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## The Service Corporation-- Who Is Taxable on Its Income: Reconciling Assignment of Income Principles, Section 482, and Section 351

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# The Service Corporation— Who Is Taxable on Its Income: Reconciling Assignment of Income Principles, Section 482, and Section 351

ELLIOTT MANNING\*

*In evaluating potential abuses in the creation and operation of service corporations, the courts have been unable to define the proper roles of assignment of income principles and section 482, both of which may under certain conditions require the taxation of such corporations' employee-shareholders, and section 351, which shields certain transfers of income to the corporation. The author, after an analysis of case law and rulings that deal with service and other closely held corporations, proposes a framework in which to harmonize the policies of sections 482 and 351 in light of the assignment of income doctrine.*

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## I. INTRODUCTION

A number of recent tax cases and Internal Revenue Service rulings<sup>1</sup> have struggled with the problems of properly applying the "assignment of income" doctrine and section 482 of the Code to the creation and operation of various closely held corporations, principally those that might be called service corporations ("SC"). An SC might be defined as a corporation whose principal activity is exploiting the personal services of its founder (usually its principal shareholder), rather than manufacturing or selling goods.<sup>2</sup> The creation and operation of an SC involve questions of the extent to which income that would have been taxed to the founder in the absence of the corporation should be taxed to the corporation.

The principal argument used by the Internal Revenue Service (the "Service") in attacking the perceived abuses in such transfers is that the creation and operation of SC's involve the improper "assignment of income." In some cases, however, courts have preferred to deal with the issue under section 482, which gives the Service broad power to reallocate income among commonly controlled businesses. Some courts have further considered the degree to which section 351, which generally permits transfers of property to controlled corporations without recognition of gain or loss, operates to limit the application of section 482.

Part of the difficulty in this area stems from the use of the phrase "assignment of income" in at least three different ways in

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1. See, e.g., *Johnson v. United States*, 83-1 U.S. Tax Cas. (CCH) ¶ 9120 (9th Cir. 1982); *Foglesong v. Commissioner*, 35 T.C.M. (CCH) 1309 (1976), *rev'd*, 621 F.2d 865 (7th Cir. 1980), *on remand*, 77 T.C. 1102 (1981), *rev'd*, 691 F.2d 848 (7th Cir. 1982); *Johnson v. Commissioner*, 78 T.C. 882 (1982) (same taxpayer as in *Johnson*, 83-1 U.S. Tax Cas. (CCH) ¶ 9120 (9th Cir. 1982), but different tax year); *Keller v. Commissioner*, 77 T.C. 1014 (1981), *aff'd*, 723 F.2d 58 (10th Cir. 1983); Rev. Rul. 80-199, 1980-2 C.B. 122; Rev. Rul. 80-198, 1980-2 C.B. 113.

Rev. Rul. 80-198, relying quite heavily on *Hempt Bros., Inc. v. United States*, 490 F.2d 1172 (3d Cir.), *cert. denied*, 419 U.S. 826 (1974), explicitly deals with issues arising after the 1978 addition to the Code of I.R.C. § 357(c)(3) (Supp. V 1981) by Pub. L. No. 95-600, § 365(a),(c), 92 Stat. 2763, 2854-55 (1978), *amended by* Pub. L. No. 96-222, § 103(a)(12), 94 Stat. 194, 213 (1980). Rev. Rul. 80-199 deals with the pre-§ 357(c)(3) issues initially raised by *Raich v. Commissioner*, 46 T.C. 604 (1966), and subsequently discussed in *Thatcher v. Commissioner*, 533 F.2d 1114 (9th Cir. 1976), *Bongiovanni v. Commissioner*, 470 F.2d 921 (2d Cir. 1972), and *Focht v. Commissioner*, 68 T.C. 223 (1977). Rev. Rul. 80-199 rejects important parts of *Bongiovanni* and *Thatcher*.

2. Cf. I.R.C. § 269A(b)(1) (West Supp. 1982). Section 269A was added by § 250 of the Tax Equity and Fiscal Responsibility Act ("TEFRA") of 1982, Pub. L. No. 97-248, § 250, 96 Stat. 324, 528.

tax analysis. The failure to recognize explicitly the three different aspects of the assignment of income doctrine—gratuitous assignment of income; transfer of rights to income earned economically but not yet recognized for tax purposes; and transfer of rights to income for consideration—has led courts to reject improperly the application of at least one of its aspects. Failure to recognize the need to harmonize the policies of sections 351 and 482—facilitating the incorporation of businesses, while concurrently preventing the abusive reallocations of income among controlled entities—has caused further difficulty. This article will suggest a means by which these policies may be reconciled.

## II. RECENT CASES AND RULINGS.

### A. *Transfers of the Right to Collect Income Attributable to Services of the Transferor*

Several recent cases and rulings are fairly representative of the types of federal income tax issues that are raised when a personal service or other cash basis business is incorporated.<sup>3</sup> In *Foglesong v. Commissioner*,<sup>4</sup> Frederick Foglesong, a manufacturers' representative, transferred his contracts with the manufacturers to a corporation in which he was virtually the sole common shareholder<sup>5</sup> and in which his four children were preferred shareholders (as a result of an investment of \$400). The Service attacked the corporation on three grounds: (1) that it was a sham to be disregarded for tax purposes; (2) that all of its income should be taxed to Mr. Foglesong under the assignment of income doctrine of *Lucas v. Earl*,<sup>6</sup> and (3) that ninety-eight percent of its income should be allocated to Mr. Foglesong under section 482.<sup>7</sup> The Tax Court accepted the first of these three arguments, but the United States Court of Appeals for the Seventh Circuit reversed on appeal. The Seventh Circuit concluded that the corporation could not be disregarded and that if the assignment of income doctrine were applied, the corpo-

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3. See cases and revenue rulings cited *supra* note 1.

4. 621 F.2d 865 (7th Cir. 1980), *rev'g & remanding* 35 T.C.M. (CCH) 1309 (1976), *on remand*, 77 T.C. 1102 (1981), *rev'd*, 691 F.2d 848 (7th Cir. 1982). The *Foglesong* case has inspired a spate of articles, including Fever, *Section 482, Assignment of Income Principles and Personal Service Corporations*, 59 TAXES 564 (1981); McFadden, *Section 482 and the Professional Corporation: The Foglesong Case*, 8 J. CORP. TAX'N 35 (1981); Comment, *Section 482 and the Personal Service Corporation*, 26 ST. LOUIS U.L.J. 155 (1981).

5. Foglesong's wife and accountant each owned one share. 621 F.2d at 866.

6. 281 U.S. 111 (1930); see also *infra* notes 47-48 and accompanying text.

7. See text of I.R.C. § 482 (1976), *infra* text accompanying note 87.

ration would, in effect, be disregarded.<sup>8</sup> In remanding the case, however, the court of appeals instructed the Tax Court to determine that portion of the income which should be allocated to Mr. Foglesong under section 482.<sup>9</sup> On remand, the Tax Court accepted the Service's allocation of ninety-eight percent of the income to Mr. Foglesong, principally because he failed to prove that a lesser amount was appropriate.<sup>10</sup> On a second appeal, a different panel of the Seventh Circuit determined that section 482 could not apply because Mr. Foglesong as employee could not be considered a separate trade or business. Accordingly, the court remanded for consideration of whether assignment of income principles could be applied to allocate to Mr. Foglesong the dividends paid to his children and the commissions earned before incorporation but paid to and reported by the corporation. In short, Mr. Foglesong won at least a stalemate in the legal and factual war.

In *Keller v. Commissioner*,<sup>11</sup> the taxpayer, Dr. Keller, was a member of a medical partnership. He assigned his partnership interest to a corporation in which he was the sole shareholder and arranged to have the corporation establish a pension plan for him. Under the arrangement, the corporation made the maximum permissible contribution to the plan and paid Dr. Keller substantially all of the balance of its income as salary. The basic reason for creating the corporation was to take advantage of the fact that larger tax-free pension contributions were permitted for a corporate employee than for a partner.<sup>12</sup>

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8. It must be noted that Mr. Foglesong was able to demonstrate nontax reasons for the incorporation. Further, he scrupulously honored the corporate form of the transaction. 621 F.2d at 868-69. The Seventh Circuit apparently believed that application of assignment of income principles required allocating all corporate income to Mr. Foglesong. *Id.* at 868. This conclusion involves a misunderstanding of the applicable assignment of income principles, which only require allocation to the extent income is transferred without consideration. See *infra* Section IV A.

9. *Id.* at 872-73. Mr. Foglesong had made the transfers, which included some commissions already earned, at the end of August 1966 and took no salary for the balance of that year. The corporation chose an August 31 fiscal year-end and in succeeding years paid about 60% of the commissions in salaries. The children received over \$30,000 of dividend income on their preferred stock over a four-year period.

10. 77 T.C. at 1106.

11. 77 T.C. 1014 (1981), *aff'd*, 723 F.2d 58 (10th Cir. 1983).

12. Before TEFRA, pension laws greatly favored corporations over both partnerships and self-employed individuals. In the typical case, a doctor or an attorney formed a professional association ("P.A.") with himself as the only employee and assigned his interest in the partnership to the P.A. The P.A. then set up a pension plan and a profit sharing plan.

There are two types of pension plans. The first type is a defined benefit plan. Annual contributions are based on the amount of funds desired for retirement. The second type is a defined contribution plan. Annual contributions are based on a percentage of salary. The

The Service attempted to allocate all of the income to Dr. Keller under section 482<sup>13</sup> but failed, principally because the Tax Court determined that the aggregate compensation paid to Dr. Keller as both salary and pension plan contributions was essentially equal to the partnership share that he would have received; thus, he satisfied the "arms-length" test of section 482.<sup>14</sup> Noting that Congress had created pension and medical reimbursement plans to implement a specific policy, the court rejected the argument that the incorporation was improper because its principal purpose was to obtain the benefits of these plans.<sup>15</sup> Thus, Dr. Kel-

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type of plan chosen depends mainly on the age of the pensioner. An older person would use a defined benefit plan because the allowable contribution would be greater.

