery, 144 F.2d 313, 315 (5th Cir. 1944); Divine Jr. v. United States, 10 AFTR2d 5403 (W.D. Tenn. 1962); H. B. Zachry Co., 49 T.C. 73, 81 (1967); Claude Neon Lights, Inc., 35 B.T.A. 424 (1937); Eaton, *supra* note 45, at 12-21; Worthy, *supra* note 10, at 90.

67. Chirelstein, *Learned Hand's Contribution to the Law of Tax Avoidance*, 77 YALE L.J. 440, 440-41 (1968); Eustice & Lyon, *Federal Income Taxation*, 36 N.Y.U.L. REV. 642, 650 (1961).

68. Higgins v. Smith, 308 U.S. 473, 477-78 (1940).

69. Knetsch v. United States, 364 U.S. 361, 367, 369 (1960).

70. Gregory v. Helvering, 293 U.S. 465, 470 (1935).

planning, stating that "there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible."[71]

While courts may recognize a corporation as a separate taxable entity even when it is formed to obtain favorable tax treatment,[72] in those instances where the principals and not the corporation control the earning of the income, the Service may contend that the corporation should be disregarded as a "bare skeleton with avoidance of taxes being its sole purpose."[73] In the case of a professional corporation then, the danger to the recognition of corporation status occurs when the individual practitioners and not the corporation control the earning of the income.[74] If the practitioners establish their own schedules and professional standards, hire their own employees and supervise their own practice without meaningful control by the corporation, the corporation may be one of form only. Expense sharing arrangements or centralized bookkeeping systems are insufficient to sustain corporate control; actual control by the corporation over the earnings is required.[75]

Because courts have limited the use of the sham transaction doctrine to situations where tax avoidance is almost the exclusive motive for the transaction,[76] professional partnerships and corporations should be able to avoid application of the doctrine with adequate planning. Obvious shams should not be attempted. When a bona fide organization is created, the traditional independence of the individual practitioner may have to be sacrificed, at least to a limited extent, for joint control with his associates, but a stronger organization should emerge in the long run. Centralized administrative control should also be established together with uniform policies within the organization. Fortunately, tax considerations in this area are aligned with good business procedure.

Thomas W. Briggs[77] illustrates the emphasis placed upon business purpose in applying section 351. Briggs had been operating a service organization as a sole proprietorship, recognizing his income on a

71. Commissioner v. Newman, 159 F.2d 848, 850-51 (2d Cir. 1947) (Hand, J., dissenting). *See also* Commissioner v. Brown, 380 U.S. 563, 579-80 (1965) (Harlan, J., concurring).
72. Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943); Rubin v. Commissioner, 429 F.2d 650, 652 (2d Cir. 1970); W. Braun Co. v. Commissioner, 396 F.2d 264, 267 (2d Cir. 1968).
73. American Sav. Bank, 56 T.C. 828, 840 (1971).
74. Jerome J. Roubik, 53 T.C. 365, 379 (1969); *cf.* Helvering v. Clifford, 309 U.S. 331 (1940); Brown v. Commissioner, 115 F.2d 337, *aff'd on rehearing*, 115 F.2d 340 (2d Cir. 1940); American Sav. Bank, 56 T.C. 828, 841 (1971).
75. These factors were considered in Jerome J. Roubik, 53 T.C. 365 (1969).
76. Knetsch v. United States, 364 U.S. 361, 365-66 (1960); Brown v. Commissioner, 115 F.2d 337, 339, *aff'd on rehearing*, 115 F.2d 340 (2d Cir. 1940).
77. 15 CCH Tax Ct. Mem. 440 (1956).

cash receipts basis. When his business expanded, it was incorporated with all assets and liabilities transferred to the new corporation. The Commissioner attempted to tax Briggs as the sole shareholder of the corporation when income was realized upon collection of the accounts receivable transferred. The court upheld the application of section 351, the receivables passing tax free and the corporation recognizing the income upon collection. The opinion emphasized the importance of the bona fide business purpose and pointed to a number of facts indicating that tax avoidance was not the primary purpose.[78] This case demonstrates the necessity of clearly recording all business considerations motivating the incorporation.[79]

Assignment of Income Doctrine

The basic concept of the federal income tax laws is to tax those who have earned income or those who have created the right to receive income.[80] Consequently, income is generally taxable to the person or entity who renders the service[81] or who owns or controls property which has generated the income.[82] Whenever an earner of income does nothing more than transfer or assign to another the right to receive that income, the transferor is taxable upon the receipt of

78. There were no new stockholders in the corporation; there was no shift in ownership; the transferor and the corporation had the same method of accounting; and there was no attempted evasion of taxes. *Id.* at 442-46.

