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SECTION 351: THE BEGINNING OF LIFE IN SUBCHAPTER C

by

*Frank M. Burke, Jr.**

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I. INTRODUCTION

The history of federal income taxation is replete with amendments enacted to facilitate and, in some cases, encourage adjustments in the form of doing business.¹ One of the earliest problems discovered in the taxing statutes was the treatment, as a taxable transaction, of a transfer of appreciated or depreciated property to a corporation in exchange for all of its capital stock.² In order to rectify this unfortunate result, Congress enacted the predecessor of section 351 of the Internal Revenue Code of 1954 as part of the Revenue Act of 1921.³ The legislative history of that provision indicates that Congress intended that the transfer of property to a controlled corporation be viewed as a mere change in form of ownership, having no adverse federal income tax consequences to the transferor or the transferee.⁴

If applied properly, section 351⁵ provides insulation from federal income

¹ Review, for example, the legislative history of the predecessor of § 332 of the Internal Revenue Code of 1954, relating to liquidation of corporate subsidiaries. 80 CONG. REC. 9038, 10288, 10452 (1936). This section was enacted to encourage elimination of unnecessary holding company structures.

² Jefferson Livingston, 18 B.T.A. 1184 (1930), *acquiesced in*, IX-2 CUM. BULL. 36 (1930).

³ Revenue Act of 1921, ch. 136, § 202(c)(3), 42 Stat. 227. With only relatively insignificant changes in language, a similar provision was included in each subsequent revenue statute. In the Revenue Act of 1928, the pertinent provision was ch. 852, § 112(b)(5), 45 Stat. 791. The Internal Revenue Code of 1954 re-enacted § 112(b)(5) of the Internal Revenue Code of 1939 as § 351. For clarity, all references in this Article will be to INT. REV. CODE of 1954, § 351, although many judicial decisions discussed herein were decided under Int. Rev. Code of 1939, § 112(b)(5).

⁴ S. REP. NO. 275, 67th Cong., 1st Sess. (1921), *reprinted in* 1939-1 CUM. BULL. (pt. 2) 181, 188-89.

⁵ INT. REV. CODE of 1954, § 351 provides:

(a) GENERAL RULE.—No gain or loss shall be recognized if property is transferred to a corporation (including, in the case of transfers made on or before June 30, 1967, an investment company) 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. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property.

(b) RECEIPT OF PROPERTY.—If subsection (a) would apply to an exchange but for the fact that there is received, in addition to the stock or securities permitted to be received under subsection (a), other property or money, then—

- (1) gain (if any) to such recipient shall be recognized, but not in excess of—
 - (A) the amount of money received, plus
 - (B) the fair market value of such other property received; and
- (2) no loss to such recipient shall be recognized.

(c) SPECIAL RULE.—In determining control, for purposes of this section, the fact that any corporate transferor distributes part or all of the stock which it receives in the exchange to its shareholders shall not be taken into account.

(d) APPLICATION OF JUNE 30, 1967, DATE.—For purposes of this section, if, in connection with the transaction, a registration statement is required to be filed with the Securities and Exchange Commission, a transfer of property to an investment company shall be treated as made on or before June 30, 1967, only if—

- (1) such transfer is made on or before such date,
- (2) the registration statement was filed with the Securities and Exchange Commission before January 1, 1967, and the aggregate issue price of the stock

taxation upon the incorporation of a proprietorship, partnership, or new business. In addition, it permits the transfer of property to an existing corporation if the transferor or transferors control the corporation immediately after the transfer.⁶ As with all federal income tax statutes, the requirements of section 351 must be carefully observed in order to achieve the desired result. Frequently, a section 351 incorporation is viewed as a "routine" transaction from a federal income tax standpoint. Many taxpayers have learned to their financial detriment that such is not always the case. Because of the number of conditions which must be met and the problems which must be resolved, the Internal Revenue Service recently issued Revenue Procedure 70-17⁷ to provide guidance for taxpayers requesting advance rulings on section 351 transactions. The Service has taken such action only with respect to a few sections of the Internal Revenue Code, and such action in itself should warn the tax practitioner that section 351 transactions must be planned with a great deal of care.

It is the purpose of this Article to review the conditions of the statute and the numerous problems which may arise in the planning and consummation of a tax-free incorporation, with emphasis on those problems frequently overlooked in what appear to be "routine" section 351 transactions.

II. THE BASIC STATUTORY SCHEME

Under the general rule of section 351(a), no gain or loss is recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities of the transferee corporation and immediately after the exchange the transferor or transferors are in control of the transferee corporation.⁸ For purposes of section 351(a), stock or

and securities of the investment company which are issued in the transaction does not exceed the aggregate amount therefor specified in the registration statement as of the close of December 31, 1966, and

- (3) the transfer of property to the investment company in the transaction includes only property deposited before May 1, 1967.

(e) CROSS REFERENCES.—

- (1) For special rule where another party to the exchange assumes a liability, or acquires property subject to a liability, see section 357.
 (2) For the basis of stock, securities, or property received in an exchange to which this section applies, see sections 358 and 362.
 (3) For special rule in the case of an exchange described in this section but which results in a gift, see section 2501 and following.
 (4) For special rule in the case of an exchange described in this section but which has the effect of the payment of compensation by the corporation or by a transferor, see section 61(a)(1).

The only changes to § 112(b)(5) of the Internal Revenue Code of 1939, which became § 351 of the Internal Revenue Code of 1954, were (1) elimination of the substantially proportionate test as discussed in the text accompanying notes 79-87 *infra*; (2) addition of the provision that, in determining control, no consideration is given to the fact that a corporate transferor distributes stock or securities received in the exchange to its shareholders as discussed in the text accompanying notes 140, 141 *infra*; and (3) addition of the provision that stock or securities issued for services shall not be considered as issued in return for property as discussed in the text accompanying notes 39-48 *infra*. Section 351 was amended in 1966 to exclude transfers to investment companies made after June 30, 1967, as discussed in the text accompanying notes 331-39 *infra*.

⁶ See Treas. Reg. § 1.351-1(a)(2), example (3) (1967).

⁷ Rev. Proc. 70-17, 1970 INT. REV. BULL. NO. 27, at 40.

⁸ INT. REV. CODE of 1954, § 368(c), defines control as ownership of at least 80% of the out-

securities issued for services are not considered as issued in exchange for property.⁹

The transferee corporation is insulated from taxation by section 1032 (a), which provides that a corporation recognizes no gain or loss upon the issuance of its stock in exchange for money or other property.¹⁰ If stock is issued for services, the corporation should be entitled to a deduction under section 162 (a) in an amount equal to the fair market value of the stock.¹¹ In the alternative, if the services relate to the organization of the corporation, the value should be capitalized and amortized under section 248.¹²

The transferor receiving solely stock or securities for property substitutes the basis of the property transferred as the basis of the stock or securities received.¹³ The transferee corporation takes as its basis the transferor's basis in such property.¹⁴ The carryover-basis provisions are consistent with the legislative intent of section 351 that a transfer of property to a controlled corporation in exchange for stock or securities be treated as a mere change in the form of ownership.

If a transferor receives "boot" in the form of money or other property in addition to stock or securities of the transferee corporation, gain is recognized by such transferor, but not in excess of the amount of money plus the fair market value of other property received.¹⁵ The receipt of boot, however, does not permit recognition of loss by the transferor.¹⁶ If a transferor recognizes gain because of the receipt of boot, such transferor's basis in the stock or securities received is decreased by the fair market value of the boot received and is increased by the amount of gain recognized.¹⁷ The transferor acquires basis in the boot equal to its fair market value.¹⁸

By virtue of the general rule of section 357 (a), the assumption of liabilities by the transferee corporation or the receipt of property subject to a liability does not constitute payment of boot to the transferor. The transferor's basis in the stock or securities received is reduced by the amount of liabilities assumed (or to which the transferred property is subject).¹⁹ As discussed below, the assumption of debt or receipt of property subject to debt may be treated as boot to the transferor if (1) the liability is assumed for tax avoidance purposes or there is no business purpose for the as-

standing voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of outstanding stock.

⁹ *Id.* § 351 (a) (last sentence).

¹⁰ See also Treas. Reg. § 1.1032-1 (a) (1956).

¹¹ Rev. Rul. 62-217, 1962-2 CUM. BULL. 59. The corporation would recognize no gain or loss by issuing stock to pay such obligation by virtue of § 1032 (a). For a case reaching this result under § 1032 (a), see *Commissioner v. Fender Sales, Inc.*, 338 F.2d 924 (9th Cir. 1964).

¹² *Cf.* *Hollywood Baseball Ass'n*, 42 T.C. 234, 270-71 (1964), *acquiesced in on this issue*, 1964-2 CUM. BULL. 6.

¹³ INT. REV. CODE of 1954, § 358 (a).

¹⁴ *Id.* § 362 (a) (1).

¹⁵ *Id.* § 351 (b) (1).

¹⁶ *Id.* § 351 (b) (2).

¹⁷ *Id.* § 358 (a) (1).

¹⁸ *Id.* § 358 (a) (2).

¹⁹ *Id.* §§ 358 (a) (1) (A) (ii), 358 (d).

sumption,²⁰ or (2) the amount of liabilities transferred exceeds the transferor's total basis in the properties transferred.²¹

The precise meaning of the terms used in any statute must be thoroughly analyzed to assure that the desired result can be achieved. If a tax-free incorporation is to be accomplished under section 351, the statutory terms must be reviewed and the meaning of each tested against the facts of a particular case.

III. PROPERTY

A. General

The first important term which must be considered in section 351(a) is "property." Property is not defined within section 351, nor is there any cross-reference to another section for a definition of the term.²² The absence of a definition of property has created few problems except with regard to certain intangibles where services of the transferor were involved in the creation of those intangibles.

Both the IRS and the courts have recognized that the term "property," as used in section 351, includes money.²³ From the transferor's point of view, little significance attaches to this treatment since no gain or loss would result from the purchase of stock or securities for cash even if section 351 did not apply to the transaction. Such treatment, however, does assume significance when one transferor purchases stock for cash and another transferor acquires stock by the transfer of appreciated or depreciated properties. For example, assume that one transferor purchases fifty per cent of the common stock of a corporation for cash and that the second transferor acquires the remaining fifty per cent by transferring property to the corporation having a basis of \$5,000 and a fair market value of \$100,000. Failure to treat cash as property would make the transaction taxable to the second transferor, and he would recognize gain on the exchange in the amount of \$95,000.

Little doubt exists that normal business assets, such as accounts receivable,²⁴ installment notes,²⁵ inventory,²⁶ patents,²⁷ stock or securities of an-

²⁰ *Id.* § 357(b)(1).

²¹ *Id.* § 357(c).

²² The definition of "property" found in § 317(a) applies only to part I of subchapter C, which does not include § 351.

²³ Rev. Rul. 69-357, 1969-1 CUM. BULL. 101; *Portland Oil Co. v. Commissioner*, 109 F.2d 479, 488-89 (1st Cir.), *cert. denied*, 310 U.S. 650 (1940); *George M. Holstein, III*, 23 T.C. 923, 924-25 (1955).

²⁴ *Cf. P.A. Birren & Son v. Commissioner*, 116 F.2d 718 (7th Cir. 1940); *Arthur L. Kniffen*, 39 T.C. 553 (1962), *acquiesced in*, 1965-2 CUM. BULL. 5; *Thomas W. Briggs*, 15 CCH Tax Ct. Mem. 440, 451 (1956). Accounts and notes receivable are, by inference, defined as "property" (although not as a capital asset) in § 1221. See INT. REV. CODE of 1954, § 1221(4).