Partnerships and self-employed individuals are limited to H.R. 10 (Keogh) plans. Before TEFRA the maximum contribution was the lesser of \$15,000 or 15% of earned income. TEFRA has substantially reduced the amount of pension contributions allowed P.A.'s and has increased contributions for partnerships and self-employed individuals, thus substantially reducing, if not eliminating, the major incentive for forming P.A.'s. See S. REP. No. 494, 97th Cong., 2d Sess. 312-18, reprinted in 1982 U.S. CODE CONG. & AD. NEWS 781, 1052-59.

13. The Service also attempted to use assignment of income arguments, but the court gave these short shrift. 77 T.C. at 1030-34. Dr. Keller also attempted to assign to the corporation income from an affiliated corporation for 1974, even though the arrangements with the affiliated corporation were not made until 1975. *Id.* at 1018. Dr. Keller was held taxable on this compensation. *Id.* at 1027. Six judges dissented and would have applied the assignment of income doctrine to tax Dr. Keller on all of the income. *Id.* at 1035-45. *Keller* was followed in *Pacella v. Commissioner*, 78 T.C. 604, 618-22 (1982).

14. The arm's-length test, as expressed in *Foglesong*, requires that the "actual dealings between the [taxpayer] and the corporation reflect arm's length dealings between two uncontrolled parties." *Foglesong*, 77 T.C. at 1105 (citing *Keller*, 77 T.C. 1014 (1981), and *Achiro v. Commissioner*, 77 T.C. 881 (1981)).

15. 77 T.C. at 1029-30; see *Achiro v. Commissioner*, 77 T.C. 881 (1981) (explicitly holding that the creation of a corporation for such purposes is not improper tax avoidance); cf. Rev. Rul. 76-363, 1976-2 C.B. 90; Rev. Rul. 70-238, 1970-1 C.B. 61. Revenue Rulings 76-363 and 70-238 hold that the creation of a corporation to enjoy the benefits of either Subchapter S or Western Hemisphere Trade Corporation status is not improper tax avoidance. Both rulings are cited in *Achiro*, 77 T.C. at 865.

This aspect of *Keller* has been legislatively modified by the addition of I.R.C. § 269A to the Code by § 250 of TEFRA. See H.R. CON. REP. No. 760, 97th Cong., 2d Sess. 633-34, reprinted in 1982 U.S. CODE CONG. & AD. NEWS 1190, 1405-06. Ironically, after 1983 the TEFRA pension amendments render § 269A ineffective against an incorporation that has as its primary purpose the tax advantage associated with a corporate form with respect to pensions. This is because the pension amendments remove the disparity between pension contributions allowed for P.A.'s and self-employed individuals. See *supra* note 12. Furthermore, the "Blue Book" explicitly states that incorporating to obtain pension deduction benefits is not an item to be taken into account for purposes of § 269A during 1983, when the disparity will still exist. STAFF OF THE JOINT COMM. ON TAXATION, 97TH CONG., 2D SESS., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX EQUITY AND FISCAL RESPONSIBILITY TAX ACT OF 1982, at 326-27 (Comm. Print 1982). But see Prop. Treas. Regs. § 1.269A-1(d)(2)(ii) (pension benefits in excess of those available to employee-owner as individual has a tax benefit that may result in reallocation).

ler won both the legal and factual battles and, accordingly, the whole war.

In *Johnson v. Commissioner*,<sup>16</sup> the taxpayer, Charles Johnson, was a basketball player who negotiated contracts, using an SC as a financial planning device.<sup>17</sup> The various basketball teams for which Johnson played refused to recognize the contracts and insisted, instead, that Mr. Johnson sign player contracts with them. The teams did agree, however, to pay his salary to the corporation. The corporation then paid Mr. Johnson a salary that was considerably less than the amount that the teams paid to the corporation for his services. Also, the corporation occasionally made loans to Johnson. Applying the assignment of income doctrine, the Tax Court required Mr. Johnson to include in his income the full amount paid by the teams. The court's apparent rationale was that the basketball franchises had not recognized the contract between Johnson and his SC.<sup>18</sup> The opinion, however, mentioned neither *Foglesong* nor section 482. Accordingly, it is not completely clear why the courts, and particularly the Tax Court, thought that the assignment of income doctrine applied to Mr. Johnson but not to Mr. Foglesong or Dr. Keller.<sup>19</sup>

### B. *Transfers of Accounts Receivable and Payable*

Revenue Rulings 80-198<sup>20</sup> and 80-199<sup>21</sup> dealt with the incorporation of two cash basis businesses: a medical practice and a contracting business. Both rulings involved transfers of accounts receivable and accounts payable. Relying heavily on *Hempt Bros.*,

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16. 78 T.C. 882 (1982).

17. Although the opinion does not indicate who owned the corporation, Johnson did receive liberal loans from the corporation, and, therefore, the reasonable inference is that he was the beneficial owner. See *id.* at 887-88.

18. *Id.* at 891, 893. Although the Service in *Johnson* recognized the corporation as a separate juridical entity, the other contracting party, unlike in *Foglesong*, did not respect the separate corporate entity. *Id.* at 893. Presumably, had Johnson been able to demonstrate that the basketball franchises respected his separate corporation, the issue would have been framed under § 482.

19. The *Foglesong* court was much more liberal in its treatment of contracts between Foglesong's corporation and the manufacturers than was the *Johnson* court in dealing with the player-franchise contracts. In *Foglesong*, when the taxpayer formed his SC, there was no written contract between the corporation and the manufacturers. Several months later a written contract was prepared. Nevertheless, the court of appeals was prepared to accept that the SC, not Foglesong, should be taxed on the income earned after incorporation but before the new contracts were executed.

20. 1980-2 C.B. 113.

21. 1980-2 C.B. 122.

*Inc. v. United States*,<sup>22</sup> Revenue Ruling 80-198 held that the corporation rather than the transferor was taxable on the receivables when collected.

*Hempt Bros.* involved a mercantile, rather than a service business, that was conducted first as a partnership and then as a corporation. Because the partnership had used the cash method of accounting, however, the incorporation of the business raised several major issues that usually arise in connection with incorporating an SC. When the corporation was forced to adopt the accrual method of accounting required of all businesses maintaining inventories,<sup>23</sup> the taxpayer contended that, under assignment of income principles, the former partnership should have been taxed on the accounts receivable at the time of incorporation. Rejecting this argument, the court held the corporation taxable on receivables when collected.<sup>24</sup> Although the fact that the partnership years in question were closed under the statute of limitations clearly influenced the decision, the court determined that section 351<sup>25</sup> required that the income be taxed to the corporation rather than to the partnership.<sup>26</sup> Thus, the taxpayers in *Hempt Bros.* were no more successful than the Service in *Foglesong* and *Keller* in their attempt to invoke assignment of income principles.

Revenue Ruling 80-199 explicitly deals with the definition of liabilities under section 357(c)<sup>27</sup> before the addition of subsection

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22. 490 F.2d 1172 (3d Cir.), *cert. denied*, 419 U.S. 826 (1974).

23. Treas. Reg. § 1.446-1(c)(2)(i) (1957).

24. 490 F.2d at 1175-78.

25. I.R.C. § 351 (West 1978 & Supp. 1982).

26. The *Hempt Bros.* case delineates a conflict between the assignment of income doctrine and § 351 of the Code. In *Hempt Bros.*, the taxpayer argued that because the partnership had earned the receivables, they must be taxed to the partnership. The Service argued that the transfer of accounts receivable to the corporation was not a taxable event. Thus, the accounts receivable had a zero basis when transferred and must be included in the corporation's income when collected. The court resolved the conflict by relying on the congressional policy underlying § 351—facilitating incorporations—in finding for the Service. *Id.* at 1177.

27. I.R.C. § 357(c)(1) (1976) provides:

(c) **Liabilities in excess of basis**

(1) **In general**

In the case of an exchange—

(A) to which section 351 applies, or

(B) to which section 361 applies by reason of a plan of reorganization within the meaning of section 368(a)(1)(D),

if the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property



(c)(3) in 1978,<sup>28</sup> and essentially rejects the Service's victory in *Raich v. Commissioner*.<sup>29</sup> In *Raich* the taxpayer incorporated his contracting proprietorship, which had been on the cash basis method of accounting. The issue in *Raich* was whether he was taxable under section 357(c). The Service asserted that, upon incorporation, the amount of taxable gain equalled the excess of the liabilities assumed by the corporation less the tax basis in the assets transferred to the corporation. Yet the proprietorship's principal liability was the accounts payable, which had not been taken into account for tax purposes, and its principal asset was the accounts receivable, which had not been taken into income and which therefore had a zero basis. The Tax Court held Mr. Raich taxable. Implicit both in the decision and in the controversy that followed<sup>30</sup> was the assumption that, except for the excess of liabilities over basis, the rationale of *Hempt Bros.* was correct and Raich was not taxable on the receivables under assignment of income principles. This assumption was perpetuated in two subsequent cases that debated (1) whether the payables were includable as liabilities for the "liabilities in excess of basis" rule of section 357(c), and (2) if these liabilities were includable, whether taxpayers in Mr. Raich's position were entitled to any deduction for the payables assumed.<sup>31</sup> The underlying assumption of *Raich* is also implicit in the 1978 amendment to section 357(c),<sup>32</sup> which partially settled the contro-

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which is not a capital asset, as the case may be.