79. The current position of the Service appears to follow *Briggs*. The income realized upon the collection of the receivables will be taxed to the transferor corporation where there is a bona fide business purpose for the organization, where there is essentially a continuance of the previous business and where the transferee agrees to report the income upon collection. Pennell & O'Byrne, *supra* note 48, at 56; Tiger, *Problems of Mismatched Income and Expenses in the Transfer of a Business Through Corporate Organization and Liquidation*, 19 TUL. TAX INST. 382, 391 (1970); Worthy, *supra* note 10, at 90.

The Commissioner's approval of the applicability of section 351 to unrealized receivables is also implied in REV. RUL. 69-442, 1969-2 CUM. BULL. 53, which was issued in response to Peter Raich, 46 T.C. 604 (1966). This ruling concerns the taxability, under I.R.C. § 357(c), of an excess of liabilities over the adjusted basis of assets transferred in a section 351 transaction. A portion of the assets transferred consisted of unrealized receivables. In order to determine the excess of the liabilities over the adjusted basis of the assets, it became necessary to determine the basis of the unrealized receivables. The *Raich* court determined that the basis of the unrealized receivables in the hands of the corporation was zero. 46 T.C. at 611. The ruling announced that the Service would follow *Raich* in similar situations. The ruling noted that the accounts receivable would not have a zero basis in the hands of a transferor reporting on an accrual basis. The obvious implication of this language is that the accounts receivable would pass tax free in the case of a cash basis transferor.

80. *See, e.g.*, Commissioner v. Sunnen, 333 U.S. 591 (1948); Helvering v. Horst, 311 U.S. 112 (1940); Blassie v. Commissioner, 394 F.2d 628 (8th Cir. 1968); Kuney v. Frank, 308 F.2d 719, 720 (9th Cir. 1962).

81. *See, e.g.*, Helvering v. Eubank, 311 U.S. 122 (1940); Lucas v. Earl, 281 U.S. 111 (1930); Jaeger Motor Car Co. v. Commissioner, 284 F.2d 127 (7th Cir. 1960), *cert. denied*, 365 U.S. 860 (1961); Van Meter v. Commissioner, 61 F.2d 817 (8th Cir. 1932).

82. *See, e.g.*, Helvering v. Horst, 311 U.S. 112 (1940); Helvering v. Clifford, 309 U.S. 331 (1940); Corliss v. Bowers, 281 U.S. 376 (1930); Austin v. Commissioner, 161 F.2d 666 (6th Cir.), *cert. denied*, 332 U.S. 767 (1947).

the income by his transferee.[83]

This assignment of income doctrine, which governs the responsibility of reporting income, was first enunciated in *Lucas v. Earl.*[84] Of particular interest is a line of cases analogous to the unrealized receivable situation concerned with the assignment of commissions. Some courts had held that income would be taxable to the assignor only in those situations where future income was assigned—where future services of the assignor were required to perfect the right to income.[85] Hence, when the income was already earned and nothing remained to be done except to collect it, these courts considered the income a property right capable of assignment and taxed the assignee. Other courts, however, had ignored the past-future services distinction, taxing the income to the assignor in both instances.[86] The Supreme Court ratified the latter line of cases in *Helvering v. Eubank,*[87] holding that when there is no purpose in the assignment other than to confer the right to collect the income, income would be taxable to the assignor.

The Commissioner has argued that the assignment of income principles apply to the assignment of unrealized receivables to a partnership[88] or corporation.[89] He maintains that as the earner of the income, the transferor cannot escape taxation merely by assigning his right to the income to another. The argument is that the transferor, having an unquestionable right to the income earned by him, is not transferring property[90] as required under the nonrecognition statutes

83. Van Meter v. Commissioner, 61 F.2d 817, 819 (8th Cir. 1932). Some courts, however, have allowed the transfer of income earned but not yet received when the property earning the income is also transferred. See Matchette v. Helvering, 81 F.2d 73 (2d Cir.), *cert. denied,* 298 U.S. 677 (1936); Elsie SoRelle, 22 T.C. 459 (1954), *acquiesced in,* 1959-1 CUM. BULL. 5.

84. 281 U.S. 111 (1930) (income from personal efforts must be taxed to the earner, despite an anticipatory assignment of the income to a spouse). For a discussion of the history, development, explanation and ramifications of the assignment of income doctrine, see Lyon & Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the P. G. Lake Case,* 17 TAX L. REV. 295 (1962).