²⁵ The transfer of an installment obligation under § 351 presumably is not a "disposition" by the transferor which would trigger previously unrecognized gain. *Treas. Reg. § 1.453-9(c)(2)* (1958); *Portland Oil Co. v. Commissioner*, 109 F.2d 479 (1st Cir.), *cert. denied*, 310 U.S. 650 (1940). *But see Jack Ammann Photogrammetric Eng'rs, Inc. v. Commissioner*, 341 F.2d 466 (5th Cir. 1965), discussed in text accompanying note 285 *infra*, which implies a contrary result in certain situations.

²⁶ Like accounts and notes receivable, inventory is, by inference, defined as "property" (although not as a capital asset) in § 1221. See INT. REV. CODE of 1954, § 1221(1).

²⁷ *Claude Neon Lights, Inc.*, 35 B.T.A. 424, 427-28 (1937).

other corporation,²⁸ and intangibles,²⁹ constitute property for purposes of section 351. Beneficial or equitable interests in property are also treated as property under section 351.³⁰ Hence, in most cases, the transfer of creditors' claims qualifies as a transfer of property under section 351.³¹

Two recent Tax Court decisions have dealt directly with the meaning of the term "property" under section 351, and have delineated, to some extent, its scope. In *H. B. Zachry Co.*³² the taxpayer entered into an agreement with a corporation to exchange a "carved-out" oil payment in the amount of \$650,000 for all of the authorized common stock of the new corporation. The taxpayer contended that its transfer of a carved-out oil payment in exchange for the common stock was a section 351 transfer, and that no gain or loss should be recognized. The Commissioner argued that the oil payment did not constitute property within the meaning of section 351(a), and that the transfer of such oil payment for stock was a taxable exchange.³³ The Commissioner argued that because of the Supreme Court's decision in *Commissioner v. P. G. Lake, Inc.*,³⁴ the carved-out oil payment was merely an income right and therefore did not constitute property for purposes of section 351. The Tax Court, relying upon the Supreme Court's observation in the *Lake* case, that oil payments are interests in land, held that the oil payment was property.³⁵ By way of footnote, the court stated:

[Section] 351 does not contain a definition of the term 'property.' However, the known inclusions and exclusions strongly suggest that the term encompasses whatever may be transferred. Significantly, 'services' are explicitly excepted by [section] 351(a). Such a singular and extraordinary exception denotes the scope of the term 'property' under the rule of statutory construction—*expressio unius est exclusio alterius*.³⁶

It appears from the rather broad language of the Tax Court in *Zachry* that anything which may be transferred to a corporation will be treated as property for purposes of section 351 regardless of its character, pro-

²⁸ G.C.M. 7285, IX-1 CUM. BULL. 181 (1930). A transfer of notes of the transferee corporation to such corporation for additional stock of such corporation also qualifies as an exchange for property to which § 351 applies. Rev. Rul. 57-296, 1957-2 CUM. BULL. 234.

²⁹ Rev. Rul. 64-56, 1964-1 CUM. BULL. 133; *cf.* Rev. Rul. 65-180, 1965-2 CUM. BULL. 279, and Rev. Rul. 64-235, 1964-2 CUM. BULL. 18, relating to treatment of goodwill as property.

³⁰ *Roberts Co.*, 5 T.C. 1 (1945), *acquiesced in*, 1945 CUM. BULL. 6.

³¹ *Helvering v. Cement Investors, Inc.*, 316 U.S. 527 (1942); *Seiberling Rubber Co. v. Commissioner*, 169 F.2d 595 (6th Cir. 1948); Rev. Rul. 57-296, 1957-2 CUM. BULL. 234. *But see* *United States v. Santa Inez Co.*, 145 F.2d 667 (9th Cir. 1944), *cert. denied*, 324 U.S. 879 (1945), and *Civic Center Fin. Co. v. Kuhl*, 83 F. Supp. 251 (E.D. Wis. 1948), *aff'd per curiam*, 177 F.2d 706 (7th Cir. 1949), in which the property transfer and the acquisition of stock were treated as separate transactions. See Note, *Section 351 of the Internal Revenue Code and "Mid-Stream Incorporations,"* 38 CINN. L. REV. 96, 101-02 (1969).

³² 49 T.C. 73 (1967).

³³ Under § 636(a), enacted as part of the Tax Reform Act of 1969, carved-out oil payments, with limited exceptions, will be treated as loans, and the question should be moot.

³⁴ 356 U.S. 260 (1958).

³⁵ The Tax Court did not decide who would be taxable on the subsequent income from the carved-out oil payment. Presumably, even though the transfer qualified under § 351, the transferor would be taxable on the subsequent income. *Cf.* *Eugene T. Flewellen*, 32 T.C. 317 (1959), in which the taxpayer was allowed a charitable contribution deduction upon assignment of a carved-out oil payment to "charity," but was taxable on subsequent income.

³⁶ 49 T.C. 73, 80 n.6 (1967).

vided services of the transferor were not involved in the creation of the item transferred. If services have been rendered by the transferor in the creation of the item transferred, the IRS and the courts will continue to examine the transaction carefully to see that the stock is not being issued for services. This approach was taken by the Tax Court in the recent case of *William A. James*.³⁷ There, the taxpayer entered into an agreement with two other parties whereby the taxpayer was to promote and construct an apartment house. The agreement provided that upon completion of the project, the parties would form a corporation to hold the apartment house. Voting stock of such corporation was to be distributed one-half to the taxpayer and one-half to the two other parties, and nonvoting stock was to be issued to equalize the equities of the parties. The agreement was executed in January 1963, and immediately thereafter the taxpayer began negotiations to fulfill his obligations under the contract. In August 1963, the taxpayer obtained mortgage commitments. In November 1963, the corporation was formed with the taxpayer transferring the mortgage commitments and certain other contracts to the corporation in exchange for stock, and the two other parties transferring land to the corporation in exchange for stock. The Commissioner alleged that the stock issued to the taxpayer had been issued for services, not property. The taxpayer argued that he received such stock in consideration for his transfer of the mortgage commitments to the corporation, and that such commitments constituted property within the meaning of section 351. The taxpayer contended that as a result of the services performed by him, he acquired property in the form of certain contract rights which he transferred to the corporation. The Tax Court found that the taxpayer did not transfer any property to the corporation, but merely performed services on its behalf pursuant to the January 1963 agreement.³⁸

It appears that the Tax Court in *James* placed strong reliance on the fact that the services were rendered as part of an overall plan to form a corporation to own the apartment house. A different decision might have resulted had the taxpayer obtained the mortgage commitments for his own benefit and subsequently decided to transfer such rights to a newly formed corporation. In such a situation, it would indeed be difficult to hold that such services were rendered for the corporation when, at the time the services were rendered, the taxpayer had no plan or obligation to transfer such rights to a corporation. Nevertheless, the Tax Court's decision in *James* illustrates well the problem which may occur under section 351 if services of the transferor have been involved in the creation of an item transferred to a corporation.

³⁷ 53 T.C. 63 (1969).

³⁸ See also *Elihu B. Washburne*, 27 CCH Tax Ct. Mem. 577 (1968), in which the taxpayer argued unsuccessfully that he received stock in a new corporation in exchange for an option to acquire 10% of the stock of such company. The Tax Court found, without deciding whether an oral option constituted "property" for purposes of § 351, that the stock was issued either for the taxpayer's bringing the availability of a business to the attention of the new corporation or for the taxpayer's agreement to continue as an employee of the new corporation. The Tax Court concluded that since such reasons were the consideration for the issuance of the stock, such stock was issued for services rendered or to be rendered for the new corporation.

In order to fully analyze the problems which may arise relating to stock or securities issued for services or for property resulting from personal services, three separate factual problems must be considered:

1. Stock or securities issued for services rendered or to be rendered to the transferee corporation;
2. Stock or securities issued for services rendered to a third party; and
3. Stock or securities issued for property created by personal services.

B. *Services to the Transferee Corporation*

As indicated above,³⁹ stock or securities received for services are not considered as having been issued for property under section 351. The legislative history of section 351 indicates that only stock or securities issued as compensation to a person who has rendered or will render services to the transferee corporations will not be treated as issued for property.⁴⁰ The regulations treat stock or securities issued for services "rendered or to be rendered to or for the benefit of the issuing corporation" as not being issued for property.⁴¹ The *James* case is an excellent example of the disqualification of a section 351 transaction because of the issuance of stock for services in such a situation.⁴²

The fact that stock or securities are issued for services by the transferee corporation does not necessarily prevent application of section 351 for the benefit of those parties transferring property to the corporation.⁴³ The person or persons receiving stock or securities in exchange for services are not included in determining whether the transferors are in control of the transferee immediately after the exchange as required by section 351. If the persons who transfer property control the corporation immediately after the exchange, section 351 applies to those transferors regardless of the fact that one or more persons may have received stock for services in the same transaction.⁴⁴ For example, assume that *A* and *B* transfer property to *X* corporation in return for eighty-two per cent of its stock, and *C* agrees to render services in the future for *X* corporation in exchange for eighteen per cent of its stock. Even though *C* received stock for services, the transferors of property (*A* and *B*) control the corporation immediately after the exchange, and section 351 applies to their transfers. The fair market value of the stock received by *C* would be taxable to *C* as compensation.⁴⁵ If, however, *A* and *B* had received less than eighty per cent of the stock

³⁹ See note 9 *supra*, and accompanying text.

⁴⁰ H. REP. NO. 1337, 83d Cong., 2d Sess. 117 (1954). See also Rev. Proc. 70-17, 1970 INT. REV. BULL. No. 27, at 40, § 3.04(1)(b).

⁴¹ Treas. Reg. § 1.351-1(a)(1)(i) (1955). It is clear that the language of the Regulations is broad enough to encompass services rendered "for the benefit of" a corporation to be formed. See, e.g., William A. James, 53 T.C. 63 (1969), discussed in the text accompanying note 37 *supra*; and Elishu B. Washburne, 27 CCH Tax Ct. Mem. 577 (1968); discussed in note 38 *supra*.

⁴² See text accompanying note 37 *supra*.

⁴³ See H. REP. NO. 1337, 83d Cong., 2d Sess. 117 (1954), which indicates that application of the last sentence of § 351(a), relating to stock or securities issued for services, is not intended to vitiate the remaining portion of the transaction if § 351(a) otherwise would apply.

⁴⁴ Treas. Reg. § 1.351-1(b)(2), example (2) (1955).

⁴⁵ *Id.*

and C had received more than twenty per cent of the stock solely for services, section 351 would not apply with respect to A and B.

If a person transfers property in exchange for stock or securities and also receives stock or securities for services, the entire amount of stock received by such transferor is counted in determining whether the transferors of property have control of the corporation,⁴⁶ unless the transfer of property by such transferor is merely a device to allow section 351 to apply to those parties actually transferring property.⁴⁷ For example, if A and B receive seventy-five per cent of the stock of X corporation for property, and C receives twenty-five per cent of the stock for services and property having substantial value, the transfer qualifies under section 351 even though C would recognize compensation income equal to the fair market value of the stock received for services.

If the corporation issues stock or securities for services, it should be entitled to a deduction under section 162(a), or to an organizational expense amortizable under section 248, in an amount equal to the fair market value of the stock issued. By virtue of section 1032(a), the corporation would realize no gain or loss on the issuance of its stock or securities for services.⁴⁸

C. Services Performed for Third Parties

The courts have indicated that stock or securities issued for cash-basis accounts receivable created by sales or services to customers of a predecessor entity are issued for property within the meaning of section 351.⁴⁹ Such a conclusion with respect to cash-basis accounts receivable not only postpones the time for taxation of such income to the transferor, but also converts such income from ordinary into capital gain income, assuming the stock is a capital asset to the transferor⁵⁰ and that the corporation is not collapsible.⁵¹

A much more difficult question arises when stock is issued to a cash-basis taxpayer for a claim resulting from services rendered to the predecessor entity or the owners of such entity. Again, if the stock or securities issued for such a claim are deemed to have been issued for property, not only will taxation of the income be postponed, but the income will also be converted from ordinary into capital gain income, assuming the capital asset test is met and collapsibility can be avoided.⁵² The regulations under section 351 deal specifically with the treatment of stock or securities issued by a corporation for services rendered to the predecessor entity or its

⁴⁶ *Id.* § 1.351-1(a)(2), example (3).