28. See Revenue Act of 1978, Pub. L. No. 95-600, § 365(a), (c), 92 Stat. 2763, 2854-55 (codified as amended at I.R.C. § 357(c)(3) (Supp. V 1981)).

29. 46 T.C. 604 (1966).

30. For a description of the controversy, see S. REP. NO. 1263, 95th Cong., 2d Sess. 183-84, reprinted in 1978 U.S. CODE CONG. & AD. NEWS 6761, 6946-47, and Kahn & Oesterle, *A Definition of "Liabilities" in Internal Revenue Code Sections 357 and 358(d)*, 73 MICH. L. REV. 461 (1975).

31. See *Thatcher v. Commissioner*, 533 F.2d 1114 (9th Cir. 1976) (liabilities are boot, but transferor entitled to deduction for liabilities paid by transferee if payment would have been deductible by transferor); *Bongiovanni v. Commissioner*, 470 F.2d 921 (2d Cir. 1972) (payables not liabilities, because only liabilities taken into account for tax purposes count under § 357(c)). The Tax Court in *Focht v. Commissioner*, 68 T.C. 223 (1977), essentially adopts the *Bongiovanni* position and overrules *Raich*.

32. I.R.C. § 357(c)(3) (Supp. V 1981) now provides:

**(3) Certain liabilities excluded**

**(A) In general**

If a taxpayer transfers, in an exchange to which section 351 applies, a liability the payment of which either—

(i) would give rise to a deduction, or

(ii) would be described in section 736(a),

then, for purposes of paragraph (1), the amount of such liability shall be excluded in determining the amount of liabilities assumed or to

versy by excluding ordinary payables from liabilities for this purpose.<sup>33</sup>

In Revenue Ruling 80-198,<sup>34</sup> the Service made explicit the implicit issue in *Raich*. The ruling permits the transfer of unrealized accounts payable and receivable in a section 351 tax-free exchange. Revenue Ruling 80-198 does not apply, however, in cases where there is an "assignment of an income right."<sup>35</sup> The ruling cites two cases to illustrate this point.<sup>36</sup> The first, *Brown v. Commissioner*,<sup>37</sup> involved a transfer of legal fees to a corporation owned by the transferor and a subsequent gift of control of the corporation to the transferor's wife;<sup>38</sup> the fees were taxed to the transferor when collected. The other case, *Rooney v. United States*,<sup>39</sup> involved a transfer to a corporation of farm land with unharvested crops. Subsequent to the transfer, the crops were harvested. The taxpayers reported as deductions the expenses of producing the crop, but the corporation reported the income from the sale of the crop. Section 482 was applied to allocate the expenses to the corporation.<sup>40</sup>

The cases and rulings briefly summarized demonstrate the confusion as to the proper roles of the assignment of income doctrine and its relation to section 482 in determining the appropriate tax treatment of an SC. The confusion stems from a failure to recognize that the two have quite different roles to perform; the failure to recognize that the assignment of income doctrine has three distinct meanings compounds the confusion. This article will attempt to clear up the confusion by exploring the meaning of the

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which the property transferred is subject.

**(B) Exception**

Subparagraph (A) shall not apply to any liability to the extent that the incurrence of the liability resulted in the creation of, or an increase in, the basis of any property.

See *supra* note 28.

33. See Hesch, *Planning For Tax-Free Exchanges Involving Partnerships and Incorporation of Partnerships*, 41 INST. ON FED. TAX'N 15-1, 15-32 to -33 (1983) (suggesting that the correct standard is whether disparate treatment would otherwise result depending on the taxpayer's method of accounting); see also *Orr v. Commissioner*, 78 T.C. 1059 (1982) (customer deposits held by travel agent were not § 357(c)(3) liabilities because the deposits did not represent obligations that would be deductible when paid).

34. 1980-2 C.B. 113.

35. *Id.* at 115.

36. *Rooney v. United States*, 305 F.2d 681 (9th Cir. 1962); *Brown v. Commissioner*, 40 B.T.A. 565 (1939), *aff'd*, 115 F.2d 337 (2d Cir. 1940).

37. 40 B.T.A. 565 (1939), *aff'd*, 115 F.2d 337 (2d Cir. 1940).

38. *Id.* at 566-67.

39. 305 F.2d 681 (9th Cir. 1962).

40. *Id.* at 682-83, 686. For additional discussion of *Rooney* and *Brown*, see *infra* notes 92-93, 111-12 and accompanying text.

phrase "assignment of income" in these cases and by exploring the proper interrelationship between the assignment of income doctrine and section 482. At the outset, however, it is necessary to do as the Seventh Circuit did in the first *Foglesong* appeal—demonstrate that an SC should properly be respected as a separate taxable entity.

### III. DISREGARD OF THE CORPORATION

In *Foglesong* and *Keller*, the Service attempted either to treat the corporation as sham or to treat the income of the corporation as income of the founder; these arguments are the same in substance. On the basis of the United States Supreme Court decisions in *Moline Properties v. Commissioner*<sup>41</sup> and *National Carbide Corp. v. Commissioner*,<sup>42</sup> the Seventh Circuit in *Foglesong* had little difficulty in respecting the separate corporate entity.<sup>43</sup> The decision is correct because the recognition of a corporation, including the one-shareholder corporation, as a separate taxable entity is fundamental to our current tax system.<sup>44</sup> Indeed, the Service's attack on the separate entity of the corporation in cases like *Foglesong* is anomalous in view of the Service's major program that insists on recognition of the separate corporate entity of both nominee and agency corporations. For example, in *Harrison Property Management Co. v. United States*,<sup>45</sup> the Court of Claims correctly upheld the Service's argument that a corporation created pursuant to a family control plan to facilitate management of property owned by a family group was a separate corporate entity and thus required to recognize income. The corporation, rather

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41. 319 U.S. 436 (1943). Noting that a corporation must be recognized as a viable tax entity if it was created to perform a business activity or if it carried on business activities, the *Moline* Court held that gains on the sale of property were taxable to the corporation created to facilitate financing, rather than to the corporation's owner.

42. 336 U.S. 422 (1949) (subsidiaries taxed on their earnings even though they were under contract to turn substantially all of the profits over to their parent).

43. 621 F.2d 865 (7th Cir. 1980), *rev'g & remanding* 35 T.C.M. (CCH) 1309 (1976), *on remand*, 77 T.C. 1102 (1981), *rev'd* 691 F.2d 848 (7th Cir. 1982).

44. See, e.g., Clark, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, 87 YALE L.J. 90 (1977).

45. 475 F.2d 623 (Ct. Cl. 1973), *cert. denied*, 414 U.S. 1130 (1974); see also Rev. Rul. 77-1, 1977-1 C.B. 161, *revoking* Rev. Rul. 56-542, 1956-2 C.B. 327, Rev. Rul. 68-28, 1968-1 C.B. 5, and Rev. Rul. 71-140, 1971-1 C.B. 161. The revoked revenue rulings had permitted participants in a "cost company" to take certain deductions and credits attributable to the property of the cost company. Rev. Rul. 77-1, to the contrary, recognizes cost companies as separate taxpaying entities. See generally Miller, *The Nominee Conundrum: The Live Dummy is Dead, but the Dead Dummy Should Live!*, 34 TAX L. REV. 213 (1979).

than the individual shareholders, was therefore entitled to the deductions attributable to ownership. Had the corporation been considered a mere agent or nominee, the deductions would have been available instead to the individual owners.<sup>46</sup>

#### IV. ASSIGNMENT OF INCOME PRINCIPLES

The application of assignment of income principles is complicated by the phrase being used to describe three related but distinct issues: (1) the gratuitous assignment of income (usually income not yet earned economically)—principally a question of to whom income is taxed; (2) the transfer of rights to income that has been earned economically but not yet recognized for tax purposes—frequently a question whether income will escape taxation because of tax accounting principles; and (3) the transfer of rights to income for consideration in transactions that seek to convert ordinary income into capital gain—a question of the character of income to the taxpayer at the time of receipt. This article is concerned principally with the first two of these issues.

##### A. *Gratuitous Assignment of Income*

The first major aspect of the assignment of income doctrine involves the gratuitous assignment of income earned by the services or property of the transferor. The gratuitous assignment of income doctrine and the descriptive fruit and tree analogy both stem from the Supreme Court decision of *Lucas v. Earl*.<sup>47</sup> In that case, pursuant to a non tax-motivated agreement,<sup>48</sup> Earl assigned to his wife a one-half interest in his future earnings. The Earls each reported one-half of Mr. Earl's \$192,000 salary. This saved taxes because there was no income splitting in the years in question.<sup>49</sup> The Supreme Court reasoned that Mr. Earl's service income could be taxed only to the earner. Therefore, Mr. Earl was required to report the entire income in the years earned. No effect was given to the "arrangement by which the fruits are attributed

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46. See *Roccaforte v. Commissioner*, 77 T.C. 263 (1981), *rev'd*, 708 F.2d 986 (5th Cir. 1983).

47. 281 U.S. 111 (1930).