85. *See* Commissioner v. Ross, 83 F.2d 18 (6th Cir. 1936); Hall v. Burnett, 54 F.2d 443 (D.C. Cir. 1931), *cert. denied,* 285 U.S. 552 (1932).

86. *See* Van Meter v. Commissioner, 61 F.2d 817 (8th Cir. 1932); Parker v. Routzahn, 56 F.2d 730 (6th Cir. 1932).

87. 311 U.S. 122 (1940). *See also* Blassie v. Commissioner, 394 F.2d 628 (8th Cir. 1968); Lyon & Eustice, *supra* note 84, at 388-90.

88. United States v. Ramos, 393 F.2d 618 (9th Cir.), *cert. denied,* 393 U.S. 983 (1968); Kuney v. Frank, 308 F.2d 719 (9th Cir. 1962); *see* Greenberg, *supra* note 12, at 85.

89. Helvering v. Eubank, 311 U.S. 122 (1940); Clinton Davidson, 43 B.T.A. 576 (1941), *acquiesced in,* 1941-1 CUM. BULL. 3; *see* Lyon & Eustice, *supra* note 84, at 300, 390, 424.

90. Helvering v. Eubank, 311 U.S. 122, 127 (1940) (McReynolds, J., dissenting); Commissioner v. Ross, 83 F.2d 18, 20 (6th Cir. 1936); Roberts Co., 5 T.C. 1, 7 (1945), *acquiesced in,* 1945 CUM. BULL. 6; *see* Lyon & Eustice, *supra* note 84, at 298, 397, 428.

but is transferring a mere right to income[91] which should be taxable to the assignor.

In attempting to apply the *Eubank* rationale to receivables in the organization of businesses, however, the Commissioner must overcome three obstacles. First, the majority in *Eubank* did not hold that the right to receive earned income was not a property right; they ignored the issue. Second, the holding was based upon the premise that the only purpose for the assignment was to confer the right to collect the income.[92] In the formation or reorganization of business organizations, there are usually legitimate business purposes for transferring the accounts receivable,[93] especially when it is only the form of an ongoing business which is transformed. Finally, in drawing the distinction between property and a right to income, the Commissioner must distinguish several definitions in the *Code*. Although "property" is not defined in either section 721 or 351 or their respective Regulations, unrealized receivables are considered property in other sections. These include sections 735 and 751, both of which relate to partnership matters. Listing unrealized receivables with several types of non-capital property, section 1221(4) also implies that receivables are property. In addition, sections 721[94] and 351[95] include installment obligations which are a form of unrealized receivables. Moreover, the meaning of property has been construed to include such accounts.[96]

Generally, courts have not supported the Commissioner's attempt to apply assignment of income principles to avoid the results of sections 721 and 351.[97] Looking to the bona fide business purpose argument, the nonrecognition statutes have been upheld where there is a going business involved and the transaction is not primarily an attempt to avoid income taxes.[98] Only in those cases some sort of sham transaction or tax avoidance scheme motivated the assignment has the assignment of income doctrine prevailed.[99] These cases further emphasize the

91. Helvering v. Eubank, 311 U.S. 122, 125 (1940); Van Meter v. Commissioner, 61 F.2d 817, 820 (8th Cir. 1932).
92. 311 U.S. 122, 124 (1940).
93. Accounts receivable usually form a substantial portion of the working capital of a professional organization and transfer and subsequent collection of receivables provide the funds necessary to carry on the business.
94. *See* Treas. Reg. § 1.721-1(a) (1960).
95. *See id.* § 1.453-9(c)(2) (1958).
96. Peter Raich, 46 T.C. 604, 611 (1966).
97. Tiger, *supra* note 79, at 388.
98. *See, e.g.,* Commissioner v. Ross, 83 F.2d 18 (6th Cir. 1936); Matchette v. Helvering, 81 F.2d 73, 74 (2d Cir.), *cert. denied,* 298 U.S. 677 (1936); H.B. Zachry Co., 49 T.C. 73 (1967).
99. *See, e.g.,* Griffiths v. Commissioner, 308 U.S. 355 (1939); Brown v. Commissioner, 115 F.2d 337, *aff'd on rehearing,* 115 F.2d 340 (2d Cir. 1940); Thomas M. Divine, Jr., 10 AFTR2d 5403 (W.D. Tenn. 1962).

basic concept of the nonrecognition provisions. When there is a change of form only, and no gain has actually been realized, the taxpayer should not be forced to recognize the non-existent gain.[100]