⁴⁷ *Id.* § 1.351-1(a)(1)(ii).

⁴⁸ See text accompanying notes 10-12 *supra*.

⁴⁹ P.A. Birren & Son v. Commissioner, 116 F.2d 718 (7th Cir. 1940); Arthur L. Kniffen, 39 T.C. 553, 565-66 (1962), *acquiesced in*, 1965-2 CUM. BULL. 5; Thomas W. Briggs, 15 CCH Tax Ct. Mem. 440 (1956). See also Rev. Proc. 70-17, 1970 INT. REV. BULL. No. 27, at 40, § 3.02(3)(b)(i). There is no question that accrual basis accounts receivable should be treated as property, since the transferor has previously reported the income with respect to such receivables and merely has a money claim which should be a property right.

⁵⁰ See INT. REV. CODE of 1954, § 1221.

⁵¹ See *id.* § 341.

⁵² See *id.* §§ 341, 1221.

owners.⁵³ The regulations provide that such a transaction, in most instances, will be treated as though all the stock had been issued first to the owner or owners of the predecessor entity in exchange for the assets of that business, with part of the stock or securities being immediately transferred to the employee for prior services.⁵⁴ For example, assume that a proprietor decides to incorporate his business and have ten per cent of the stock issued directly to an employee for prior services. In that case, the regulations presumably would treat all of the stock as having been issued to the proprietor in exchange for the assets of his business, and the proprietor would be deemed to have immediately transferred ten per cent of such stock to pay his obligation to his employee.⁵⁵ As a result of such treatment, the employee would have compensation income in an amount equal to the fair market value of the stock received,⁵⁶ and the transferor would have a deduction under section 162, or section 212, for compensation paid in a like amount.⁵⁷ However, the proprietor might lose a substantial part of the benefit arising from such deduction due to the fact that he would be deemed to have disposed of the stock in cancellation of a debt.⁵⁸ If the amount of the debt discharged, presumably measured by the value of the stock transferred to the employee, exceeded the proprietor's tax basis in the stock transferred, gain (perhaps capital gain⁵⁹) would result which would partially or completely offset the deduction for compensation paid. If the transferor's basis in the stock exceeded the debt discharged, the resulting loss, unless disallowed under section 267 by virtue of a tainted relationship, would, of course, increase the proprietor's deduction.

In considering cases where stock has been issued for services rendered to the predecessor entity, the courts have either avoided or confused the issue and have not taken the approach suggested by the regulations. In *Roberts Co.*⁶⁰ certain attorneys had a contingent fee arrangement with the owners of certain property. Such fee arrangement was made prior to the transfer of such property to a corporation. Upon incorporation, the attorneys received approximately twenty-three per cent of the stock for their interest in the property arising under the contingent fee arrangement. The Tax Court found that the attorneys had an equitable interest in the land transferred, and, therefore, had transferred property to the corporation. Assuming that the attorneys had reported the value of their equitable interest in the property as taxable income prior to the time such interest was transferred to the corporation, the case was properly decided. If, however, the value of the equitable interest had not been previously reported, the Tax Court erroneously allowed the attorneys to escape tax-

⁵³ Treas. Reg. § 1.351-1(b)(1) (1955).

⁵⁴ *Id.*

⁵⁵ *Id.* § 1.351-1(b)(2), example (1).

⁵⁶ *Id.* (last sentence).

⁵⁷ This assumes that the obligation arose in a trade or business of the transferor, or in an activity to which § 212 applies.

⁵⁸ Treas. Reg. § 1.351-1(b)(2), example (1) (1955) (last sentence).

⁵⁹ A serious question of collapsibility could arise if the new corporation receives tainted assets, particularly if substantial unrealized receivables have been transferred by the predecessor entity. Collapsible treatment would, of course, cause the transferor's gain to be treated as ordinary gain.

⁶⁰ 5 T.C. 1 (1945), *acquiesced in*, 1945 CUM. BULL. 6.

ation on their fee income. There is no suggestion in the opinion that all of the stock might have been constructively issued to the original property owners with an immediate transfer of twenty-three per cent of the stock in payment of the contingent fee. The case arose under the predecessor of section 351, and, at that time, the regulations did not contain the concept outlined above.

A more difficult case to explain is *United States v. Frazell*.⁶¹ There, the taxpayer was entitled to a thirteen per cent contingent interest in oil properties owned by a joint venture by virtue of having performed geological services for such venture. Shortly before the contingent interest was to vest, the joint venture was incorporated, and the taxpayer received thirteen per cent of the corporation's stock in exchange for his contingent interest. Without precisely deciding the issue, the Fifth Circuit found that the taxpayer had received either a capital interest in a partnership for services,⁶² or stock for prior services to the corporation under section 351.⁶³ In its opinion, the Fifth Circuit referred to the regulations under section 351 dealing with stock or securities issued for services rendered or to be rendered for the benefit of the issuing corporation.⁶⁴ Clearly, in *Frazell* the services were rendered for the predecessor joint venture, and the stock-for-services rule of section 351 should not have been applied.⁶⁵ Assuming, however, that section 351 did apply and that the thirteen per cent stock interest was received for services, it is submitted that the Fifth Circuit should have found that all of the stock of the corporation had been constructively issued to the other venturers, and that thirteen per cent of such stock was immediately transferred to the taxpayer as compensation for prior services to the joint venture. Under this view, the tax position of the recipient of the stock would not have changed, but the consequences to the other venturers would have been more properly reflected.⁶⁶ Of course,

⁶¹ 335 F.2d 487 (5th Cir. 1964), cert. denied, 380 U.S. 961 (1965).

⁶² Treas. Reg. § 1.721-1(b)(1) (1956). Presumably, under this alternative, the other joint venturers would have a deduction under § 162(a) equal to the value of the capital interest transferred, and would recognize gain or loss equal to the difference between such value and their basis in the interest transferred.

⁶³ *Id.* § 1.351-1(a)(1)(i). Under this alternative, the corporation would be entitled to a deduction (see text accompanying notes 11, 12 *supra*) and would recognize no gain or loss upon issuance of its stock (see text accompanying note 10 *supra*).

⁶⁴ In the author's view, reference to § 351 is in error, since at the time the services were rendered the facts indicate that the corporation did not exist, nor was its existence contemplated. Therefore, it is obvious that the services were rendered for the benefit of the joint venture, not the corporation. Cf. William A. James, 53 T.C. 63 (1969), discussed in text accompanying note 37 *supra*, for a case involving facts justifying a holding that services were "for the benefit of" a corporation, even though such corporation did not actually exist at the time the services were rendered.

⁶⁵ Even if § 351 did not apply and the taxpayer was deemed to have received an interest in the joint venture (presumably a partnership under § 761 and therefore subject to the provisions of subchapter K) prior to incorporation, a substantial conflict exists as to whether such interest should have been taxable upon receipt or should have been nontaxable under the "pool of capital" theory of G.C.M. 22730, 1941-1 CUM. BULL. 214. The *Frazell* decision has been highly criticized because of its conclusion that the recipient was taxable upon receipt of the interest. See Smith, *Confusion Twice Confounded—The Service Partner In and Out of the Partnership*, in 19TH INSTITUTE ON OIL AND GAS LAW AND TAXATION 371, 407 (1968).

⁶⁶ Under this approach, of course, the other joint venturers would have a deduction for the value of the stock constructively transferred, and would recognize gain or loss equal to the difference between such value and their basis in the stock. This approach would have produced a

the tax consequences of the incorporation to the other venturers were not before the court, and it was unnecessary for the Fifth Circuit to consider this approach. It may be possible to rationalize the result of *Frazell*, though not the court's reasoning, by arguing that the other venturers transferred the property to the corporation for eighty-seven per cent of the stock, and that the corporation assumed their obligation to the taxpayer and discharged such obligation by issuing thirteen per cent of the stock.⁶⁷

D. Property Created by Personal Services

Property created by the prior personal efforts of the transferor would seem to qualify as property for purposes of section 351. For example, a secret process created by a transferor through his own efforts, and not at the request of the transferee corporation, should be property for purposes of section 351.⁶⁸ For a number of years, however, the IRS labored with the problem of transfers of know-how, secret processes, patents, trademarks, and other such intangible assets under section 351. In 1964, Revenue Ruling 64-56⁶⁹ was issued in an attempt to establish guidelines for section 351 transfers of such assets. In that ruling, the Service stated that the term "property" for purposes of section 351 would include "anything qualifying as 'secret processes and formulae' within the meaning of sections 861(a)(4) and 862(a)(4) of the Code, and any other secret information as to a device, process, etc., in the general nature of a patentable invention without regard to whether a patent has been applied for [and] without regard to whether it is patentable in the patent law sense."⁷⁰ The ruling further stated that other information which was secret in nature would be given consideration as "property" on a case-by-case basis.

Under the ruling, if the asset being transferred is "property," the transfer will be tax-free under section 351, even though services were used to produce the property. If, however, the information transferred has been developed especially for the transferee, the stock received in exchange for such information may be treated as payment for services rendered. If the transferor agrees to perform services which are merely ancillary or subsidiary to the property transferred, tax-free treatment will be allowed under section 351. Where both property and services are furnished as a consideration and the services are not merely ancillary and subsidiary, a reasonable allocation of the stock received must be made between compensation and the property transferred.

result for the other joint venturers identical to that discussed in note 62 *supra* under the partnership alternative.

⁶⁷ Presumably, under this alternative, the corporation would get no deduction since it is merely paying an assumed obligation. See B. BITTKER & C. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 99 (2d ed. 1966) [hereinafter cited as BITTKER & EUSTICE]; Paul & Kalish, *Transition from a Partnership to a Corporation*, N.Y.U. 18TH INST. ON FED. TAX. 639, 656-58 (1960); Tritt & Spencer, *Current Tax Problems in Incorporation of a Going Business*, U. So. CAL. 1958 TAX INST. 71, 98-99. Of course, the corporation would recognize no gain or loss on the issuance of its stock by virtue of § 1032(a).

⁶⁸ Cf. Wall Prods., Inc., 11 T.C. 51, 57 (1948), *acquiesced in*, 1949-1 CUM. BULL. 4.

⁶⁹ Rev. Rul. 64-56, 1964-1 CUM. BULL. 133.

⁷⁰ *Id.* at 134.

The ruling specifically provides that the rendering of certain types of services after the transfer might cause a portion of the stock to be treated as compensation. Such services include:

1. Training the transferee's employees, unless the transferee's employees already have the particular skills required to operate the transferred process;
2. Continuing technical assistance after start-up; and
3. Assistance in the construction of a plant.

However, services performed (1) by promoting the transaction through demonstrating and explaining the use of the property; (2) by assisting in the effective "start-up" of the property transferred; or (3) by performing under a guarantee relating to such effective start-up will ordinarily be treated as ancillary and subsidiary to the property transfer.