48. It took place in 1901 before there was an income tax, which, of course, followed the sixteenth amendment in 1913.

49. The joint return privilege with its income splitting feature was added by the Revenue Act of 1948, Pub. L. No. 80-471, § 301, 62 Stat. 110, 114 (current version at I.R.C. §§ 1, 6013 (1976 & Supp. V 1981)).

to a different tree from that on which they grew."<sup>50</sup>

This doctrine was extended to property income in *Helvering v. Horst*.<sup>51</sup> Mr. Horst detached interest coupons from bonds that he continued to own and gave them to his son. The Supreme Court held that Mr. Horst, rather than his son, was taxable on the income when the interest was collected.<sup>52</sup> There have been many cases seeking to delimit what constitutes an adequate property transfer outside the *Horst* doctrine, the examination of which is beyond the scope of this article.<sup>53</sup> It is important to note, however, that in all of these cases, the transfers were gratuitous.<sup>54</sup>

An opposite finding would obtain if an arm's-length consideration were supplied for the transfer. Thus, in either *Horst* or *Earl*, if the transferee had paid the transferor the discounted value of the future income at the time of the assignment, there is little doubt that each transferor would have been taxed upon receipt of the consideration (assuming that the present income tax laws were in effect at the time).<sup>55</sup> Similarly, the transferee would have been

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50. 281 U.S. at 115. The fruit and tree analogy of the case has been a potent and persistent one in the federal income tax law. See, e.g., Lyon & Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case*, 14 MAJOR TAX. PLAN. 47, 65-70 (1962).

51. 311 U.S. 112 (1940).

52. There is some language in the opinion that would imply that the taxable event was the transfer. See *id.* at 116-18.

53. See generally Lyon & Eustice, *supra* note 50, at 58-60.

54. In fact, the Earls' contract contained an agreement to split their property and any income from that property as well as all earnings. The government respected the splitting of the income from the property but not from the services. The reason for the distinction is not clear. The taxpayer's argument was cast more in terms of the contract's having transferred to Mrs. Earl a beneficial property interest that should be respected for federal income tax purposes, rather than in terms of her having purchased such rights. Thus, the salary transfer was discussed as if it were separate from the property transfer, which appears sound since Mrs. Earl's property at the time was \$30,000 and Mr. Earl's was apparently considerably more, so that it would have been hard to treat her transfer as consideration for the salary transfer. See *Earl v. Commissioner*, 10 B.T.A. 723 (1928).

55. Cf. *Pounds v. United States*, 372 F.2d 342 (5th Cir. 1967) (broker taxed on collection of one-half of commission purchased from co-broker); G.C.M. 24849, 1946-1 C.B. 66.

Assignments of income rights by the earner for cash or property, measured by the then worth of such rights, may not be disregarded, and as respects such earner-assignor, he has elected to anticipate normal realization by assigning or discounting such right. Consideration received by him represents ordinary income realized by him upon the anticipatory assignment of his right to income. Once such rights to income from property or for services are separated from the earner by his act of assignment, they become property rights owned by the purchaser or assignee with a basis in his hands measured by the consideration paid. Thus, any discounting of the face value of the income right or claim by the earner thereof upon the assignment will result in income to the assignee when such discount is realized by him.

*Id.* at 68.

taxed on the amount received as salary or interest, but only to the extent that the payments received exceeded the consideration given.<sup>56</sup> This is entirely proper; the difference between the amount paid and that received represents either interest earned by the recipient from having paid the consideration in advance of collection (i.e., the time value of money) or, possibly, in a case like *Earl* in which the amount to be collected was uncertain, a good bargain.

In the case of a transfer to a wholly owned SC, the transfer is not gratuitous. The value of the stock received or the increase in the value of stock already owned,<sup>57</sup> of necessity, equals the value of the income transferred. Whether such transfer or receipt is taxable will be discussed below.<sup>58</sup>

### *B. Transfer of the Right to Collect Economically Earned Income and the Clear Reflection of Income Doctrine*

The second major aspect of the assignment of income doctrine involves income earned economically, but not "earned" for tax purposes; it is therefore properly called the "transfer of the right to collect economically earned income." The term "economically earned income" comprehends (1) income that has been earned but has not yet been reported for tax purposes because of the taxpayer's accounting method, and (2) amounts previously written off as losses or expenses that are subsequently recovered by the taxpayer. The principal questions litigated in this area involve corporate dividend and liquidating distributions, which may be considered, in a broad sense, gratuitous transfers.

#### 1. RIGHT TO COLLECT ECONOMICALLY EARNED INCOME

Some of the early cases dealing with the transfer of the right to collect economically earned income relied on the gratuitous assignment of income doctrine.<sup>59</sup> Nevertheless, the real issue is

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56. *Cf. Stranahan v. Commissioner*, 472 F.2d 867 (6th Cir. 1973) (father taxed in 1964 on proceeds received from son representing discounted value of dividends sold to son; son reported full dividends received in 1965, offset by payment to father—the Service had contended that the transaction represented a loan and that the father was taxable in 1965, when the dividends were collected).

57. *Cf. Pvt. Ltr. Rul. 7935115 IRS LETTER RUL. REP. (CCH) No. 131 (May 31, 1979)* (on gratuitous transfer of stock by family member to corporation, the amount of gift for gift tax purposes to other family members who owned stock in corporation was measured by the excess of value of stock transferred, over increase in value of retained stock).

58. See *infra* notes 102, 115-18 and accompanying text; see also note 84.

59. See, e.g., *Commissioner v. First State Bank*, 168 F.2d 1004 (5th Cir.), *cert. denied*, 335 U.S. 867 (1948).

whether the clear reflection of income requires that income be reported at the time of the transfer even though it would not normally have been reported then, absent a transfer. The leading case in this area is *Commissioner v. First State Bank of Stratford*.<sup>60</sup> That case involved a bank's distribution of promissory notes that had been written off as worthless in a prior tax year, but that later recovered their value. Had the bank collected the notes, clearly it would have had to recognize the income element under the tax benefit theory.<sup>61</sup> The bank contended that the distribution of the notes did not result in recognition of income under the principle of *General Utilities & Operating Co. v. Helvering*<sup>62</sup> that a corporation does not realize or recognize income on distributions to its shareholders. The court of appeals held that, under the assignment of income doctrine, the bank had to recognize income when the notes were collected by the shareholders. The court relied on *Horst* even though there was no separation of the fruit from the tree when the notes together with their corresponding interest element were distributed rather than merely the interest element.

Unlike cases involving gratuitous assignments of income (where the issue is *to whom* the income will be taxed), a major issue in those distributions is whether the income will be taxed. The distribution would escape taxation entirely unless taxed upon distribution because the shareholders' tax basis in the notes is generally the notes' fair market value.<sup>63</sup>

Although the court in *First State Bank* applied gratuitous assignment of income principles in taxing the collections on the notes when received by the shareholders, later cases, generally aris-

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60. *Id.*

61. See *Alice Phelan Sullivan Corp. v. United States*, 381 F.2d 399 (Ct. Cl. 1967) (corporation taxed on return of property previously given to charity at amount of deduction previously taken, even though tax in year of return was higher than tax saving in year of original gift); see also *infra* note 66-80 and accompanying text. See generally Bittker & Kanner, *The Tax Benefit Rule*, 26 U.C.L.A. L. Rev. 265 (1981).

62. 296 U.S. 200, 205-06 (1935). Although the *General Utilities* case is generally cited for this principle, the only substantive issue decided by the Supreme Court was that the court of appeals had erred in attributing to the corporation a subsequent sale of distributed property. The basis for the reversal was that the court of appeals did not properly have before it the question of a subsequent sale. The Board of Tax Appeals and the court of appeals assumed that the distribution would be taxable only if the resolution declaring it had fixed a dollar amount. They had held that the resolution did not so provide.

63. I.R.C. § 301(d)(1) (1976 & Supp. V 1981) provides that the basis of property received as a dividend distribution by a noncorporate distributee is its fair market value. Although the provision is new in the 1954 Code, the legislative history indicates that it is a declaration of existing law. See H.R. REP. No. 1337, 83rd Cong., 2d Sess. A70-71, *reprinted in* 1954 U.S. CODE CONG. & ADMIN. NEWS 4017, 4207.

ing under sections 334(b)(2) and 336,<sup>64</sup> have taxed the income at time of distribution or upon a nonrecognition sale under section 337.<sup>65</sup> The latter is the more correct approach because the transactions are not ones involving transfer of basis, which indicates that the recipient of the distribution or the buyer is considered a separate and independent taxpayer whose collections should not relate back to the transferor.

## 2. PREVIOUSLY EXPENSED ITEMS

Taxation of distributions and liquidation sales, under the assignment of income theory, is closely related to taxation of previously expensed items, such as small tools and supplies, in these transactions.<sup>66</sup> In the liquidation-sale context, the courts and the Service normally invoke the tax benefit rule and generally tax the recovery of previously deducted amounts where the prior deduction resulted in a tax benefit.<sup>67</sup> Until the Supreme Court's decision in *Hillsboro National Bank v. Commissioner*,<sup>68</sup> there was controversy concerning the kind of "recovery" required to invoke the rule.

Some courts, most notably the United States Court of Appeals for the Ninth Circuit, had refused to apply the tax benefit principle to liquidations on the theory that a corporation has no recovery when it makes a distribution in liquidation.<sup>69</sup> Others, most notably

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64. I.R.C. § 336 West 1978 & Supp. 1982 provides, with certain exceptions, that no gain or loss is recognized by the distributing corporation on distributions in complete liquidation. There is no general exception for distributions in which the basis to the distributee is determined by reference to the basis of recently purchased stock. See, e.g., I.R.C. § 334(b)(2) (1976) (repealed 1982). TEFRA replaced § 334(b)(2) with § 338, Pub. L. No. 97-248, § 224(a), 96 Stat. 324, 485 (West Supp. 1982). Section 338 provides for a similar step-up in basis by election rather than by liquidation, and it explicitly applies § 337 for determining the consequences of a hypothetical transfer of assets. I.R.C. § 337 (West 1978 & Supp. 1982) generally provides for nonrecognition of gain or loss on sales by a liquidating corporation.