Since the nonrecognition sections technically state only that there will be no recognition when the property is transferred or contributed, it must be asked whether classifying receivables as property at the time of transfer should foreclose recognition of gain by the transferor at a later time when the receivables are collected. Although *Briggs*[101] appears to hold that nonrecognition will carry through the actual realization, there are those who question whether nonrecognition would carry that far.[102] If the policies underlying the nonrecognition statutes are examined, however, it is seen that application of the assignment of income doctrine contravenes the intent of Congress. It must be realized that when the assignment of income doctrine prevails, the result is a reallocation of income based upon a "common law" rule. Not only is the income reallocated, it is distributed under an aggregate theory of business organization, a theory which Congress clearly rejected in regard to the nonrecognition sections. In the case of partnerships, Congress expressly mandated that the aggregate theory would apply only at the option of the partners.[103] Thus, any gain realized by the partnership attributable to the difference between the basis and fair market value at the time of contribution is to be shared by the partners according to their proportionate interest in the partnership.[104] Corporations present an even clearer case of rejection of the aggregate theory. Not only is a corporation treated as a separate taxpayer whose shareholders necessarily share the precontribution gains in proportion to their interest in the corporation, but because the corporation is a separate entity, applying the assignment of income doctrine could create situations where losses are locked into the corporation with the practitioners paying a greater tax on the receipt of the receivables than they would have paid had they never incorporated.[105] Once it has been established that receivables qualify as property for purposes of the nonrecognition sections, there is no basis for a "common law" theory which treats them differently than other property transferred pursuant to those sections.

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100. *See, e.g.*, Helvering v. Cement Investors, 316 U.S. 527, 533 (1942); Portland Oil Co. v. Commissioner, 109 F.2d 479, 488 (1940); Peter Raich, 46 T.C. 604, 607-08 (1966).
101. 15 CCH Tax Ct. Mem. 440 (1956).
102. *See* Lyon & Eustice, *supra* note 84, at 424; Tiger, *supra* note 79, at 387.
103. *See* U.S. CODE CONG. & ADM. NEWS 5319 (1954).
104. Treas. Reg. § 1.704-1(c)(1) Exs. (1)-(3) (1964).
105. An adjustment under the assignment of income doctrine would result in substantially the same result as described in note 116 *infra*.

Matching of Income and Expense

Supplementing the judicial doctrines are a number of *Code* provisions which also tend to undermine the operation of the nonrecognition sections.[106] One of these, section 446, provides that the taxpayer must compute his taxable income consistently, using a method which clearly reflects income.[107] When the Commissioner determines that the method used by the taxpayer is inconsistent with the method used in previous years, or that the method used does not clearly reflect income,[108] he has authority to recompute the income.[109]

Inherent in the concept of clearly reflecting income is the matching of income with the expense incurred to produce that income.[110] When unrealized receivables are transferred to a new entity without the recognition of income by the transferor under sections 351 or 721, the expenses and income may be split between the transferor and transferee.[111] Since in a professional organization expenses are generally paid before the related income is collected, the old entity deducts the expense while the new entity recognizes the income upon collection. As a result of this split in income and expense, the Commissioner can argue that to clearly reflect income, the income should be recognized by the old entity upon collection[112] or, in the alternative, that the

106. *See, e.g.*, I.R.C. §§ 269, 446, 482.

107. I.R.C. § 446 provides, as a general rule, that the method of accounting used to prepare the taxpayer's books will be used to compute his taxable income, subject to the qualification that the method clearly reflects income.

108. The method of accounting used by the taxpayer is never conclusive, even when it was consistently used over a long period of time, or there was a previous audit without objection by the Service. Standard Paving Co. v. Commissioner, 190 F.2d 330, 332 (1st Cir.), *cert. denied*, 342 U.S. 860 (1951); Ezo Products Co., 37 T.C. 385, 391 (1961).

109. I.R.C. § 446(b). The Commissioner's authority to reallocate income or expense under this section is extremely broad. Brown v. Helvering, 291 U.S. 193, 204 (1934); Lucas v. American Code Co., 280 U.S. 445, 449 (1930); Standard Paving Co., 13 T.C. 425, 437 (1949), *aff'd*, 190 F.2d 330 (1st Cir.), *cert. denied*, 342 U.S. 860 (1951). Once the Commissioner has reallocated under the authority granted by this section, the courts will not review his determination unless the taxpayer can show that it is clearly unreasonable and arbitrary. Brown v. Helvering, 291 U.S. 193, 204-05 (1934); Lucas v. American Code Co., 280 U.S. 445, 449 (1930); Standard Paving Co., 13 T.C. 425, 437 (1949), *aff'd*, 190 F.2d 330 (1st Cir.), *cert. denied*, 342 U.S. 860 (1951); Jud Plumbing & Heating, Inc., 5 T.C. 127, 135 (1945), *aff'd*, 153 F.2d 681 (5th Cir. 1946).