Revenue Ruling 64-56 concludes that the transfer of all substantial rights in the secret process or other intangible property will be treated as a transfer of property under section 351. It further concludes that limited transfers will also qualify, provided the transferred rights extend to all of the territory of one or more countries and consist of all substantial rights to the process or other property within the specified country or countries.⁷¹

The requirements of Revenue Ruling 64-56 involve substantial issues of both fact and law, and they have created numerous problems in obtaining an advance ruling for transfers to foreign corporations under section 367. As a result, in the latter part of 1969, the IRS issued Revenue Procedure 69-19,⁷² which sets forth requirements which must be met in order for an advance ruling to be issued under section 367 relating to a transfer of know-how to a foreign corporation under section 351. The new procedure provides that the IRS will accept appropriate representations, and that, if applicable, the following statement should be included in the request for ruling:

It is represented that the 'information' being transferred in exchange for stock under Section 351 is 'property' within the meaning of Revenue Ruling 64-56 . . . and as such is afforded substantial legal protection against unauthorized disclosure and use under the laws of the country from which it is being transferred. It is further represented that any services to be performed in connection with the transfer of the property are merely ancillary and subsidiary to the property transfer within the meaning of Revenue Ruling 64-56 or the transferor will be compensated by a fee negotiated at arm's length (in consideration other than stock or securities of the transferee unless such stock or securities are identified) for any other services to be performed on behalf of the transferee.⁷³

Revenue Procedure 69-19 also sets forth certain specific information which must be provided in the ruling request. The procedure concludes

⁷¹ See *Lanova Corp.*, 17 T.C. 1178 (1952), *acquiesced in*, 1952-1 CUM. BULL. 3. For further discussion of the transfer of "all substantial rights," see Rev. Rul. 64-56, 1964-1 CUM. BULL. 133, 135 (last two paragraphs).

⁷² 1969-2 CUM. BULL. 301.

⁷³ *Id.* at 302.

that if required representations are made by the transferor, the Service will consider for purposes of the requested ruling that the country in which the transferee corporation is to operate affords to the transferor substantial legal protection against unauthorized disclosure and use of the information. Revenue Procedure 69-19 does not mention, although it may be implicit by its reference to Revenue Ruling 64-56, the requirement that all substantial rights under property be transferred or that all substantial rights for property within one or more countries be transferred. Nevertheless, it appears that such characteristic should be present in any transfer of know-how to assure qualification under section 351.

Obviously, Revenue Ruling 64-56 and Revenue Procedure 69-19 are intended to cover primarily transfers to foreign corporations. Nevertheless, they should provide rather definitive guidance as to the views of the IRS regarding section 351 transfers of intangible property created by personal services.⁷⁴

E. *Transfer Versus Use*

Section 351(a) requires that property be *transferred* to the transferee corporation. It is obvious that Revenue Ruling 64-56 and Revenue Procedure 69-19 are concerned to some extent with the problem of partial transfers of rights which might constitute licensing transactions. In Revenue Ruling 69-156,⁷⁵ the IRS considered a specific factual situation involving the problem of whether a transferor had actually transferred a property interest or had merely allowed the transferee corporation to use the property.

In Revenue Ruling 69-156, a domestic corporation transferred to a foreign subsidiary, in exchange for stock, the exclusive right to import, make, use, sell, and sublicense one of the parent company's products in the country in which the foreign subsidiary was organized and operated. The foreign subsidiary agreed not to assert the right so granted to prevent the parent and its other subsidiaries from importing, using, and selling the product covered by the patent in the foreign subsidiary's country of operation. The Service held that in order for the grant of patent rights to constitute a transfer of property under section 351, the grant had to be made in a transaction which would qualify as a sale or exchange, rather than as a licensing transaction. The Service concluded that all substantial rights had not been transferred, and that the transaction did not come within section 351. As a result, the receipt of the stock of the foreign subsidiary resulted in ordinary income to the parent corporation.

The reference to the term "sale or exchange" in Revenue Ruling 69-156 seems to be an overextension of the requirement of section 351 which requires only a "transfer of property." The theory of Revenue Ruling 69-156 conflicts directly with the Tax Court's decision in *H. B. Zachry Co.*,⁷⁶ since the assignment of a carved-out oil payment was not a sale or ex-

⁷⁴ See also Rev. Proc. 70-17, 1970 INT. REV. BULL. No. 27, at 41-42, §§ 3.02(4)-(6).

⁷⁵ 1969-1 CUM. BULL. 101.

⁷⁶ 49 T.C. 73 (1967), discussed in text accompanying notes 32-36 *supra*.

change, but merely an anticipation of income under the law in effect at the time of the *Zachry* decision. Nevertheless, the result of Revenue Ruling 69-156 seems to correspond with the legislative intent of section 351 which requires a transfer of property and not a transfer of the right to use property. Accordingly, stock issued for the use of property should not be treated as stock issued for property under section 351.

IV. "ONE OR MORE" TRANSFERORS

A. General

The term "one or more persons" allows individuals, corporations, associations, partnerships, trusts, or estates to be transferors for purposes of section 351.⁷⁷ Obviously, one transferor can incorporate his sole proprietorship and qualify under section 351. In many cases, however, more than one transferor is involved. In such situations, it is essential that control be vested within the group of transferors immediately after the exchange. In order to satisfy section 351, it is not essential that each transferor convey property to the transferee corporation in exchange for stock or securities at the same time, as long as the rights of the parties have been previously defined and the exchanges are part of one plan occurring within a reasonable time consistent with orderly procedure.⁷⁸ A wise procedure in situations where the transfers will not or cannot be simultaneous is to have a written plan outlining the rights of the parties and, more particularly, establishing the fact that the transferors will be in control of the transferee corporation as a result of the contemplated plan.

Ordinarily, when more than one transferor is involved, the consideration received by each transferor is in proportion to the value of the property transferred by such transferor, but such is not always the case. Under the 1939 Code, the predecessor of section 351 applied only if the value of the stock or securities received by a transferor was substantially in proportion to the value of such transferor's interest in the property prior to the exchange.⁷⁹ The "substantially proportionate" test was eliminated in 1954.⁸⁰ However, as indicated in the Senate Finance Committee Report on section 351 of the 1954 Code, other provisions of the Code may apply to cause a disproportionate issuance of stock or securities to be a taxable event.⁸¹ The regulations under section 351 indicate that "in appropriate cases" the issuance of stock or securities will be deemed to have been made in proportion to the values of property received, and that some of such stock or securities will then be deemed to have been used

⁷⁷ Treas. Reg. § 1.351-1(a)(1) (1955). See also INT. REV. CODE of 1954, § 7701(a)(1), for the definition of the term "person."

⁷⁸ Treas. Reg. § 1.351-1(a)(1) (1955). See also *Portland Oil Co. v. Commissioner*, 109 F.2d 479 (1st Cir.), cert. denied, 310 U.S. 650 (1940); Rev. Proc. 70-17, 1970 INT. REV. BULL. No. 27, at 43, § 3.05(3).

⁷⁹ Int. Rev. Code of 1939, § 112(b)(5). See Hoffman, *The Substantial Proportionment Requirement of Section 112(b)(5)*, 5 TAX L. REV. 235 (1950).

⁸⁰ The Senate Finance Committee Report on the 1954 Code states that § 351 of the 1954 Code applies "irrespective of any disproportion of the amount of stock or securities received . . . as a result of the transfer." S. REP. No. 1622, 83d Cong., 2d Sess. 264 (1954).

⁸¹ *Id.*

(1) to make gifts, (2) to pay compensation,⁸² or (3) to satisfy other obligations of the transferor.⁸³ Such constructive transfers could constitute taxable gifts or give rise to deductions under section 162, as the case may be. In the event an obligation of a transferor (whether to pay compensation or some other debt) is satisfied by the constructive transfer, such transferor would recognize gain or loss equal to the difference between the amount of the obligation satisfied and his basis in the stock constructively transferred.⁸⁴ Since the regulations apply only "in appropriate cases," it appears that a disproportion resulting solely from disagreements as to value among the transferors should not be affected.⁸⁵

If the transferor or transferors are deemed to have disposed of enough stock to lose "control immediately after the exchange" by virtue of the constructive transfer, the entire transaction might fail if such constructive transfer were an integral part of the plan.⁸⁶ Conversely, if there is no pre-existing obligation to make the constructive transfer, the transferor or transferors could be deemed to own more stock than actually received in the transfer so as to make section 351 applicable. For example, assume that A transfers his proprietorship assets to X corporation for seventy per cent of its stock and causes the remaining thirty per cent to be issued directly to his employee, B, for past services to the proprietorship. If the transfer to B is pursuant to a pre-existing obligation, A, the sole transferor of property, would not be in "control" of X corporation immediately after the exchange, and his transfer would be taxable. If, however, the constructive transfer was not pursuant to such an obligation, A might be able to argue that he constructively owned 100 per cent of the X stock immediately after the exchange, thereby making section 351 applicable.⁸⁷ However, such an argument would be extremely difficult to sustain due to the fact that A never actually owned the stock.

B. Combining Section 351 with a Tax-Free Reorganization

From time to time a situation will arise in which one or more non-corporate taxpayers and one or more corporate taxpayers propose to combine their properties by transferring them to a new corporation. The corporate transferor hopes to qualify the transaction as a tax-free reorganization under section 368(a)(1)(A) or section 368(a)(1)(C), in order that the subsequent receipt of the stock of the transferee corporation by its shareholders will be tax free under section 354. If the transaction is not a reorganization but qualifies only under section 351, the transaction would be taxable to the transferor corporation's shareholders. Since an exchange by a noncorporate transferor cannot qualify as a reorganization, the trans-

⁸² See text accompanying notes 53-59 *supra*.

⁸³ Treas. Reg. § 1.351-1(b)(1) (1955).

⁸⁴ *Id.* § 1.351-1(b)(2), example (1) (last sentence); see note 59 *supra*.

⁸⁵ The original proposed regulations under § 351 would have required a realignment of stock or securities whenever a disproportion existed. See 19 Fed. Reg. 8237, 8268 (1954). The final regulations limit the realignment requirement to "appropriate cases." Treas. Reg. § 1.351-1(b)(1) (1955). But see Rev. Proc. 70-17, 1970 INT. REV. BULL. No. 27, at 42-43, § 3.04(4).

⁸⁶ See text accompanying notes 120-41 *infra*.

⁸⁷ Cf. *Dunn v. United States*, 259 F. Supp. 828 (W.D. Okla. 1966).

action, as a whole, must be characterized as a transfer under section 351, with the transferors being in control immediately thereafter.

The IRS considered this problem in Revenue Ruling 68-357,⁸⁸ which involves a situation in which three corporations and a sole proprietor transferred their assets to a corporation in exchange for voting stock of the transferee corporation. The four transferors were in control of the transferee corporation immediately after the exchange. The three corporate transferors were liquidated, and the stock of the transferee corporation was distributed to the shareholders of the three transferor corporations. The Service held that the exchanges of property by the transferor corporations and the proprietorship solely for voting stock of the transferee corporation constituted a section 351 transaction, inasmuch as the transferors were in control of the transferee corporation immediately after the exchanges within the meaning of section 368(c). By virtue of section 351(c), which disregards, for purposes of determining control, the fact that a corporate transferor distributes part or all of the stock received in a section 351 transaction to its shareholders, the immediate distributions of the transferee corporation's stock by the three transferor corporations were ignored. The transaction was treated as a reorganization under section 368(a)(1)(C) with respect to the three transferor corporations so as to allow tax-free receipt of the stock by their shareholders under section 354. Hence, no gain or loss was recognized by the proprietorship, the three transferor corporations, or their shareholders.

Revenue Ruling 68-357 leaves two significant questions unanswered. First, would the same result be obtained if the three transferor corporations had been merged into the transferee in a reorganization qualifying under section 368(a)(1)(A)? Secondly, would the same result be obtained if there had been only one corporate transferor?

In a statutory merger qualifying under section 368(a)(1)(A), the transferor corporation becomes a part of the acquiring corporation on the effective date of the merger by operation of law.⁸⁹ In such a case, it is difficult to prove that the transferor corporation ever received the stock of the transferee. Under the approach of Revenue Ruling 68-357, therefore, the merged corporation might not be considered a transferor. The IRS has never formally ruled on this subject, but it should rule favorably, regardless of the technical distinction between an "A"- and "C"-type reorganization, because the Service has ruled privately for years that a merged corporation is deemed to have exchanged its property for stock under section 361(a). In order for section 361(a) to apply to an "A"-type reorganization, the transferor corporation must have at least constructive ownership (albeit momentary) of the transferee's stock. In any event, it is suggested that a ruling be obtained if an "A" reorganization is necessary in facts similar to Revenue Ruling 68-357.