65. *Midland-Ross Corp. v. United States*, 485 F.2d 110 (6th Cir. 1973) (construction corporation using completed contract method of accounting taxed in year of sale, under I.R.C. § 337, on completed contracts transferred); see *Williamson v. United States*, 292 F.2d 524 (Ct. Cl. 1961) (cash basis corporation taxed in year of liquidation on accounts receivable distributed to shareholders; year of collection not shown). But see *Siegel v. United States*, 464 F.2d 891 (9th Cir. 1972), cert. dismissed, 410 U.S. 918 (1973); *Sol C. Siegel Prod., Inc. v. Commissioner*, 46 T.C. 15 (1966) (cash basis corporation, which remained in existence after a liquidating distribution of contract rights, was taxable in year of collection, not in year of distribution).

66. See *infra* notes 82-86 and accompanying text.

67. See *supra* note 61 and accompanying text.

68. *Hillsboro Nat'l Bank v. Commissioner*, 103 S. Ct. 1134 (1983).

69. See *Bliss Dairy, Inc. v. United States*, 645 F.2d 19 (9th Cir. 1981) (per curiam), *rev'd & remanded sub nom. Hillsboro Nat'l Bank v. Commissioner*, 103 S. Ct. 1134 (1983);



the United States Court of Appeals for the Sixth Circuit,<sup>70</sup> had found that recovery was not required to apply the principle, but found taxable those events inconsistent with prior deductions. The distribution in liquidation of previously expensed items that still have value is inconsistent with the prior deduction and is an example of such a taxable event. This result was approved in *Hillsboro*, although with some narrowing—the subsequent event must be “fundamentally inconsistent with the premise on which the deduction was initially based.”<sup>71</sup> The tax benefit doctrine, so limited, essentially applies tax accounting principles and determines that taxation at the time of the distribution is necessary to clearly reflect income as required by Code section 446(b).<sup>72</sup> Although the Court did not rely on this section, doing so would have clarified the opinion.<sup>73</sup>

### 3. RESERVES FOR BAD DEBTS

A superficially similar application of the section 446(b) clear reflection of income issue was involved in *Nash v. United States*.<sup>74</sup> In *Nash* an accrual basis partnership that had established a bad debt reserve was incorporated. The Service contended that the re-

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Commissioner v. South Lake Farms, Inc., 324 F.2d 837 (9th Cir. 1963), *nonacq.*, 1977-2 C.B. 2. In Rev. Rul. 74-396, 1974-2 C.B. 106, the Service disagreed with the Ninth Circuit's requirement of “recovery” as expressed in Commissioner v. South Lake Farms, Inc., 324 F.2d 837 (9th Cir. 1963). The Service clarified its position, in Rev. Rul. 77-67, 1977-1 C.B. 33, by explaining that it had acquiesced to the Tax Court's decision in *South Lake*, 36 T.C. 1027 (1961), because the “tax benefit” issue was raised on appeal only. See Comment, *The Tax Benefit Rule: Recovery Reevaluated*, 36 U. MIAMI L. REV. 533 (1982). Regardless, the Supreme Court's *Hillsboro* decision has settled the issue, ostensibly at least, in favor of the Service. See *infra* text accompanying notes 70-73.

70. See *Tennessee-Carolina Transp., Inc. v. Commissioner*, 582 F.2d 378 (6th Cir. 1978), *cert. denied*, 440 U.S. 909 (1979); see also *Hillsboro Nat'l Bank v. Commissioner*, 641 F.2d 529 (7th Cir. 1981), *rev'd*, 103 S. Ct. 1134 (1983).

71. 103 S. Ct. at 1143 (footnote omitted).

72. I.R.C. § 446(b) (1976) provides that “if the method [of accounting] used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.”

73. In a dissenting opinion, Justice Stevens protested, “I cannot tell whether or why the fundamentally inconsistent event theory prefers LIFO accounting over FIFO.” 103 S. Ct. at 1162-63. Because LIFO and FIFO are simply methods of determining inventory cost and do not involve deductions, an event such as distribution in liquidation cannot be “inconsistent,” whereas distribution of gain that has previously been deducted is. See *infra* text accompanying note 83. Recognizing this distinction, Rev. Rul. 74-431, 1974-2 C.B. 107, held that there is no need to include the difference between LIFO and FIFO amounts in a sale under § 337. The amendment adding what are now § 336(b) and § 337(f), however, changes the result of the ruling. See Pub. L. No. 96-223, § 403(b)(1), (2)(A), 94 Stat. 229, 304-05 (1980).

74. 398 U.S. 1 (1970).

serve had to be included in the partnership's income upon incorporation because the partnership, no longer being in business, no longer needed the reserve. The Service's argument was made without regard to whether the fair market value of the receivables was equal to their gross or net book value (face amount of receivables reduced by the reserve for bad debts), or to some other relevant amount. The Supreme Court held that such an adjustment was not required absent evidence that the receivables were worth more than their net book value. Although the Court cast its decision in terms of an absence of a recovery, it also referred to the nonrecognition provisions of section 351<sup>75</sup> as a secondary basis of its opinion. If the nonrecognition rules with their corollary of transferred basis<sup>76</sup> are taken into account, then even if the receivables have a fair market value greater than their net book value, nothing will escape taxation. This is because the transferee-corporation will have to report the excess in the form of reduced future additions to the bad debt reserve. Accordingly, the Service should not require the reserve to be taken into income when there is a carryover basis, regardless of whether the receivables have a fair market value equal to or greater than their net book value. This is implicitly, although unfortunately not explicitly, recognized in a trilogy of revenue rulings issued in response to *Nash*.<sup>77</sup>

In the first two rulings, which dealt respectively with liquidations under sections 332 and 334(b)(2)<sup>78</sup> and with liquidation sales under section 337,<sup>79</sup> two situations are considered. In the first situation, the receivables have a fair market value equal to their net book value. In the second, the fair market value exceeds the net book value. Applying tax benefit principles, both rulings hold that no amount need be included in income in the first situation, but in the second situation, the excess of the fair market value over the net book value must be included in income. In the third ruling, which dealt with a section 351 transfer, the only situation consid-

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75. I.R.C. § 351(a) (Supp. V 1981) provides, "No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation."

76. I.R.C. § 358 (1976 & Supp. V 1981) provides that the basis of property to the transferee in a transfer governed, *inter alia*, by § 351, will be the basis in the hands of the transferor adjusted for gain recognized.

77. See Rev. Rul. 78-80, 1978-2 C.B. 139; Rev. Rul. 78-279, 1978-2 C.B. 135; Rev. Rul. 78-278, 1978-2 C.B. 134.

78. Rev. Rul. 78-278, 1978-2 C.B. 134.

79. Rev. Rul. 78-279, 1978-2 C.B. 135.

ered is one where the fair market value equals the net book value of the receivables.<sup>80</sup> The ruling holds that the transferor need not include anything in income. The ruling continues by detailing the treatment of the transferee-corporation, depending on whether the reserve or the specific charge-off method is used to account for receivables. If the reserve method is used, the transferee must, for tax purposes, carry the receivables at face value less the reserve for bad debts. The reserve is nondeductible to the transferee-corporation as it has already been deducted by the transferor. If the specific charge-off method is used, the transferee must, for tax purposes, carry the receivables at their basis, net of the reserve. The reserve must be allocated ratably to the fair market value of the receivables in the absence of some other basis for allocation. These accounting principles could be applied equally as well to the second situation—where the receivables have a fair market value greater than their net book value. In short, the section 351 transfer is not an event inconsistent with the prior deduction, whereas a section 334(b)(2) liquidation and a section 337 liquidation sale are inconsistent because the transferee gets a fair market value basis rather than a transferred basis.

#### 4. CLEAR REFLECTION OF INCOME

The same rationale should apply where a right to collect economically earned income is transferred. In transactions under section 351, the existence of a transferred basis obviates the need to require immediate recognition to clearly reflect income because the transferee will report it in due course.<sup>81</sup> Conversely, in transactions under sections 337, 338, and old 334(b)(2), as well as under sections 311 and 333,<sup>82</sup> the tax must be collected at the time of the distribution because there is no carryover of basis; otherwise the

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80. Rev. Rul. 78-280, 1978-2 C.B. 139.

81. See the discussion of Rev. Rul. 80-198, *supra* notes 1, 20-26, 30-40 and *infra* notes 110-12 and accompanying text.

82. I.R.C. § 311 (West 1978 & Supp. 1982) provides for nonrecognition of gain to the distributing corporation on dividend distributions and on certain redemptions. In the case of a dividend, the basis to the distributee is generally the fair market value. I.R.C. § 301(d) (1976 & Supp. V 1981); *see supra* note 63. In the case of a redemption, the distributee's basis is the fair market value because the distributee recognizes gain on the transaction under § 1011. *See* I.R.C. 302(a) (West Supp. 1982). I.R.C. § 333 (1976) provides generally for nonrecognition of gain to the distributee on certain one-month liquidations, with basis equal to the distributee's basis in the stock under § 334(c). Section 333 was involved in *Bliss Dairy*, 645 F.2d 19 (9th Cir. 1981) (*per curiam*), *rev'd & remanded sub nom.* *Hillsboro Nat'l Bank v. Commissioner*, 103 S. Ct. 1134 (1983). *See supra* note 69.

opportunity to tax vanishes.