110. Palmer v. Commissioner, 267 F.2d 434, 438 (9th Cir.), *cert. denied*, 361 U.S. 821 (1959); Central Cuba Sugar Co. v. Commissioner, 198 F.2d 214, 216 (2d Cir.), *cert. denied*, 344 U.S. 874 (1952).

111. As a result, it is felt that allocation of income to the transferor is permissible notwithstanding the nonrecognition provisions. See Tiger, *supra* note 79, at 390. *See also* Commissioner v. South Lake Farms, Inc., 324 F.2d 837, 850 (9th Cir. 1963) (Carter, J., dissenting) ("The fact that sections 446(b) and 482 appear to run afoul of other sections providing for non-recognition of tax in certain situations does not bar their application").

112. *See* Commissioner v. Kuckenberg, 309 F.2d 202, 206 (9th Cir. 1962), *cert. denied*, 373 U.S. 828 (1963); Palmer v. Commissioner, 267 F.2d 434, 438 (9th Cir.), *cert. denied*, 361 U.S. 821 (1959); Standard Paving Co., 13 T.C. 425, 435 (1949), *aff'd*, 190 F.2d 330 (10th Cir.), *cert. denied*, 342 U.S. 860 (1951); Jud Plumbing &

expenses be disallowed to the old entity[113] and deducted by the new one in order to match the income collected.

If the Commissioner should prevail in his arguments, an entering partner with the largest amount of receivables would not be able to postpone a portion of his tax for the year of organization by having the tax allocated among the other partners. This may be particularly harmful where the formation was timed to result in the splitting of an unusually large fee collected in a lump sum, or where a practicing professional admits a new partner who has not previously practiced. In the formation of a professional corporation, reallocating the income to the old entity would result in a bunching of income for the year, as both the old receivables collected and the salary drawn from the corporation would be includable in the professional's individual income.[114] In a professional operation, the disallowance of the deductions on the tax return of the old entity would have the same result, except that as expenses usually constitute but a small percentage of income, the impact would not be as great.

To illustrate the possible operation of section 446, assume that Able and Beginner[115] have been practicing as a partnership for a number of years, reporting income on a calendar year basis. In July 1972, they form a professional corporation, transferring all of the assets of the partnership to the new entity in a section 351 exchange. Assume further that they are billing $25,000 per month in fees, realizing a net income of $2,000 per week and each drawing $500 per week. After incorporation, each takes a salary of $500 per week and the rate of profit remains constant. Unrealized receivables amount to $75,000 at the time of incorporation, all of which is collected by the corporation during the next 3 months. Believing that their incorporation comes squarely under the nonrecognition provisions of section 351, each of the partners reports his distributive share of partnership income ($26,000) plus his salary from the corporation ($13,000) on his individual income tax return for 1972. The corporation reports the profit remaining after the salaries are paid ($26,000) as its net income for the year. The Commissioner, however, maintaining that the income was attributable to the efforts and expenditures of the partner-

Heating, Inc., 5 T.C. 127, 134 (1945), *aff'd*, 153 F.2d 681 (5th Cir. 1946). *But see* Commissioner v. South Lake Farms, Inc., 324 F.2d 837 (9th Cir. 1963) (allowing an unharvested crop transferred just days before the harvesting to remain untaxed to the transferor).

113. *See* Rooney v. United States, 305 F.2d 681 (9th Cir. 1962); Palmer v. Commissioner, 267 F.2d 434, 438 (9th Cir.), *cert. denied*, 361 U.S. 821 (1959); Central Cuba Sugar Co. v. Commissioner, 198 F.2d 214, 216 (2d Cir.), *cert. denied*, 344 U.S. 874 (1952); Greenberg, *supra* note 12, at 86; Eaton, *supra* note 45, at 12-21.

114. Greenberg, *supra* note 12, at 86.

115. *See* text accompanying notes 32-38 *supra*.

ship rather than the corporation, reallocates the income to the partnership. Each of the partners is thus taxed on his share of the partnership profits ($26,000 plus 1/2 of $75,000), plus his salary from the corporation ($13,000), or a total of $76,500 in the year of incorporation—$24,500 more than each partner would have reported had they not incorporated. The corporation, having elected to report on a cash basis method of accounting and deprived of the income from the collection of the transferred accounts receivable, shows a loss of $49,000 for which no tax benefit is available during 1972, this being the first year of its existence.[116] The net result is that the taxpayers have been penalized for incorporating.