⁸⁸ 1968-2 CUM. BULL. 144.

⁸⁹ In a "C"-type reorganization, the acquired corporation effectively "sells" its assets for the stock of the acquiring corporation. Upon the receipt of the stock, the corporation usually liquidates, distributing the acquired stock to its shareholders. Such corporation may, however, continue to exist as a holding company. Rev. Rul. 68-358, 1968-2 CUM. BULL. 156.

In many cases, one or more noncorporate taxpayers propose to combine their property with that of a single corporate taxpayer. A transfer to the existing corporation under section 351 is not acceptable because the noncorporate transferors may not acquire the necessary control. A solution sometimes suggested is to form a new corporation and have both the noncorporate and corporate parties transfer their properties to the new corporation in exchange for voting stock. The corporate transferor is then liquidated, distributing the stock of the corporate transferee to its shareholders. The transaction could then presumably be accorded the treatment found in Revenue Ruling 68-357. However, in Revenue Ruling 68-349,⁹⁰ the IRS considered such a plan and held that as to the corporate transferor, the transaction was a reorganization under section 368(a)-(1)(F). Since the noncorporate transferors did not control the new corporation immediately after the exchange, section 351 did not apply to their exchanges. The Service found that it was "apparent that [the new corporation] was organized for the purpose of enabling [the noncorporate transferors] to transfer the appreciated assets without the recognition of gain."⁹¹ Indirectly, the Service applied the "business purpose" test and found tax avoidance to be the sole purpose for the transaction. The result of Revenue Ruling 68-349 is the same as if the noncorporate transferors had transferred their properties directly to the existing corporation.

Revenue Ruling 68-349 can be distinguished from Revenue Ruling 68-357, since in the later ruling there was no single, existing corporation to which the noncorporate transferor's assets could have been transferred. A realignment of corporate entities was necessary in Revenue Ruling 68-357 so that all the assets could be held within one corporate structure.

Revenue Ruling 68-349 leaves open the possibility that the shareholders of a corporation could transfer their stock in the corporation to the new corporation and the noncorporate transferors could transfer their property to such new corporation. As a result, the new corporation would own directly the properties transferred by the noncorporate transferors and hold the existing corporation as a subsidiary. It would be essential that the existing corporation not be liquidated as part of the plan, because the net effect would be a "C"-type reorganization⁹² and Revenue Ruling 68-349 would apply. Further, the new corporation should not transfer the acquired assets to either the existing corporation or a new subsidiary because of the potential "double" section 351 problem discussed below.⁹³ Because of the uncertainty created by Revenue Ruling 68-349, this alternative should be used with care and only after evaluating the risk of challenge by the Service.

C. *Transitory Ownership*

For many years, some noncorporate taxpayers have held false hopes that section 351, or its predecessors, would provide insulation from tax-

⁹⁰ 1968-2 CUM. BULL. 143.

⁹¹ *Id.*

⁹² See BITTKER & EUSTICE 524.

⁹³ See text accompanying note 100 *infra*.

ation in situations where an offer is received for property held by a non-corporate taxpayer, such property is transferred to a corporation under section 351, and such corporation is immediately acquired in a tax-free reorganization. For example, in *West Coast Marketing Corp.*,⁹⁴ a closely-held corporation and its sole shareholder owned interests in two adjacent tracts of land. At the time when a taxable disposition of such land was about to be consummated for stock in a publicly-held corporation, a new corporation was formed and the land was transferred to such new corporation for stock, ostensibly under section 351. Subsequently, the stock of the new corporation was exchanged for stock in the publicly-held company in a "B"-type reorganization. Shortly thereafter, the new corporation was dissolved. The Tax Court found that the new corporation was not organized or used for any bona fide business purpose, and, relying upon the rationale of *Gregory v. Helvering*,⁹⁵ held that the substance of the transaction was a taxable exchange of land for publicly-held stock.

The most recent pronouncement on the transitory ownership problem is found in Revenue Ruling 70-140.⁹⁶ In that ruling, an individual owned a proprietorship and all of the stock of a corporation engaged in a similar business. Pursuant to an agreement with an unrelated corporation, the individual transferred the assets of the proprietorship to his wholly-owned corporation in exchange for additional shares of that corporation's stock. The individual then exchanged all of the stock of his wholly-owned corporation for stock of the unrelated corporation in a "B"-type reorganization. The IRS ruled that the two steps were part of a prearranged plan and could not be considered independently of each other for federal income tax purposes. The receipt by the individual of the additional stock of his wholly-owned corporation in exchange for the proprietorship assets was merely transitory and without substance for tax purposes, since it was apparent that the assets of the proprietorship were transferred for the purpose of enabling the unrelated corporation to acquire such assets without the recognition of gain to the individual. Accordingly, the individual was deemed to have sold his proprietorship assets to the unrelated corporation.⁹⁷

The principle of *West Coast Marketing Corp.* and Revenue Ruling 70-140 has been applied many times to overcome the device of using section 351 as a method of avoiding a taxable exchange.⁹⁸ The rationale applied by the courts in these cases is strongly reminiscent of the business purpose requirement of a tax-free reorganization developed by the Supreme Court in *Gregory v. Helvering*. The general applicability of the business purpose doctrine to section 351 transactions is discussed in a subsequent section of this Article.⁹⁹

⁹⁴ 46 T.C. 32 (1966).

⁹⁵ 293 U.S. 465 (1935).

⁹⁶ 1970 INT. REV. BULL. No. 13, at 11.

⁹⁷ That portion of the stock of the wholly-owned corporation not received in the tainted exchange was deemed to have been exchanged in a "B"-type reorganization.

⁹⁸ Cf. *Electrical Sec. Corp. v. Commissioner*, 92 F.2d 593 (2d Cir. 1937); *Handbird Holding Corp.*, 32 B.T.A. 238 (1935), *appeal dismissed* (2d Cir. 1936).

⁹⁹ See text accompanying notes 266-76 *infra*.

D. "Double" Section 351 Transactions

The transient ownership cases may give rise to problems in perfectly innocent tax planning situations. Such problems might arise in the situation where property is transferred to a corporation for all of its stock under section 351 and the transferee corporation immediately transfers all or some part of such property, for some reason other than tax avoidance, to a wholly-owned subsidiary in exchange for stock. In such a situation, the transferors obviously have complied with the requirements of section 351 in their transfer to the first corporation, and the parent corporation has met the requirements of section 351 for its transfer to the subsidiary. However, the original transferors are not in control of the ultimate recipient of the property. Without question, section 351 should apply to both transactions. The IRS, however, has informally indicated difficulty in finding control in the original transferors, for purposes of section 351, if the two transactions are part of one plan.¹⁰⁰ In order to avoid the problem, the transferors might transfer the properties to a new corporation under section 351, and then transfer the stock of the new corporation to the original transferee corporation. As long as the second transfer is not pursuant to a legally binding obligation, the Service should apply section 351 to each transaction. The Service has so ruled privately in the past, but it is suggested that an advance ruling be obtained in such cases to avoid problems arising from technical factual differences.

E. Transfers of Partnership Assets

Whenever a partnership is incorporated, problems may arise as to the method to be used to accomplish the tax-free transfer of the business to a new corporation. The first and simplest method is a direct transfer of the assets and liabilities of the partnership to the corporation with the corporation issuing its stock to the partnership and with a subsequent distribution of such stock to the partners. The second method is to have the assets and liabilities which are to be transferred distributed to the partners in partial or complete liquidation with the partners conveying such assets and liabilities to the corporation. The third is to have all partnership interests transferred to the corporation, thereby terminating the partnership.

The Service considered these three possibilities in Revenue Ruling 70-239,¹⁰¹ and held that the federal income tax consequences of each alternative were the same. The partnership in each situation is deemed to be the transferor and the subsequent distribution of stock to the partners in proportion to their partnership interests, where applicable, was held not to violate the control requirements of section 368(c). Since, in each of the situations enumerated in the ruling, the partnership was completely liquidated or terminated, it was held that the basis of stock received by a partner was determined under the provisions of section 732(b).

¹⁰⁰ See text accompanying notes 120-41 *infra*.

¹⁰¹ 1970 INT. REV. BULL. No. 20, at 15.

The ruling does not discuss two possible problems which might arise in incorporating a partnership. The first problem is where the partnership transfers its assets to the corporation and causes the corporation to issue its stock directly to the partners rather than to the partnership. In such a situation, there is authority that the partnership constructively received the stock and distributed it to the partners.¹⁰² The fact that the partnership never actually held the stock seems to be immaterial. This position, of course, is in accord with the rule of section 351(c) which permits a corporate transferor to distribute stock received in a section 351 transaction to its stockholders without violating the control requirement. In order to avoid any possible problem, however, it would appear advisable to have the stock issued to the partnership and then distributed to the partners.

The second problem may arise where a partner's basis in his partnership interest differs from the partnership's tax basis in his share of partnership assets. Such a situation could occur when a partner acquired his interest by purchase or inheritance.¹⁰³ Where the tax basis in a partner's interest is larger than his portion of the partnership's tax basis in assets, it is possible that the indirect transfer method, whereby the partnership assets are distributed to the partners in liquidation of the partnership and the partners transfer such assets to the corporation, might create a stepped-up basis for the transferred assets without adverse tax consequences.¹⁰⁴ On the other hand, if a partnership's tax basis in its assets exceeds the partner's basis in his interest, such a procedure could result in a reduction in basis. In either case, if the assets are distributed by the partnership to the partners in complete liquidation of the partnership, each partner will receive a basis in such assets equal to his basis in his partnership interest.¹⁰⁵ In order to achieve the possible increase in basis, the distributions must be in complete liquidation of the partnership, since in nonliquidating distributions, the partnership's tax basis in the distributed property carries over and becomes the partner's tax basis in such assets.¹⁰⁶ If a significant tax benefit is received through this technique, the IRS would no doubt contend that the partnership liquidation and the transfer to the new corporation were part of one plan, and that the result achieved is the same as if there had been a direct transfer by the partnership.¹⁰⁷

V. "CONTROL"

A. General

In order for section 351 to apply, the transferors as a group must be in control of the transferee corporation immediately after the exchange. Since section 351 applies not only to transfers to a newly organized corporation, but also to transfers of property to a corporation already con-

¹⁰² *Miller Bros. Elec., Inc.*, 49 T.C. 446, 451 (1968).

¹⁰³ INT. REV. CODE of 1954, §§ 743, 754.

¹⁰⁴ *Id.* § 732(b).

¹⁰⁵ *Id.*

¹⁰⁶ *Id.* § 732(a).

¹⁰⁷ The theory of Rev. Rul. 70-239, 1970 INT. REV. BULL. No. 20, at 15, would support this reconstruction by the Internal Revenue Service.

trolled by the transferor or transferors,¹⁰⁸ it is not necessary that control result from the exchange. The essential test is the status of control immediately after the exchange.

B. *The Eighty Per Cent Test*

The term "control," as used in section 351, is defined in section 368(c) as ownership of (1) at least eighty per cent of the total combined voting power of all classes of stock entitled to vote, and (2) at least eighty per cent of the total number of shares of all other classes of stock of the transferee corporation. Only outstanding stock, and not authorized but unissued stock or treasury stock,¹⁰⁹ is considered in determining control. Further, options to purchase stock are disregarded.¹¹⁰ No attribution rules apply for purposes of determining control under section 368(c).¹¹¹ Hence, only stock owned directly by the transferors is considered in ascertaining whether control exists for purposes of section 351.