That the items will otherwise escape taxation is not sufficient in itself to require inclusion in income, as the cited sections are all general nonrecognition provisions. They state that no gain or loss is to be recognized in transactions subject to their provisions. It must be remembered, however, that we are dealing here with a rather narrow group of items. The transfer of the right to collect economically earned income includes such items as accounts receivable that already have been earned in economic or accounting terms, but that have not been reported yet because of the use of the cash or some other special method of accounting (such as the completed-contract method). The tax benefit cases generally concern such items as small tools and other supplies that normally should be deducted only as used, but that as a matter of administrative convenience, are permitted to be deducted on purchase.<sup>83</sup> In each case, the permitted accounting practices distort income to some degree, but the distortion is acceptable in the ordinary course of business because eventually there will be either an inclusion in income or the items will be exhausted without further deduction. Only a timing matter is involved. When an event occurs that means there will never be the normally expected "day of reckoning," immediate inclusion in income is required.

When it is recognized that a question of proper tax accounting is involved, rather than whether a nonrecognition provision should be applied or an "exception" created, these cases become quite simple.<sup>84</sup> All of the items should be reported when, and only when, an event inconsistent with the accounting practice occurs. A transfer of such items without a transfer of basis is such an event; a transfer with a transferred basis generally is not.<sup>85</sup> As was indi-

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83. See Treas. Reg. § 1.162-3 (1958).

84. In one sense, the application of a nonrecognition provision involves the third aspect of the assignment of income doctrine—the characterization of the receipt when there has been a transfer of an income right in exchange for consideration. The taxpayers in *Hempt Bros., Inc. v. United States*, 490 F.2d 1172 (3d Cir.), *cert. denied*, 419 U.S. 826 (1974), invoked *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260 (1958) (holding that amounts received for a "carve-out" of oil or mineral payments are ordinary income, not capital gain), in arguing that the partnership receivables were taxable to the partnership. The Court determined that the congressional policy underlying § 351 overrides the assignment of income doctrine and makes the receipt of stock in a § 351 transaction a nonrecognition event. See *supra* notes 22-26 and accompanying text.

85. The importance of this distinction is recognized in § 247 of TEFRA, Pub. L. No. 97-248, § 247 (not codified in the I.R.C.), which permits liquidation of certain personal service corporations under I.R.C. § 333 (1976) without the recognition of unrealized receivables (as would normally be the case), subject to the requirement that the receivables be assigned a

cated above, the Supreme Court implicitly recognized this in *Hillsboro*.<sup>86</sup> Thus, except to the extent that section 482 applies, there is no reason to apply any different approach in taxing SC's.

## V. SECTION 482

The final provision that must be considered in determining the proper taxation of SC's is section 482 of the Code, which provides:

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses.<sup>87</sup>

The application of section 482 thus requires that there be two or more trades or businesses and that they be commonly controlled by the same interests. Once these two elements are met, section 482 permits the allocation of income and deductions to reflect income clearly and to prevent tax evasion.

### A. *Two (or More) Trades or Businesses*

As to the first requirement, a question has arisen as to whether a shareholder who also is an employee of the corporation is engaged in two separate trades or businesses, permitting the allocation of income to him from his controlled corporation. Although the courts, beginning with the case of *Ach v. Commissioner*,<sup>88</sup> have approached this issue somewhat gingerly, in *Keller* and *Foglesong* the Tax Court correctly assumed that the answer is "yes." On the other hand, the Seventh Circuit in the second *Foglesong* appeal reached the opposite conclusion. It reasoned that "or-

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zero basis.

86. See *supra* text accompanying notes 68-73.

87. I.R.C. § 482 (1976).

88. 358 F.2d 342 (6th Cir. 1966), *aff'g* 42 T.C. 114 (1964), *cert. denied*, 385 U.S. 899 (1966); see also *Rubin v. Commissioner*, 56 T.C. 1155 (1971) (explicitly stating that it did not find employee status constituting, in and of itself, a trade or business, but nevertheless allocating income to shareholder-employee under § 482).

ganization" in section 482 requires a business entity of independent significance and requires that the employee have some business operation other than services as a corporate employee.<sup>89</sup> This approach is too narrow. Since for many other purposes it is recognized that an employee is engaged in a trade or business,<sup>90</sup> there is no reason why a shareholder-employee should not be so recognized. Furthermore, external activities by an employee (i.e., whether he is otherwise engaged in separate activities that can be characterized as a separate business) are irrelevant to the allocation of income related to his services to the corporation. On the other hand, if the shareholder is not also an employee, it is somewhat difficult to see any reason for allocating income to him.<sup>91</sup>

### B. Control

The second requirement, that the businesses be controlled by the same interests, provides one of the principal reasons why section 482 cannot answer all SC taxation problems and why the gratuitous assignment of income doctrine is still needed. This appears to have been the Service's initial concern in Revenue Ruling 80-198 when it limited that ruling to instances where the transfer involves "an assignment of an income right."<sup>92</sup> The ruling cites *Brown v. Commissioner*,<sup>93</sup> which involved a transfer to a corporation of the right to collect a legal fee, followed by the transfer of that corporation's stock to the transferor's wife. The revenue ruling cites *Brown* for two propositions: first, that such a transaction properly involves the application of *Lucas v. Earl* (assignment of income) principles in a section 351 transfer and, second, that the transfer of a legal fee to a corporation not engaged in business is an example

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89. 691 F.2d 848 (7th Cir. 1982).

90. See, e.g., *United States v. Generes*, 405 U.S. 93 (1972) (recognizing that if the dominant motive of a loan by a shareholder-employee to the corporation were to protect his employee status, loss on nonpayment would be deductible as a business bad debt; the Court, however, made a finding of fact that such dominant motive was not present and that the loss was nonbusiness).

91. See *Davis v. Commissioner*, 64 T.C. 1034 (1975) (orthopedic surgeon not taxed on income of x-ray and physical therapy corporations, 90% of the stock of which was owned by his minor children, when he did not render substantial services to the corporations). The result of this case may be affected by I.R.C. § 269A added by TEFRA. See *supra* note 2. But see *Horn v. Commissioner*, 1982 Tax Ct. MEM. DEC. (P-H) ¶ 82,741 (Dec. 28, 1982) (allocating x-ray corporation's income to orthopedic professional corporation, where x-ray corporation had no employees or activities separate from the professional corporation).

92. See *supra* note 35 and accompanying text.

93. 40 B.T.A. 565 (1939), *aff'd*, 115 F.2d 337 (2d Cir. 1940); see *supra* notes 37-38 and accompanying text.

of tax avoidance. The ruling confuses two ideas. The transfer of the stock to the wife (or any transfer to a corporation owned by the wife) should properly have triggered the gratuitous assignment of income principle.<sup>94</sup> The limitations in Revenue Ruling 80-198 demonstrate that the first panel of the court of appeals in *Foglesong* incorrectly rejected the application of that doctrine. Assume that, in the *Foglesong* case, Mr. Foglesong had not retained the common stock of the corporation but had arranged for all of the stock to be owned by his children. Section 482 then should not apply as there would be no control by the same interests (unless it might be possible to equate Mr. Foglesong's children with Mr. Foglesong).<sup>95</sup>

Equating Mr. Foglesong with his children considerably strains the concept of their separate identities. In many other contexts, the courts have been reluctant to find an identity of interest between members of a family, absent specific statutory attribution rules.<sup>96</sup> Statutory language more definite than the general words "same interests" is required before courts find that a parent and his children are the "same interests."<sup>97</sup>

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94. In this respect, the decision in *Brown* does not support the argument that the transfer of the stock to the wife was important. On rehearing the court explicitly stated that the assignment of income doctrine was used under the assumption that Mr. Brown was the stockholder. This aspect of the case was implicitly rejected in *Hempt Bros.* and in Rev. Rul. 80-198. The other aspect, that the transfer had nothing to do with the business of the transferee corporation, is more properly a § 482 issue. See *infra* note 112 and accompanying text.

95. Cf. *Burr Oaks Corp. v. Commissioner*, 365 F.2d 24 (7th Cir. 1966), *aff'g* 43 T.C. 635 (1965), *cert. denied*, 385 U.S. 1007 (1967). In *Burr Oaks*, the husbands and a brother of the owners of a corporation's common stock transferred property to the corporation in exchange for corporate notes. The Court of Appeals for the Seventh Circuit affirmed the Tax Court's holding that the notes were preferred stock and that the transferors were members of the control group for purposes of § 351, even though their preferred stock had no vote. The court of appeals emphasized that the transferors exercised practical control of the corporation. In view of the finding that the notes were preferred stock, however, this seems unnecessary because the definition of control in I.R.C. § 368(c) (1976) includes nonvoting stock (whether common or preferred). Accordingly, the principle of Rev. Rul. 73-472, 1973-2 C.B. 114 and Rev. Rul. 73-473, 1973-2 C.B. 115—which excludes from the control group transferors who had only debt securities—would not apply.

96. See, e.g., *In re Estate of Lukens*, 246 F.2d 403 (3d Cir. 1957), *aff'g* 26 T.C. 900 (1956) (The court did not treat a father's redemption of part of his stock as equivalent to a dividend, even though the remainder of the stock was owned by family members. The court recognized, however, that the result of the case, which was decided under § 115(g) of the Internal Revenue Code of 1939, would be changed by §§ 302 and 318 of the 1954 code).