These disastrous results are exactly what Congress attempted to avoid in the passage of the nonrecognition statutes when it sought to prevent the taxation of unrealized income to the transferor if there was merely a change in the form of ownership.[117] Yet section 446 has been used to defeat a number of other *Code* sections,[118] and it is likely that it will be invoked to attack the nonrecognition of income

116. The effect of the incorporation together with a comparison of the results afforded by the operation of section 351 and the reallocation of income under section 446 is as follows:

	Total	Partnership	Corporation
Collections	$300,000	$150,000	$150,000
Expenses paid	196,000	98,000	98,000
	$104,000	$ 52,000	52,000
Corporate salaries			26,000
Corporate net income			$ 26,000

	No change in organization	Under § 351	Under § 446 income reallocation
Able: ½ partnership profits	$ 52,000	$ 26,000	$ 26,000
Corporate salary	—0—	13,000	13,000
½ reallocated income	—0—	—0—	37,500
	$ 52,000	$ 39,000	$ 76,500
Beginner: (same as above)	$ 52,000	$ 39,000	$ 76,500
Corporation	—0—	26,000	(49,000)
Total all entities	$104,000	$104,000	$104,000

Although the total reported from all entities is the same, it is evident that the best distribution is obtained under section 351, with the alternative of not incorporating being less objectionable than the results under the section 446 reallocation. For an example of reallocating expenses, see note 139 *infra*.

117. *See* authorities cited note 45 *supra*.

118. I.R.C. § 337 (corporate liquidations); Commissioner v. Kuckenberg, 309 F.2d 202 (9th Cir. 1962), *cert. denied*, 373 U.S. 828 (1963); Jud Plumbing & Heating, Inc., 5 T.C. 127 (1945), *aff'd*, 153 F.2d 681 (5th Cir. 1946). I.R.C. § 332 (liquidation of subsidiaries); Standard Paving Co., 13 T.C. 425 (1949), *aff'd*, 190 F.2d 330 (10th Cir.), *cert. denied*, 342 U.S. 860 (1951). I.R.C. §§ 334, 337 (sale of unrealized receivables by a liquidating corporation); Family Record Plan, Inc. v. Commissioner, 309 F.2d 208 (9th Cir. 1962), *cert. denied*, 373 U.S. 910 (1963).

upon a transfer of unrealized receivables in an organizing transaction. In one instance,[119] it was reasoned that section 446 should be used to eliminate any advantage of the cash basis taxpayer over the accrual basis taxpayer when the reporting entity had changed. The court failed to consider, however, that the cash receipts method of accounting has an inherent advantage—the postponement of recognition of income. This advantage is realized not only when the entity is changed but, in the ordinary course of events, when the entity remains the same. Despite this inherent advantage, the method is specifically approved by section 446 itself,[120] and there is no reason why its benefits should be disallowed when the entity changes form.

Allocation Between Controlled Organizations

Section 482 is another allocation section potentially available to the Commissioner if he decides to attack the effect of the nonrecognition statutes. Under this section, the Commissioner has the power to reallocate income or expenses between controlled organizations[121] in order to prevent the shifting of profits from one to the other.[122] After the reallocation, the entities should stand in the same position as if they had been uncontrolled taxpayers and the transaction involved had been negotiated at arm's length.[123] The reallocation power has been granted to prevent the evasion of taxes or to clearly reflect income.[124]

The usual transaction contemplated under the section envisions the simultaneous existence of two trades or businesses, each controlled by the same interests, in which products or services are exchanged for less (or more) than adequate consideration.[125] Moreover, the two entities usually comprise distinct trades or businesses serving different customers or furnishing different products. When a professional or-

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119. Commissioner v. Kuckenberg, 309 F.2d 202, 206 (9th Cir. 1962).
120. I.R.C. § 446(c)(1).
121. "The term 'organization' includes any organization of any kind, whether it be a sole proprietorship, a partnership, a trust, an estate, an association, or a corporation . . . ." Treas. Reg. § 1.482-1(a)(1) (1968).
122. W. Braun Co. v. Commissioner, 396 F.2d 264, 266 (2d Cir. 1968); Central Cuba Sugar Co. v. Commissioner, 198 F.2d 214, 216 (2d Cir.), *cert. denied*, 344 U.S. 874 (1952); Nat Harrison Associates, Inc., 42 T.C. 601, 621 (1964), *acquiesced in*, 1965-2 CUM. BULL. 5; Seminole Flavor Co., 4 T.C. 1215, 1228 (1945). Under section 482, as under section 446, the allocation power is broad, and when exercised by the Commissioner it will be reviewed only when it is shown to be arbitrary and unreasonable. W. Braun Co. v. Commissioner, 396 F.2d 264, 266 (2d Cir. 1968); Nat Harrison Associates, Inc., 42 T.C. 601, 617 (1964), *acquiesced in*, 1965-2 CUM. BULL. 5.
123. Treas. Reg. § 1.482-1(b)(1) (1968).
124. I.R.C. § 482.
125. *See, e.g.*, Commissioner v. First Security Bank, 405 U.S. 394 (1972) (allocation of insurance commissions between bank and wholly owned insurance company); United States Gypsum Co. v. United States, 452 F.2d 445 (1971) (shipping rates charged by subsidiary corporation to parent corporation); Eli Lilly & Co. v. United States,

