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Interpreting the Code

A healthy percentage of what tax professionals do is interpreting the Code, the Treasury Regulations and assorted other published guidance. A good deal of the rest is wrestling with the facts. Much emphasis has been placed on facts in recent years—including assuming facts, being complete in assembling facts and knowing which facts are relevant—in the context of opinions on less than certain tax positions. Somewhat less emphasis has been placed on legal interpretation.

The ability to or the process of interpreting the Code is viewed as "natural" or innate to the tax professional. Perhaps this is a reason for reduced attention to the process. In the United States' world of academia, there are two interpretive "camps": the literalists and the purposivists. Actually, there is nothing new about the camps, because interpretation always has swung between text and the purpose of the writer, whether in interpreting a will, a deed or a tax law.

Like it or not, the Supreme Court has many times used the purposes of Congress, be they stated in legislative history or inferred from other sources, to interpret the Code. Sometimes, though, it does not, hewing to the text. Determining where the balance lies is the art of the tax professional.

Example: Earnings and Profits

A good example of the interpretive process is determining the meaning of Section 312(d)(1). It is one of the several exceptions to section 312(a), which states that all distributions reduce earnings and profits (E&P) of the corporation. Section 312(d)(1) states:

> The distribution to a distributee by or on behalf of a corporation of its stock or securities, of stock or securities in another corporation, or of property, in a distribution to which this title applies, shall not be considered a distribution of the earnings and profits of any corporation—
>
> (A) if no gain to such distributee from the receipt of such stock or securities, or property, was recognized under this title, or
>
> (B) if the distribution was not subject to tax in the hands of such distributee by reason of section 305(a).

What does subparagraph (A) mean? Specifically, does it mean that E&P is not reduced if a shareholder receives cash equal to the value of the stock in a situation in which it does not have to report income because its basis in its stock is also equal to its value? This might occur in two situations: (1) a section 302(a) redemption that is treated as a sale, and (2) a section 356 reorganization exchange of stock for boot.

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We know that situation (1) is not controlled by section 312(d) because it is subject to a special rule in section 312(n)(7). That rule indicates, without directly providing, that first there is a reduction of corporate capital account and then there is no more than a pro rata reduction of E&P. Since the pro ration is a cap and not a floor, presumably that could mean there is no reduction of E&P, but that has never been the law, despite decades of disputes over the subject.

So that leaves the boot in the reorganization case. The interpretation of section 312(d) should go like this:

- The first issue is whether the section should apply separately to each stock, security or property received, or to the totality of the property received as a unit, without regard to the components of the unit. It should apply to each separate property because (1) it says "or" property and not "and" property; and (2) its legislative history shows that it was originally intended to apply to certain types of property that were received tax-free by virtue of that particular property and the rules applicable to it.
- Based on the same legislative history, such property can be received tax-free due to its nature and the controlling rules (such as stock for stock under section 354), and clearly does not reduce E&P.
- Possibly the section might be read to deny E&P reduction also for property that is not of a nonrecognition type (and so is generally referred to as "boot") if the shareholder both (1) realized no overall gain on the exchange, and (2) received boot, which could be taxed if gain had been realized.
- However, such a reading is illogical because it would draw a line at an arbitrary place: between no gain realization cases and $1 of gain realization cases. Presumably if $1 of gain were realized, the boot would reduce E&P by its value, but if no gain were realized there would be no E&P reduction; this line has no policy justification.
- A better interpretation would be to read the section to say that E&P will not be reduced "to the extent" gain is not recognized, but that is not what the statute says; it does not state a "to the extent" concept, but asks what is the recognition-or-not treatment of each property item. Moreover, such a reading would present the practical difficulty that the corporation may not know how much gain the shareholder realizes, while it will know what sorts of property it distributes, and the corporation must know how to adjust its E&P because that is a corporate level account.
- Therefore, the only interpretation that is both a plausible reading of the literal words and does not run into the problems of the other alternatives is that section 312(d) refers to property that by its nature can be received without gain recognition, regardless of the presence or absence of gain realization.

Conclusion

This isn't as easy as it may look. Knowledgeable persons have read the section differently. It matters in the cases known as the all-cash D reorganization: reading the statute one way results in the cash not reducing the corporate E&P when the shareholder realizes no gain; read the other way, it will reduce E&P by the amount of the cash.

For additional information, call Jack Cummings at 919.862.2302.

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