97. See, e.g., I.R.C. § 704(e)(3) (1976); *id.* § 1366(e) (West Supp. 1982) (formerly § 1375(c) (1976)). These provisions deal with family partnerships and family groups in subchapter S corporations, and specifically authorize allocation to recognize the value of services of a family member. Section 269A added by TEFRA, see *supra* note 2, also explicitly authorizes the allocation of income of certain personal service corporations to their em-

In cases where section 482 cannot apply because of lack of control, however, the assignment of income doctrine works quite well. Thus, in the hypothetical, to the extent that Mr. Foglesong did not receive or own stock in the transferee corporation which is increased in value by his services, allowing the corporation to collect the value of his services without adequate compensation is clearly a gratuitous assignment, and Mr. Foglesong should be taxed on the transferred income; but it is not within section 482. This was recognized by the second panel in *Foglesong*, which, after refusing to apply section 482, remanded the case for application of assignment of income principles to commissions earned before incorporation and to dividends paid to Mr. Foglesong's children. As a practical matter, the Tax Court should determine the amount on which Mr. Foglesong should be taxed on the basis of considerations similar to those discussed below for the application of section 482 (i.e., the degree to which he has been adequately compensated for his services).<sup>98</sup> In this regard, the approach of the second panel is too narrow because it seeks to tax him only on dividends distributed to his children and not on the income of the corporation accumulated for future distribution to them; thus, this approach grants Mr. Foglesong, at a minimum, an improper tax deferral until distribution of the accumulated income.

### C. Allocation of Income

The third and most important element of section 482 is the ability of the Secretary to allocate income to prevent tax evasion or to reflect clearly the income of the trades or businesses involved. The concept of clearly reflecting income is somewhat different in the section 482 context than in transfer of rights to economically earned income where the doctrine is applied to prevent timing rules from allowing tax avoidance.<sup>99</sup> The regulations indicate that section 482 is designed to determine the "true taxable income . . . which means, in the case of a controlled taxpayer, the taxable income . . . which would have resulted to the controlled taxpayer, had it in the conduct of its affairs . . . dealt with the other member or members of the group at arm's length."<sup>100</sup> Thus the general

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ployee-owner (a term defined by using constructive ownership rules) to prevent tax evasion or to clearly reflect income—a standard similar to that of § 482. See *infra* text accompanying notes 115-18.

98. See *infra* notes 115-18 and accompanying text.

99. See *supra* note 59-85 and accompanying text.

100. Treas. Reg. § 1.482-1(a)(6) (1962).



standard is one of arm's-length dealing. In this sense it has elements closely related to the gratuitous assignment of income doctrine, as its result is to determine to whom rather than when income is taxed. On the other hand, a shareholder is entitled to make transfers to a controlled corporation, including transfers of the right to collect earned income, without recognition at the time of the transfer.<sup>101</sup>

## VI. RELATIONSHIP BETWEEN SECTIONS 482 AND 351

The question then arises whether Mr. Foglesong and Dr. Keller are entitled to transfer to their SC's their right to earn income at whatever salary they desire, or even at no salary, without examination under section 482 or otherwise. The Tax Court in *Foglesong* and *Keller* correctly indicated that section 482 does apply. How then are the provisions of sections 482 and 351 to be reconciled? In the first instance, they can be reconciled by noting that section 351 applies only to transfers of property to controlled corporations, and not to transfers of services. It is clear that, to the extent that stock is received in a controlled corporation in exchange for services, income is recognized.<sup>102</sup>

As will be discussed below,<sup>103</sup> cases like *Foglesong* may also involve a transfer of intangible property that represents an entrepreneurial, good will, or going concern value.

### A. When Section 482 Applies to a Non-Arm's-Length Property Transfer to a Controlled Corporation

When dealing with property, several questions concerning the

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101. See *supra* notes 47-58 and accompanying text.

102. See I.R.C. § 351(d)(1) (Supp. V 1981); Treas. Reg. § 1.351-1(a)(1), (2)(ex. 3) (1955). If no stock is received, the issue is more difficult. In the case of a wholly owned corporation, it might be argued that the result should be the same, as if stock were received, since the receipt of stock is essentially meaningless. Cf. *Commissioner v. Morgan*, 288 F.2d 676 (3d Cir.), *cert. denied*, 368 U.S. 836 (1961) (reorganization found on transfer of stock to controlled corporation even though no stock was distributed as provided in the predecessors (§§ 112(b)(3) and 112(g)(1)(D) of the Internal Revenue Code of 1939) of I.R.C. §§ 354(b)(1)(B) and 368(a)(1)(D) (1976 & Supp. V 1981); Rev. Rul. 81-3, 1981-1 C.B. 125 (partial liquidation treatment on pro rata distribution even though there was no redemption as provided in § 346(a)(2) (repealed 1982) (current version at § 302(b)(4),(e) (West Supp. 1982)); Rev. Rul. 79-257, 1972-2 C.B. 136 (similar to Rev. Rul. 81-3, but involving wholly owned subsidiary). Partial liquidation treatment in the absence of an actual redemption was explicitly endorsed in the legislative history of the TEFRA amendments enacting § 302(b)(4) and repealing § 346(a)(2). See GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX EQUITY AND FISCAL RESPONSIBILITY TAX ACT OF 1982, *supra* note 15, at 126.

103. See *infra* notes 115-18 and accompanying text.

relationship between sections 482 and 351 remain. For one, if there is a transfer of property at a non-arm's-length price, does section 482 inevitably apply? This issue was raised in *Huber Homes, Inc. v. Commissioner*.<sup>104</sup> In *Huber Homes* a construction corporation built houses and transferred them at cost to its controlled subsidiary, which then rented them out. The parties stipulated that an unrelated buyer would have paid a substantially higher price. The Service argued that, under section 482, the proper result would be for the transferor corporation to include as income the excess of the fair market value of the houses over the price at which they were transferred. This taxed excess would be reflected as an increase in the basis of the homes held by the subsidiary. The Service acknowledged that if the transfer had been without consideration, then no income would have been recognized; but it argued that since the transfer was in the form of sale, it had to be at arm's length. The court properly rejected this argument on two grounds: First, it concluded that section 482 does not permit the "creation of income"—a rationale rejected in later cases;<sup>105</sup> and second, it recognized that in some cases it is appropriate for a controlling person to contribute to the capital of his controlled corporation. On the other hand, numerous cases have applied section 482 to situations in which a parent sells property to its controlled subsidiary at less than the property's fair market value, and also to other transfers among controlled entities.<sup>106</sup>

The question remains, can the differing results be justified? The solution appears to be that *Huber Homes* involved a single transfer of property to be used in the business of the subsidiary. There was no indication that the subsidiary intended to resell the property. The latter cases, instead, involved transactions in the ordinary course of business of the transferor and transferee—usually the inventory of both. In such cases, the policy of section 351 to facilitate transfers to controlled corporations must yield to the pol-

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104. 55 T.C. 598 (1971).

105. See, e.g., *Latham Park Manor, Inc. v. Commissioner*, 69 T.C. 199 (1977) (allocating interest to subsidiaries on noninterest-bearing loans to parent, even though parent did not use any part of loan to produce income that could be allocated to the subsidiaries). Although the same result could have been reached by allocating the subsidiaries' interest deductions to the parent, the court did not rely on this argument. The regulations also create arms-length interest and other charges without finding actual deductions to reallocate. See, e.g., Treas. Reg. § 1.482-2(a),(b) (1968).

106. See, e.g., *E.I. Du Pont de Nemours & Co. v. United States*, 608 F.2d 445 (Ct. Cl. 1979); *Eli Lilly & Co. v. United States*, 372 F.2d 990 (Ct. Cl. 1967). The courts in both cases allocated to a parent-manufacturer the income in excess of the sales prices of inventory sold to a subsidiary-distributor.

icy of section 482 to ensure that the "true taxable income" of various controlled entities in the ordinary course of business transactions is properly determined and taxed. In short, the most reasonable harmonization of the two provisions that adequately recognizes the policies of both is to apply section 482 to transactions occurring in the ordinary course of business and to apply section 351 to transactions that involve the creation of a controlled corporation and to extraordinary transfers to a controlled corporation (i.e., not in the ordinary course of business).

The distinction between extraordinary transactions and transactions occurring in the ordinary course of business, however, is not by itself a sufficient basis for determining that section 351 rather than section 482 should apply. There are certain one-shot transactions in which section 482 must be given priority. For example, in *National Securities Corp. v. Commissioner*,<sup>107</sup> the predecessor of section 482<sup>108</sup> was properly applied to allocate back to the parent-transferor a tax loss on stock where the subsidiary promptly sold the stock after transfer.<sup>109</sup> The short period of ownership by the subsidiary factually distinguishes *National Securities* from *Huber Homes*. Accordingly, this is not the type of transaction that fits within the policy of section 351, because it has no relation to an ongoing business of the transferee. The blatant attempt to shift the loss in *National Securities* is clearly the type of income-shifting that section 482 was designed to prevent.

A further conflict between sections 482 and 351, involving aspects of "transfers of the right to collect economically earned income,"<sup>110</sup> was dealt with somewhat summarily in Revenue Ruling 80-198. In that ruling, the Service stated (using *Rooney v. United States*<sup>111</sup> as an illustration) that the nonrecognition principle of section 351 may not apply to a transfer in which the transferor takes a deduction for crop expenses before the transfer of the crops, which were subsequently harvested by the new transferee-corporation.<sup>112</sup> Because Revenue Ruling 80-198 allows the transfer of routine receivables and payables as part of a tax-free incorpora-

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107. 137 F.2d 600 (3d Cir.), cert. denied, 320 U.S. 794 (1943).

108. Revenue Act of 1936, § 45, 49 Stat. 1648, 1667-68 (current version at I.R.C. § 482 (1976)).

109. Cf. *Northwestern Nat'l Bank v. United States*, 556 F.2d 889 (8th Cir. 1977) (parent not entitled to contribution deduction for appreciated property distributed by subsidiary as dividend and then promptly donated by parent to charity).

110. See *supra* notes 59-63 and accompanying text.

111. 305 F.2d 681 (9th Cir. 1962); see *supra* notes 36, 39-40 and accompanying text.

112. *Rooney* applies I.R.C. § 482 to a similar situation.

tion, a basis for distinguishing between the transfer of receivables and payables and the transfer of unharvested crops is needed.