ganization changes form, there is actually one business at any given time, the two forms furnishing the same services to the same clientele. Although it can be argued that the two forms are technically two organizations, the rule of *noscitut a sociis*, which has been applied to other tax statutes,[126] would dictate that two or more organizations be given the same connotation as two or more trades or businesses.

In seeking to apply section 482 to the investment of unrealized receivables into a professional corporation, the Commissioner must not only disregard the basic purpose of the section, he must also face three principal issues: whether the control factor is satisfied, whether the two or more organizations involved must exist simultaneously and whether the presence of a bona fide business purpose will preclude the application.

Compared with section 351 which sets out specific control requirements in terms of ownership, "control" under section 482 is broadly defined, encompassing actual control in whatever form it may take.[127] The control may be direct or indirect, whether actually exercised or not, and a presumption of control arises when there is an arbitrary shifting of income or deductions.[128] A "controlled taxpayer" then means any one of two or more organizations which are controlled by the same interests.[129] Undoubtedly, when members of an ongoing professional partnership decide to incorporate, the requisite control exists. The section taken broadly, however, may also include the formation of a new professional organization by five individual practitioners, the same five individuals collectively controlling both the five old entities and the one new entity.

In the usual transaction coming within the ambit of section 482, both of the controlled organizations exist at the time of the questioned transaction. Even if it is assumed that the old and new entities comprise two organizations within the meaning of section 482, in the usual section 721 or 351 transaction the transferor disappears upon the transfer of the business to the new organization, making simultaneous existence impossible. The question whether the control could exist subse-

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372 F.2d 990 (1967) (sale of products for resale between parent and subsidiary corporations); Oil Base, Inc. v. Commissioner, 362 F.2d 212 (1966) (commissions and discounts between parent and subsidiary corporations); Dillard-Waltermire, Inc. v. Campbell, 255 F.2d 433 (1958) (transfer of partially completed oil drilling contracts from corporation to partnership controlled by same interests). *See also* Treas. Reg. § 1.482-2(b)(2) Exs. (1)-(3) (1968).

126. Jarecki v. G.D. Searle & Co., 367 U.S. 303 (1961); Comar Oil Co. v. Helvering, 107 F.2d 709 (8th Cir. 1939).

127. Treas. Reg. § 1.482-1(a)(3) (1968).

128. *Id.*

129. *Id.* § 1.482-1(a)(4) (1968).

quently rather than simultaneously and still be within the Commissioner's allocation powers arose in *Rooney v. United States.*[130] Appellant contended that the control of the subsequent organization did not bring the transaction within section 482, arguing that the simultaneous existence of each entity was necessary. The court, taking a less literal approach, rejected the contention, stating that actual control as to the particular transaction was the only material consideration, and that the continuing existence of the organizations involved was unimportant.[131]

Allocation of income and deductions is allowed under section 482 to prevent the evasion of taxes or to reflect income.[132] It has been argued that the presence of a bona fide business purpose without a tax avoidance motive will remove a transaction from the section's provisions.[133] Although the literal language of the *Code* seems to refute this, implying that distortion of income alone is sufficient to sustain the allocation, a review of the legislative history lends some justification to this argument.[134] The issue is important in the case of investment of unrealized receivables. The assignment of receivables to a professional organization is generally for a bona fide business purpose[135] and normally without an overriding tax avoidance motive. If the contention, which has received mixed reaction from the courts,[136] should be sustained, it could effectively remove section 482 as a threat to the tax effects of the transaction.