There is no requirement that voting rights be proportionate to the value of the assets transferred by the transferors. In *George M. Holstein, III*¹¹² one transferor conveyed property valued at \$16,710 for 210 shares of one dollar par value, voting common stock and 16,500 shares of one dollar par value, nonvoting preferred stock, and two others acquired 210 shares of one dollar par value, voting common stock for \$210 cash in a section 351 transaction. The Tax Court did not find the disproportion in voting rights objectionable under section 351.

In some cases, allocation of voting rights can be helpful in accomplishing the desired balance of power in the new corporate structure. For example, the general partner of a limited partnership which is to be incorporated may hold a relatively small interest in the partnership, but desire to retain effective control of the new corporation. By proper allocation of the voting rights among more than one class of stock, such control can be achieved. Care must be taken, of course, that the relative values of the classes of stock do not create a "stock for services" problem with respect to the general partner.¹¹³

The determination of control presents no problem, of course, in cases where the transferor or transferors own 100 per cent of all classes of outstanding stock of the transferee corporation, or more than eighty per cent of the common stock if it is the only class of stock outstanding after the transfer. If there is more than one class of stock outstanding and the transferor or transferors do not own all of each class of outstanding stock, any one or more of the following phrases may create a problem in determining control: (1) "total combined voting power"; (2) "stock entitled to vote"; and (3) "all other classes of stock."

¹⁰⁸ Treas. Reg. § 1.351-1(a)(2), example (3) (1955).

¹⁰⁹ *Louangel Holding Corp. v. Anderson*, 9 F. Supp. 550 (S.D.N.Y. 1934); *American Bantam Car Co.*, 11 T.C. 397 (1948), *aff'd per curiam*, 177 F.2d 513 (3d Cir. 1949), *cert. denied*, 339 U.S. 920 (1950).

¹¹⁰ *American Wire Fabrics Corp.*, 16 T.C. 607 (1951), *acquiesced in*, 1951-2 CUM. BULL. 1.

¹¹¹ See Rev. Rul. 56-613, 1956-2 CUM. BULL. 212, 213.

¹¹² 23 T.C. 923 (1955).

¹¹³ See text accompanying notes 39-48 *supra*.

The phrase "total combined voting power" seemingly allows a mere counting of voting rights, while totally disregarding the number of shares involved and the relative fair market values of the shares. In the consolidated return area, the power to elect directors is considered controlling in determining total voting power.¹¹⁴ Presumably, the same test would apply for purposes of section 351. The mere right of a class of stock to vote only on extraordinary events, such as a merger or liquidation, should not require that such class of stock be considered in the determination of "total combined voting power."¹¹⁵ An early Board of Tax Appeals decision indicates that control means actual ownership of stock and does not require exercise of voting rights.¹¹⁶ Assuming that the rationale of that case still applies, voting trusts or other shareholder agreements relating to voting rights presumably should not be considered when computing "total combined voting power," although the Service may take a contrary view.¹¹⁷

Neither the statute nor the regulations define "stock entitled to vote." As indicated above, stock which under state law votes only on an extraordinary event should not be deemed to be "stock entitled to vote" for purposes of determining control under section 351.¹¹⁸ The proper test for determining "stock entitled to vote" should be whether such stock has the right to vote for directors, but this test has not been formally adopted by the IRS for purposes of section 351.

In considering ownership of "other classes of stock," the total number of shares of such stock, rather than the relative values of such stock, must be considered. Section 368(c) would seem to group all classes of non-voting stock together for purposes of determining eighty per cent ownership. The Service, however, has ruled that in order to meet the eighty-per-cent-of-all-other-classes-of-stock test, the transferors must own eighty per cent of the total number of shares of each class of such stock.¹¹⁹

VI. "IMMEDIATELY AFTER THE EXCHANGE"

A. General

Perhaps the most troublesome and most litigated issue relating to section 351 is the determination of whether the transferors have control of the transferee corporation immediately after the exchange. Of course, if such control is absent, section 351 will not apply to prevent recognition of gain or loss.

The question of control immediately after the exchange has been

¹¹⁴ Rev. Rul. 69-126, 1969-1 CUM. BULL. 218; I.T. 3896, 1948-1 CUM. BULL. 72. See also Rudolph Wurlitzer Co., 29 B.T.A. 443 (1933), *aff'd*, 81 F.2d 971 (6th Cir.), *cert. denied*, 298 U.S. 676 (1936).

¹¹⁵ Cf. Treas. Reg. § 1.302-3(a) (1955), which states that such stock is not generally "voting stock" until the specified event occurs.

¹¹⁶ Federal Grain Corp., 18 B.T.A. 242 (1929).

¹¹⁷ Cf. Rev. Rul. 63-226, 1963-2 CUM. BULL. 341, which indicates that voting agreements among shareholders create more than one class of stock for purposes of subchapter S treatment.

¹¹⁸ See note 115 *supra*.

¹¹⁹ Rev. Rul. 59-259, 1959-2 CUM. BULL. 115.

thoroughly discussed by commentators,¹²⁰ the courts¹²¹ and the IRS.¹²² Although the conclusions of such parties are not in complete agreement, it appears that the test of whether such requirement is met is whether the section 351 transaction would have been consummated *but for* the transaction or transactions causing the transferors to lose control. The Tax Court stated this test rather succinctly in the *American Bantam Car Co.* case, as follows: "An important test [in determining control immediately after the exchange] is that of mutual interdependence. Were the steps so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series?"¹²³

The problem of control immediately after the exchange may arise in a number of different contexts. An attempt has been made in the succeeding sections to describe the factual patterns in which the problem most frequently appears, and to discuss with respect to each such factual pattern the difficulties which may arise under the "immediately after" test.

B. Sales of Stock by Transferors or Issuance of Additional Stock by Corporation

On many occasions, a new corporation will be formed expressly for the purpose of subsequently becoming a publicly-held corporation. Such status may, of course, be achieved either by a sale of stock by the transferors, or by issuance of additional stock by the transferee corporation. It appears obvious that if a person transfers property to a new corporation in exchange for stock and has previously entered into a binding agreement to sell more than twenty per cent of the stock received, such sale should disqualify the section 351 transaction. For example, in *May Broadcasting Co. v. United States*¹²⁴ the Eighth Circuit found that a subsequent sale of stock disqualified a purported section 351 transaction even though the sale of such stock was approximately eighteen months after the exchange of property for stock. The delay was necessitated by the required approval of such sale by a governmental agency. The court found that the delay did not prevent the subsequent sale from being treated as part of the overall plan.¹²⁵

On the other hand, where the subsequent sale is separated from the section 351 transaction by a period of time and is merely contemplated at the time the section 351 transaction occurs, such subsequent sale should not disqualify the section 351 transaction. In *National Bellas Hess, Inc.*¹²⁶ it was contemplated at the time of the section 351 transaction that the corporation would issue additional shares of its stock for cash, since

¹²⁰ BITTKER & EUSTICE 89-94; Mintz & Plumb, *Step Transactions in Corporate Reorganizations*, N.Y.U. 12TH INST. ON FED. TAX. 247 (1954).

¹²¹ See, e.g., *American Bantam Car Co.*, 11 T.C. 397 (1948), *aff'd*, 177 F.2d 513 (3d Cir. 1949), *cert. denied*, 339 U.S. 920 (1950).

¹²² Rev. Rul. 54-96, 1954-1 CUM. BULL. 111.

¹²³ 11 T.C. 397, 405 (1948), *aff'd*, 177 F.2d 513 (3d Cir. 1949), *cert. denied*, 339 U.S. 920 (1950).

¹²⁴ 200 F.2d 852 (8th Cir. 1953).

¹²⁵ See also *Manhattan Bldg. Co.*, 27 T.C. 1032 (1957), *acquiesced in*, 1957-2 CUM. BULL. 5.

¹²⁶ 20 T.C. 636 (1953), *aff'd*, 220 F.2d 415 (8th Cir. 1955).

additional funds were needed to conduct its business. At the time of the section 351 transaction, however, there was no obligation to issue such stock. The Tax Court found that the subsequent sale did not affect the section 351 transaction, because of the lack of a binding obligation to issue such stock at the time of the section 351 transaction, and because of the passage of a substantial period of time before the subsequent sale. Other cases have followed the rule of *National Bellas Hess, Inc.* where the facts indicated that the seller was not committed to sell additional stock at the time the section 351 transaction occurred.¹²⁷

Perhaps the leading case dealing with subsequent dispositions of stock by transferors is *American Bantam Car Co.*¹²⁸ There, property was transferred to a corporation in exchange for all of its common stock on June 3, 1936. Five days later the new corporation entered into a contract with an underwriter for the sale of its preferred stock. Under that agreement, the underwriter was to receive 100,000 shares of common stock from the transferors over a specified period of time if and when the preferred stock was sold. In October 1937, more than twenty per cent of the common stock was transferred to the underwriter. The Tax Court held that the transferors had the required control in June 1936, and that the subsequent loss of such control was not an integral part of the section 351 transaction. The court found that there was no binding commitment in existence on the date of the section 351 transaction, but only an oral understanding of the plan.

In today's rush to the public marketplace, although depressed at the moment, the effect of a public sale of stock might have an unfavorable effect on the tax-free nature of a section 351 incorporation which preceded the public offering. It seems clear that *American Bantam Car Co.* would protect a section 351 transaction where there was no underwriting agreement in existence at the time of the transfer. Further, it would seem that if a binding underwriting agreement were not executed until after the transferors had executed a legally enforceable contract to make their transfers to the corporation, such subsequent underwriting agreement would not affect the section 351 transaction. It would seem that a prerequisite to such a contract would be that the transferors be legally obligated to make the transfers of property to the corporation even if the Securities and Exchange Commission rejected the corporation's registration statement.

If an underwriting agreement has been executed, the consequences of such an agreement might depend upon the type of underwriting contemplated. If the agreement provides for a "firm" underwriting, whereby the underwriter will purchase a specified number of shares directly from the corporation, it would seem that the underwriter could qualify as a transferor if his purchase of the stock were part of the overall section 351 trans-

¹²⁷ See, e.g., *Lodi Iron Works*, 29 T.C. 696 (1958); *John C. O'Connor*, 16 CCH Tax Ct. Mem. 213 (1957).

¹²⁸ 11 T.C. 397 (1948), *aff'd*, 177 F.2d 513 (3d Cir. 1949), *cert. denied*, 339 U.S. 920 (1950).

action. In *Hartman Tobacco Co.*¹²⁹ an underwriter and several other transferors transferred cash and other property to a new corporation in exchange for all of its stock. Shortly thereafter, the underwriter sold substantially all of his stock to the general public. The Tax Court held that the underwriter was a transferor, and that his subsequent sale of stock did not disqualify the section 351 transaction because at the time he acquired the stock he had no binding agreement to sell the stock to outsiders. Therefore, if a firm underwriting is contemplated and the underwriter has no obligation to dispose of his shares at the time of the section 351 transaction, the subsequent sale of stock should not affect the tax-free nature of the incorporation. If, however, the underwriter has a binding commitment to dispose of shares sufficient in number to fail the control test, section 351 might not apply.

If the underwriting contemplated is to be a "best efforts" underwriting, whereby the underwriter is not obligated to purchase shares of stock but agrees to sell shares to the public for the corporation, such an agreement may disqualify the section 351 transaction. In *Overland Corp.*¹³⁰ a "best efforts" underwriting agreement which was part of the overall transaction was fatal to section 351 treatment. It would seem that the holding in *Overland Corp.* is incorrect, since the purchasers of stock under the "best efforts" offering in that case actually transferred cash to the corporation as part of the overall section 351 plan.¹³¹ That such persons were not directly parties to the section 351 plan may have been the basis of the Tax Court's decision.