If one type of earned income may be assigned, why should not this other type be transferable as well? The synthesis of the general concepts of clearly reflecting income and the tax benefit principle, when applied to the difference between routine and extraordinary transfers, provides a partial basis for generalization. When cash basis businesses are transferred to controlled corporations, inevitably there will be some uncollected receivables and some unpaid expenses; the Code should permit these to be transferred without immediate recognition of gain or loss. A transfer of unharvested crops, however, tends to be a one-shot, distorting event that is less properly condoned by the Code.<sup>113</sup> The Service's position is emphasized in private letter rulings issued in connection with transfers of cash basis businesses to controlled corporations.<sup>114</sup> In these rulings, the Service routinely requires representations both that the receivables have not been allowed to accumulate in an unusual way and that the transferors have not made extraordinary payments of expenses before transfer. In short, the principle of allowing certain assignments of income to controlled corporations without recognition does not sanction transactions that deliberately distort accounting principles. Applying this analysis to Mr. Foglesong and Dr. Keller would result in the taxation of their pre-incorporation earned income that was not properly part of the assets of a going business. The proper application of sections 446 and 482 in all transfers of cash basis businesses to controlled corporations promotes the congressional policy of facilitating incorporation, requires a clear reflection of income, and prohibits abuse caused by extraordinary accounting for the income rights transferred.

#### B. *Distinction Between the Entrepreneurial and Service Elements of SC Income*

Although tax may be imposed when stock is actually (and possibly constructively) received for services, a standard is still needed to determine how to tax the employee-owner after initial incorporation. The arm's-length standard of section 482 should serve

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113. In that sense it may be analogized to *National Sec. Corp. v. Commissioner*, 137 F.2d 600 (3d Cir.), cert. denied, 320 U.S. 794 (1943), which was relied on in *Rooney*.

114. See, e.g., Pvt. Ltr. Rul. 8220016, IRS LETTER RUL. REP. (CCH) No. 273 (Feb. 11, 1982) (oil and gas business).

nicely. In applying the arm's-length standard to services in cases like *Foglesong*, is it appropriate to allocate almost 100% of the income to the transferor, as was done on remand? The answer is a resounding "no." The decision on remand in *Foglesong* was caused by the taxpayer's failure to prove his case and was probably a reaction to his overly aggressive tax planning. In a business, even a personal service business such as Mr. Foglesong's or Dr. Keller's, there are two elements of profits: the personal service element and the entrepreneurial profit element. The entrepreneurial profit element may be defined as the appropriate amount of return on the risk capital involved, including goodwill.<sup>115</sup> Section 482 requires that Mr. Foglesong and Dr. Keller recognize an adequate amount of compensation for their personal services, but the general policy of recognizing SC's as separate entities for income tax purposes requires that they be allowed to accumulate entrepreneurial profit. Dr. Keller did not try to distinguish between the personal service and entrepreneurial elements, but simply provided for payment of his salary in two forms: direct salary and salary paid into his pension fund—a tax-favored form of compensation. Thus, as the court held, he clearly met the requirements of section 482. Mr. Foglesong, on the other hand, attempted to transfer both elements and, on remand, simply failed to prove the appropriate amount of the entrepreneurial profit—income attributable to capital, including goodwill. The Service's allowance of two percent for the entrepreneurial element was probably inadequate, but the Tax Court was correct on remand because it was Mr. Foglesong's job to establish the proper amount.

In some ways the question posed in *Foglesong* and *Keller* is the reverse of that posed in *Edwin's, Inc. v. United States*.<sup>116</sup> In *Edwin's*, the Service argued that the payment as salary of almost all of the corporate income of a ladies' specialty shop implied that part of the salary was a dividend. The facts indicated that the substantial skill and experience of the shareholder-employee had contributed to the store's outperforming its competitors. The Service argued that a deduction under section 162 should not be allowed as

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115. The Service has recognized that even a professional practice may involve goodwill. See Rev. Rul. 70-45, 1970-1 C.B. 17.

116. 501 F.2d 675 (7th Cir. 1974) (distinguishing *Charles McCandless Tile Serv. v. United States*, 422 F.2d 1336 (Ct. Cl. 1970), which held to be a dividend 15% of owner-employees' compensation, which was equivalent to 50% of corporation's net-profit calculated before payment of salaries and taxes); see also Griswold, *New Light on "A Reasonable Allowance for Salaries,"* 59 HARV. L. REV. 286 (1945).

the compensation was really a distribution of profits. The United States Court of Appeals for the Seventh Circuit found, however, that the compensation was reasonable and allowed the deduction. Revenue Ruling 79-8<sup>117</sup> is based on *Edwin's*. The Service holds that deductions for *reasonable* compensation will not be denied solely on the ground that the corporation has not paid more than an insubstantial portion of its earnings as dividends. But the ruling notes also that the failure to pay dividends is a significant factor to be taken into account in determining reasonable compensation.

Shareholder-employees are entitled to a reasonable compensation even if their efforts do not result in any significant entrepreneurial profit for their corporation. Conversely, they should be entitled to limit their compensation to a reasonable amount and to accumulate the entrepreneurial profit in their corporation. The burden of distinguishing between the compensatory and entrepreneurial elements is, of course, on the taxpayer.<sup>118</sup>

## VII. SUMMARY AND CONCLUSION

In conclusion, we should attempt to summarize and apply the principles outlined above to the five cases with which we started. Perhaps the easiest case is that of Dr. Keller. Since he owned all of the corporation's stock, there is no issue of the gratuitous assignment of income.<sup>119</sup> Dr. Keller did not attempt to assign income; instead, he apportioned it between ordinary income and tax preferred income, neither of which would escape ultimate taxation. The court, therefore, properly held that he was not currently taxable on the deferred income element. Any dissatisfaction with that result properly required amendment of the pension provisions, as the Tax Equity and Fiscal Responsibility Act did in 1982.<sup>120</sup>

Frederick Foglesong, who was considerably more aggressive, deserved to have some of his aggressive tax planning foiled, although probably not to the degree that it was done by the Tax Court on remand or by the second panel of the Seventh Circuit. Because he was not the sole shareholder of the corporation, any notion that the "assignment of income" could not be involved is

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117. 1979-1 C.B. 92.

118. See Vogel, *Unreasonable Compensation—To What Extent Do Professional Corporations Have the Problem?*, S.R.C. QUARTERLY REPORTS, Fall 1981, at 1-2.

119. Dr. Keller was properly taxed, however, to the extent that he attempted to assign an already earned salary to the corporation. See *supra* note 14. Such an assignment is not a normal part of an incorporation of a business and results in a clear distortion of income.

120. See *supra* note 12.

clearly erroneous. That Foglesong's children paid \$400 for stock on which they received over \$30,000 of dividends in four years indicates that a gratuitous assignment of income was involved to some degree. The determination of the gratuitous assignment element must be made in conjunction with the section 482 determination of his proper arm's-length salary. If the principal issue of section 482's application in this context is whether a shareholder-employee has received an adequate salary and has left only the "entrepreneurial profit" in the corporation,<sup>121</sup> reliance solely on section 482 tends to disguise the fact that cases like *Foglesong* also involve a significant transfer of income to the shareholder-employee's children. Failure to treat the issues separately has two additional results: it tends to disguise the potential for a taxable gift at the time of the initial organization or at the time of the receipt of an inadequate salary or both—an issue not explicitly dealt with in *Foglesong*—and it confuses the issue of timing the taxation of Mr. Foglesong on income accumulated for his children.<sup>122</sup>

Similar principles should apply to Mr. Johnson. The adequacy of the salary that he received from his controlled corporation should be analyzed under section 482 without regard to the fact that the basketball franchises refused to recognize his controlled corporation. Important tax issues of this type should not turn on the willingness of the other party to recognize the transaction, which is merely an issue of bargaining power.

The basic principles that should govern cases like *Hempt Bros.* and *Raich* have been determined properly by the Service in Revenue Rulings 80-198 and 80-199.<sup>123</sup> Normal transfers of rights to income, including previously earned receivables, should be allowed without adverse tax consequences. Extraordinary transfers like those attempted in part by Dr. Keller and Mr. Foglesong, however, should not escape immediate taxation. Similarly, Revenue Ruling 80-198 and *Rooney* correctly suggest that the taxpayer should be prevented from timing the creation of a corporation if it results in an extraordinary transfer of income.<sup>124</sup>

In short, transfers to newly created corporations, including service corporations, should result in nonrecognition for transfers of property, including the right to collect economically earned income that has not been reported, and transfers of previously de-

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121. See *supra* notes 115-18 and accompanying text.

122. See *supra* note 98 and accompanying text.

123. See *supra* notes 20-40 and accompanying text.

124. See *supra* notes 111-14 and accompanying text.

ducted items. Nonrecognition should not be permitted for transfers that shift the incidents of taxation of extraordinary items (for example, unharvested crops for which the raising expenses have been previously deducted or rights to salary already earned) that are not part of normal incorporation. Of course, transitory, one-shot transfers must also be prohibited.

In subsequent dealings between the transferee-corporation and its shareholders, section 482 should apply to ensure that the employee-shareholder is reasonably compensated, while allowing the corporation to accumulate the entrepreneurial profit.<sup>125</sup> When other members of the family are shareholders in the corporation, then the gratuitous assignment of income may also be involved.<sup>126</sup> Finally, where the transferee does not receive a transferred basis in the unrealized receivables or previously deducted items that it has received in the transfer, the transferor must be required to recognize income to clearly reflect income in a tax accounting sense.<sup>127</sup>

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125. See *supra* notes 115-18 and accompanying text.

126. See *supra* notes 92-98 and accompanying text.

127. See *supra* notes 59-80 and accompanying text.