Even if all the issues are resolved in favor of the Commissioner, the allocation may still be attacked on the basis that the adjustment must be made "to clearly reflect income."[137] Adjustments of income between entities under section 482 will have essentially the same effects as those described under section 446. The question arises whether the adjustment then results in clearly reflecting the income for the year involved. In the previous example,[138] Able and Beginner had an economic net income for the year of $104,000, yet were required

130. 305 F.2d 681 (9th Cir. 1962).
131. *Id.* at 683. *See also* Walling v. Commissioner, 373 F.2d 190 (3rd Cir. 1967).
132. I.R.C. § 482.
133. *See* cases cited note 136 *infra.*
134. *See* 1939-1 CUM. BULL. 384, 395; 1939-1 CUM. BULL. 409, 426.
135. *See* text of note 93 *supra.*
136. Courts have been in disagreement, some holding that the section applies only where there is no bona fide transaction, or where there is an overriding tax avoidance motive. Simon J. Murphy Co. v. Commissioner, 231 F.2d 639, 645 (6th Cir. 1956); Tillotson v. McCrory, 202 F. Supp. 925, 929 (D. Neb. 1962). Other courts maintain that the presence of a bona fide business purpose does not preclude the allocation. Dillard-Waltermire, Inc. v. Campbell, 255 F.2d 433, 436 (5th Cir. 1958); Central Cuba Sugar Co. v. Commissioner, 198 F.2d 214, 215 (2d Cir.), *cert. denied,* 344 U.S. 874 (1952).
137. I.R.C. § 482.
138. *See* text accompanying notes 115-116 *supra.*

to pay taxes on individual incomes totaling $153,000, the difference of $49,000 being locked into a corporate loss which resulted in no tax benefit in the year of organization. Theoretically, the net between entities does reflect income, but when the discrepancies between economic income and taxable income are so far apart the court may preclude the adjustment because of the actual tax burden attaching. An adjustment of expenses—disallowing the expenses on the partnership return and allowing the deductibility of the expenses by the corporation —would not dislocate the total net income to be reported by both entities as seriously and may be more likely to be sustained.[139] The result would remain, however, that income would not be reflected accurately.

In addition to the technical objections, the purpose of the nonrecognition sections is clearly in conflict with the operation of section 482, if it is applicable to business organization. At the time the nonrecognition statutes were passed, Congress expressed its desire that changes in the form of organization should not be impeded by the imposition of taxes.[140] Yet despite this clearly expressed mandate, there is authority that section 482 will control when it conflicts with section 351.[141] If this position is followed, there is no doubt that the application of section 482 would place a serious obstacle in the path of professionals desiring to form partnerships and corporations without undue tax burdens.[142]

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139. The effect of reallocating expenses under section 482 using the same facts as in the example in text accompanying note 116 *supra* is as follows:

	No change in organization	Under § 351	Under § 482 expense reallocation
Able reports:			
½ partnership profits	$ 52,000	$ 26,000	$ 26,000
Corporate salary	—0—	13,000	13,000
½ reallocated expenses applicable to $75,000 transferred receivables	—0—	—0—	24,500
Total	$ 52,000	$ 39,000	$ 63,500
Beginner reports: (same as above)	$ 52,000	$ 39,000	$ 63,500
Corporation reports:	—0—	26,000	(23,000)
Total all entities	$104,000	$104,000	$104,000

While the total of the entities is the same, section 351 provides the best distribution. The loss locked into the corporation is less under the expense reallocation than it is under the income reallocation, thus lessening the tax burden in the year of organization.

140. *See* text of note 45 *supra*.

141. *See, e.g.*, Rooney v. United States, 305 F.2d 681, 686 (9th Cir. 1962); National Sec. Corp. v. Commissioner, 137 F.2d 600 (3d Cir. 1943); Treas. Reg. § 1.482-1(d)(5) (1968); Tiger, *supra* note 79, at 391.

142. Section 482 may also be used to attack the corporation's income after organization. *See, e.g.*, Rubin v. Commissioner, 429 F.2d 650 (2d Cir. 1970); Aland, *Section 482: 1971 Version*, 49 TAXES 815, 848 (1971); Egerton, *supra* note 8.

CONCLUSION

Thousands of professional partnerships and corporations are formed each year. Most encounter the question of the advisability of transferring unrealized accounts receivable to the new entity in return for an interest in capital. The tax effects of this relatively common and simple transaction appear to be stipulated in sections 721 and 351 of the *Code*. Despite those sections, a host of conflicting judicial doctrines and overlapping statutory provisions cast doubt on the tax consequences. Although tax planners aware of the problem might alleviate some of the worst consequences with proper timing of income, deductions, organization and fiscal years, the Service must ultimately adopt a firm, publicly promulgated position. Unforeseen tax results have a tendency to impair the stability of professional organizations, and few policy reasons justify the continuing uncertainty in this area.