It is understood that the IRS recently ruled privately that even where a letter had been executed expressing an intention to have a public offering which would reduce the transferors' ownership to less than eighty per cent, there was no binding commitment or integrated plan to issue additional shares. It appears that the Service properly considers a letter of intent as a contingent agreement and not as a binding obligation.

In any event, where a public offering is contemplated, it would be advisable to consummate the incorporation prior to beginning negotiations with an underwriter. If this cannot be done and the public offering involves more than twenty per cent of the stock of the corporation, an advance ruling should be obtained.

C. Stock Issued for Prior Services

As indicated above,¹³² the transferors may cause stock to be issued directly to employees of the predecessor business for past services. It seems clear from the decided cases that if there is an existing obligation on the part of the transferors at the time of the incorporation to transfer part of the stock to an employee, the issuance of such stock to an employee,

¹²⁹ 45 B.T.A. 311 (1941), *acquiesced in*, 1943 CUM. BULL. 11.

¹³⁰ 42 T.C. 26 (1964), *nonacquiesced in*, 1966-2 CUM. BULL. 8. In this case, the Commissioner argued that the transaction qualified under the predecessor of § 351, and apparently the non-acquiescence relates to the Tax Court's finding on that point.

¹³¹ Cf. Treas. Reg. § 1.351-1(a)(1) (1955).

¹³² See text accompanying notes 53-59 *supra*.

if more than twenty per cent of the stock is involved, will cause disqualification of the section 351 transaction.¹³³ In *Schmieg, Hungate & Kotzian, Inc.*,¹³⁴ however, the Board of Tax Appeals found that the transfer of stock to an employee more than twelve months after the date of incorporation did not disqualify the section 351 transaction, even though it appears from the facts of the case that there was a pre-existing commitment on the part of the transferors to make such a transfer. Obviously, the court gave considerable weight to the timing of the transfer. It should be noted that this case was decided in 1932, prior to the lucid enunciations on the subject of binding commitments and interdependent steps found in *American Bantam Car Co.*¹³⁵

D. Gifts by Transferors

Transferors may desire to give a part of their stock to other family members as gifts. It would seem logical to conclude that such gifts could be made by having the corporation issue the stock directly to the donees. In one case, however, where more than twenty per cent of the stock was transferred directly by the corporation to a son, it was held that the "immediately after" test was not satisfied.¹³⁶ In another case, a father transferred twenty-one per cent of the stock to his son immediately after incorporating a sole proprietorship, and it was held that the "immediately after" test was satisfied because immediately after the transaction the father had the legal right to do whatever he wished with his stock.¹³⁷ The difference in methods of making gifts seemingly should not be material and hardly justifies the difference in result described in the two cases. In any event, if gifts exceeding twenty per cent of the stock are contemplated, all of the stock should be issued to the transferors and the gifts should be made after the section 351 transaction is completed.

E. Effect of Options

In several cases, a transferor has granted an option to a third party to acquire stock immediately after the exchange. Where the option is exercised, the courts have generally held that the exercise of the option does not disqualify the section 351 transaction.¹³⁸ Presumably, such a conclusion is based upon the fact that the *option* did not constitute an obligation to purchase. At least one commentator has indicated that the likelihood of exercise of the option should be considered, and if exercise is a foregone

¹³³ For cases where stock was issued directly to employees, see *Fahs v. Florida Mach. & Foundry Co.*, 168 F.2d 957 (5th Cir. 1948); *Majonnier & Sons*, 12 T.C. 837 (1949), *nonacquiesced in*, 1949-2 CUM. BULL. 4. For a case where the stock was issued to the transferors and immediately transferred to employees, see *Columbia Oil & Gas Co.*, 41 B.T.A. 38 (1940).

¹³⁴ 27 B.T.A. 337 (1932).

¹³⁵ See text accompanying note 128 *supra*.

¹³⁶ *Fahs v. Florida Mach. & Foundry Co.*, 168 F.2d 957 (5th Cir. 1948). Apparently, under present law, Treas. Reg. § 1.351-1(b)(1) (1955) would permit direct issuance of the stock to be treated as a gift, but the effect of such direct issuance on control is not clear. See text accompanying notes 86, 87 *supra*.

¹³⁷ *Wilgard Realty Co. v. Commissioner*, 127 F.2d 514 (2d Cir. 1942), *cert. denied*, 317 U.S. 655 (1943).

¹³⁸ See, e.g., *National Bellas Hess, Inc.*, 20 T.C. 636 (1953), *aff'd*, 220 F.2d 415 (8th Cir. 1955); *Robert J. Harder*, 17 CCH Tax Ct. Mem. 494 (1958).

conclusion, such option might well disqualify section 351 treatment.¹³⁹ This approach would place the IRS in a position of superimposing its judgment on the facts in hindsight, and, if any option were exercised, the Service would no doubt conclude that such exercise was a foregone conclusion. The better rule would be that an option is not an obligation of the transferor to transfer stock until it is exercised, assuming that the option is not a sham, and that an option should not affect the validity of the section 351 transaction.

F. *Distributions by a Corporate Transferor*

Section 351(c) provides that in determining control under section 351, the fact that a corporate transferor immediately distributes to its shareholders all or any part of the stock it receives may be ignored. Therefore, if a corporate transferor distributes stock received in a section 351 transaction, regardless of the nature of the distribution to the recipient, such subsequent transaction will not affect the determination of control for purposes of section 351.¹⁴⁰ In Revenue Ruling 68-298,¹⁴¹ where twenty-five per cent of the stock of a subsidiary was distributed, the Service held that section 351(c) would apply if the corporate transferor distributed the subsidiary's stock received in a section 351 transaction to one of its shareholders in complete redemption of such shareholder's stock in the transferor corporation.

VII. "IN EXCHANGE FOR STOCK OR SECURITIES"

A. *General*

In order to achieve a tax-free transfer of property under section 351(a), the transfer must be "in exchange for stock or securities" of the transferee corporation. It is well accepted that the statute is met if stock *and* securities are received in the exchange as well as if stock *or* securities are received.¹⁴² As a result, transferors who are in control of the corporation immediately after the exchange may receive securities, as well as stock, in the exchange without disturbing the tax-free nature of the transaction.

B. *Must There Be an Exchange?*

Section 351(a) seems to contemplate and, in fact, require that a transferor receive stock or securities "in exchange" for property. The IRS, however, takes the position that a contribution of appreciated property to the capital of a wholly-owned corporation is governed by section 351, presumably under the theory that the issuance of additional stock or securities would be a meaningless gesture on the part of the corporation. In Revenue Ruling 64-155,¹⁴³ the Service held that if a domestic corporation contributed depreciated property to a wholly-owned foreign subsidiary, the

¹³⁹ BITTKER & EUSTICE 94.

¹⁴⁰ S. REP. No. 1622, 83d Cong., 2d Sess. 265 (1954).

¹⁴¹ 1968-1 CUM. BULL. 139.

¹⁴² Treas. Reg. § 1.368-2(h) (1955).

¹⁴³ 1964-1 CUM. BULL. 138.

transaction would be considered as an exchange of property for stock under section 351, regardless of the fact that no additional stock or securities were issued. In that ruling, the Service relied on *King v. United States*¹⁴⁴ and *Commissioner v. Morgan*¹⁴⁵ as authority for the proposition that a transfer by way of contribution to capital of a wholly-owned corporation was within the purview of section 351.

In *Morgan* the question was whether the transfer by one corporation of all of its operating assets to another corporation constituted a complete liquidation under section 115(c) of the 1939 Code, or a reorganization under section 112(b)(3) and (c)(1) of the 1939 Code, where there had been no actual exchange of stock and all of the stock of both corporations was owned by the same person. The Third Circuit held that an actual physical exchange of stock was not necessary in order for a reorganization to have occurred where all of the stock of both corporations was owned by the same party. In *Morgan* no section 351 transaction was involved.

In *King* the question related to the basis of property transferred to a corporation. In that case, a taxpayer organized a new corporation and transferred certain stock to it in exchange for substantially all of the stock of the new corporation. Shortly thereafter, the taxpayer transferred additional stock to the new corporation without additional consideration. Presumably, the reason the second block of stock was not transferred at the same time as the first block was because the certificate for the second block was not immediately available. The new corporation sold the second block of stock approximately six years after the transfer. The Commissioner claimed that the transfer of the second block of stock was in connection with a transaction described in section 203(b)(4) of the Revenue Act of 1926 (the predecessor of section 351), and that the basis of such stock should be determined under section 204(a)(8) of the Revenue Act of 1926. The taxpayer argued that the basis of such stock to the corporation was its fair market value on the date of transfer, because there was no statute in effect for the year in question requiring a carryover of basis in contributions to capital. The district court stated that issuance of additional stock to a person already owning all of the stock of the transferee corporation was not material, since the value of all the stock held by him would remain substantially the same irrespective of the total number of shares outstanding. The court then expressed the view that it would do no great violence to the statute to treat the transactions as if additional securities had been issued for property. It should be noted, however, that the court also found that the transfers of both blocks of stock were part of one plan.¹⁴⁶ On appeal, the Fourth Circuit found that the issuance of additional stock would be a meaningless gesture, and treated the transaction as though there had been an issuance of securities for property. Both the district court and

¹⁴⁴ 10 F. Supp. 206 (D. Md.), *aff'd*, 79 F.2d 453 (4th Cir. 1935).

¹⁴⁵ 288 F.2d 676 (3d Cir. 1961), *cert. denied*, 368 U.S. 836 (1962).

¹⁴⁶ This finding should have been dispositive of the § 351 issue. *Cf.* Treas. Reg. § 1.351-1(a)(1) (1955).

the Fourth Circuit noted that section 113(a)(8) of the Revenue Act of 1932 (the predecessor of section 362(a) of the 1954 Code) would have required, had it been in effect for the year in question, that the transferee corporation carry over the basis of the transferor regardless of whether the transfer had been a contribution of capital or in connection with a section 351 transaction. Obviously, the decision in *King* was an attempt to reach the same result for the year in question that would have been reached had the predecessor of section 362(a) been in effect for that year. To this end, the courts held that a constructive section 351 transaction had occurred.

The question whether an exchange is required under section 351 was placed squarely before the Tax Court in the recent case of *Werner Abegg*.¹⁴⁷ There, the taxpayer made a transfer of stocks to a wholly-owned foreign corporation as a contribution to capital. The Commissioner contended that the transfer was, in effect, an exchange under section 351, and that gain was realized upon the transfer of the appreciated stocks because the taxpayer had not complied with section 367. In support of his position, the Commissioner relied upon Revenue Ruling 64-155 and the *King* and *Morgan* cases. The Tax Court found that the *Morgan* case was distinguishable in that it was concerned with the question of whether a transfer of a corporation constituted a liquidation or reorganization, and that the *King* case was distinguishable because it related to determination of basis. The Tax Court stated that the sole question with which it was concerned in *Abegg* was whether there was in fact an "exchange" as provided by section 351. The court found that there was no justification in extending the holdings of the *Morgan* and *King* cases to the facts of *Abegg*, since such an extension would be contrary to the plain and unambiguous language of section 351. On appeal, the Second Circuit affirmed the Tax Court, based upon a somewhat different and more complicated analysis of the problem. The Commissioner argued that the holding of the Tax Court left open a substantial tax avoidance potential whereby appreciated securities could be contributed to a foreign corporation and sold in a foreign country without taxation. The Second Circuit found that section 901 of the Revenue Act of 1932 (the predecessor of section 1491 of the 1954 Code), which imposed an excise tax on the transfer of stock or securities by certain taxpayers to a foreign corporation as a contribution to capital, was enacted to preclude the possibility of tax avoidance pointed out by the Commissioner. The Second Circuit reasoned that if section 367 and section 351 apply to a contribution to the capital of a foreign corporation, section 901 of the Revenue Act of 1932 was unnecessary, since Congress obviously did not mean that such a contribution should be subjected to both an income and an excise tax, while an exchange of such property for stock or securities should be subjected only to an income tax in the absence of a ruling under section 367.

On the basis of the *Abegg* decision, it appears that the IRS must look to

¹⁴⁷ 50 T.C. 145 (1968), *aff'd*, 429 F.2d 1209 (2d Cir. 1970).

Congress to include contributions of capital within the purview of section 367, since the constructive section 351 transaction theory is invalid.¹⁴⁸ At this time, the Service has attempted to apply the theory only to contributions of capital to foreign corporations, but could attempt to apply it in a situation where a taxpayer made a bargain sale (*i.e.*, at his cost basis) to a wholly-owned corporation. In such a situation, the taxpayer obviously intends to contribute the unrealized appreciation to his corporation and recover only his cost. If, however, a constructive section 351 exchange occurs, the payment by the corporation of an amount equal to his cost could be considered boot under section 351(b), and gain would be recognized. Such a result certainly is not justified under section 351 if no stock or securities are issued.

C. Definition of "Stock"

There is no definition of the term "stock" in the Code, the regulations, or the published rulings, but the term is generally considered to mean an equity interest in a corporation, whether (1) voting or nonvoting, or (2) common or preferred. Presumably, the term has the same meaning for section 351 as it has for purposes of sections 354(a)(1) and 361(a), which relate to corporate reorganizations. Quite often in "thin capitalization" cases the courts will extend the definition of stock to hold that purported debt is, in effect, stock.¹⁴⁹

The regulations under section 351 state that stock rights and stock warrants do not come within the meaning of the term "stock or securities."¹⁵⁰ Obviously, such rights do not represent an equity interest in the corporation until exercised and should not be accorded treatment as either stock or securities.¹⁵¹ Presumably, therefore, the value of such rights, if received in connection with a section 351 transaction, might well be treated as boot.¹⁵² This result, insofar as it relates to noncompensatory rights or warrants, is difficult to reconcile with the rule of section 305 which allows shareholders of an existing corporation to receive stock rights or warrants tax-free in most instances. A literal reading of section 351, however, requires such a result. Therefore, care should be taken not to issue rights or warrants as part of an incorporation transaction.

If a transferor is given a nontransferable contingent right to additional stock, as contrasted to rights or warrants to acquire stock, such right has been held to be the equivalent of stock, since only additional stock can be received pursuant to such right and the transferor cannot sell it. In *James*

¹⁴⁸ Section 1491 applies only to contributions of stock or securities and would not apply to contributions of other appreciated property. Therefore, a loophole does exist for contributions of property, other than stock or securities, to a foreign corporation.

¹⁴⁹ See Goldstein, *Corporate Indebtedness to Shareholders: "Thin Capitalization" and Related Problems*, 16 TAX L. REV. 1 (1960).

¹⁵⁰ Treas. Reg. § 1.351-1(a)(1) (1955).

¹⁵¹ Cf. *Helvering v. Southwest Consol. Corp.*, 315 U.S. 194 (1942), holding that warrants are not voting stock for purposes of a § 368(a)(1)(B) reorganization.

¹⁵² Cf. *William H. Bateman*, 40 T.C. 408 (1963), *nonacquiesced in*, 1965-2 CUM. BULL. 7, holding warrants were "other property" for purposes of § 356. For a contrary view, see BITTKER & EUSTICE 75.

C. *Hamrick*¹⁵³ the taxpayer, an inventor, acquired a contractual right to receive additional shares of stock if a patent which he had transferred to a corporation under section 351 proved successful. The Tax Court found that the contingent right was, in substance, the equivalent of stock, since the holder could receive nothing other than stock under the contract. The IRS announced in Revenue Ruling 66-112¹⁵⁴ that it would follow *Hamrick* under section 351 in cases where: (1) the contract right is not specifically assignable nor readily marketable; (2) the contract right can only give rise to receipt of additional stock by one who was a party to the section 351 transfer; and (3) a bona fide business purpose exists for not issuing all of the stock immediately. The ruling further provides that the delayed issuance will be scrutinized to assure that the additional stock does not constitute compensation income to the recipient.

D. Definition of "Securities"

As with the term "stock," the term "securities" is not defined in the Code, regulations, or published rulings, but presumably has the same meaning as under the reorganization provisions.¹⁵⁵ The definition of the term has been confused for a number of years, principally because of the holding in a reorganization case, *Pinellas Ice & Cold Storage Co. v. Commissioner*,¹⁵⁶ in which the Supreme Court held that short-term notes were not securities since such notes were the equivalent of cash. At least one commentator has indicated that the *Pinellas* decision has led the courts to unduly restrict the scope of the term "securities."¹⁵⁷ Because of the prevailing confusion, the IRS has substantially limited its advance ruling policies in section 351 transactions where securities are involved.¹⁵⁸

Although it is difficult to ascertain whether a formal corporate obligation to a shareholder will be considered a security or ordinary debt, certain guidelines have been developed which should help determine whether an obligation constitutes a security. For a time, it was thought that the name of the obligation was significant, and that "notes" could not qualify as securities.¹⁵⁹ This approach has little, if any, basis in the court decisions and should no longer be a consideration in determining the nature of a debt.¹⁶⁰ The principal factor which the courts have looked to in recent years is the term of the note. Most practitioners follow the rule of thumb that obligations payable in five years or less do not qualify as securities

¹⁵³ 43 T.C. 21 (1964), *acquiesced in result only*, 1966-1 CUM. BULL. 2.

¹⁵⁴ 1966-1 CUM. BULL. 68.

¹⁵⁵ Cf. INT. REV. CODE OF 1954, §§ 354(a)(1), 361(a).

¹⁵⁶ 287 U.S. 462 (1933).

¹⁵⁷ Griswold, "Securities" and "Continuity of Interest," 58 HARV. L. REV. 705 (1945).

¹⁵⁸ Rev. Proc. 64-31, 1964-2 CUM. BULL. 947. Under § 3.01(10)(a) of Revenue Procedure 64-31, the Service will not rule on a § 351 transaction involving securities if a "thin corporation" problem is involved. Under § 4.01(4) of Revenue Procedure 64-31, the Service will not ordinarily issue advance rulings as to the tax effect of a transfer under § 351 if part of the consideration received by a transferor consists of bonds, debentures, or other evidences of indebtedness of the transferee corporation.

¹⁵⁹ See Griswold, "Securities" and "Continuity of Interest," 58 HARV. L. REV. 705 (1945); Weiss, *Notes as Securities Within Section 112(b)(3)*, 26 TAXES 228 (1948).

¹⁶⁰ See *L & E Stirn, Inc. v. Commissioner*, 107 F.2d 390 (2d Cir. 1939) (bonds not securities); *Burnham v. Commissioner*, 86 F.2d 776 (7th Cir. 1936) (notes held to be securities).

while those of ten years or more do qualify, although there are exceptions to the general rule.¹⁶¹

In an interesting recent case, *United States v. Mills*,¹⁶² the Fifth Circuit found that there was substantial evidence to support the jury's finding that the transfer of property by a taxpayer to his own corporation in return for a \$197,879.55, one-year note was a tax-free exchange under section 351 because the note was a security. In reviewing the jury's verdict, the Court relied upon the test applied by the Tax Court in *Camp Wolters Enterprises, Inc. v. Commissioner*:

The test as to whether notes are securities is not a mechanical determination of the time period of the note. Though time is an important factor, the controlling consideration is an overall evaluation of the nature of the debt, degree of participation and continuing interest in the business, the extent of proprietary interest compared with the similarity of the note to a cash payment, the purpose of the advances, etc. It is not necessary for the debt obligation to be the equivalent of stock since . . . [section 351] . . . specifically includes both 'stock' and 'securities.'¹⁶³

Apparently, the finding that the one-year note was a security was based upon evidence that the taxpayer intended the note to remain more or less indefinitely an obligation of the corporation upon which he would draw interest to supplement his annual income. Although the case is a refreshing victory for the taxpayer, it will be difficult, in most cases, to prove that a short-term note will be renewed over a sufficient period to cause it to be a security.¹⁶⁴ Prior to restricting its ruling policies with respect to the question of securities under section 351, the IRS issued Revenue Ruling 56-303,¹⁶⁵ in which it was held that notes of less than four years and an average life of two-and-one-half years did not qualify as "securities." However, that ruling was withdrawn, but not revoked, in line with the IRS's new policy relating to rulings involving securities under section 351.¹⁶⁶ In Revenue Ruling 59-98,¹⁶⁷ which involved a reorganization, the Service ruled that bonds which were payable in from three to ten years with an average period to maturity of six and one-half years were securities under section 354. Presumably, since the definition of securities for both section 351 and reorganization purposes should be identical, this ruling provides some guidance in planning incorporation transactions.

The payment of notes in installments has given rise to problems in qualifying an instrument so payable as a security. In one case, *Warren H.*

¹⁶¹ BITTKER & EUSTICE 73.

¹⁶² 399 F.2d 944 (5th Cir. 1968).

¹⁶³ 22 T.C. 737, 751 (1954), *acquiesced in*, 1954-2 CUM. BULL. 3, *aff'd*, 230 F.2d 555 (5th Cir. 1956).

¹⁶⁴ See *Turner Constr. Co. v. United States*, 364 F.2d 525 (2d Cir. 1966) (6-month note not a security, but on remand *sub nom.* *Prentis v. United States*, 273 F. Supp. 460 (S.D.N.Y. 1967) such notes were held to be securities since they were part of a plan for deferred issuance of preferred stock); *L & E Stirn, Inc. v. Commissioner*, 107 F.2d 390 (2d Cir. 1939) (bonds with average maturity of 2½ years held not securities); *Cortland Specialty Co. v. Commissioner*, 60 F.2d 937 (2d Cir. 1932) (notes maturing 1 to 14 months after issuance held not securities).

¹⁶⁵ 1956-2 CUM. BULL. 193.

¹⁶⁶ Rev. Rul. 63-28, 1963-1 CUM. BULL. 76.

¹⁶⁷ 1959-1 CUM. BULL. 76.

Brown,¹⁶⁸ the Tax Court held that a contract payable in ten annual installments with interest was not a security because the contract did not insure a continued participation of the business of the transferee corporation. Obviously, whether a note is payable in a lump sum at the end of a period of time or in installments throughout a period of time, the holders of such instruments have a continuing interest in the affairs of the corporation for the life of the instrument. It appears that the distinction of the *Brown* case is not proper, and that the courts are not following the restrictive view of *Brown*.¹⁶⁹

Certain characteristics, if present, may aid in qualifying an instrument as a security, although because certain of these characteristics are also characteristics of preferred stock, there is a danger, particularly in a thin capitalization situation, that a court may find such instrument to be preferred stock. Such characteristics are:

1. If at all possible, the term of the note should be at least ten years. Such a time period should be more than sufficient to give the noteholder the required continuing interest in corporate affairs.
2. The instrument should be in writing, as an open account does not qualify as a security.¹⁷⁰
3. The obligation should be negotiable and registered as a corporate security.
4. The obligation should be secured to the extent possible by corporate assets.
5. The note should provide for interest of at least four per cent per annum.¹⁷¹

Hopefully, as a result of the enactment of section 385 as part of the Tax Reform Act of 1969, the IRS will issue authoritative regulations defining the difference between stock and debt. That new provision specifically authorizes the issuance of regulations to determine whether an interest in a corporation is to be treated as stock or debt. If these regulations define an obligation as a debt, it will then be necessary for the taxpayer to be in a position to prove that such debt is a security.

Even though an obligation can not qualify as a security under section 351, it may, nevertheless, qualify as "other property." Hence, if the transferor receiving such obligation also receives stock, such non-qualifying obligation should be considered boot under section 351(b), and the rules applying to taxation of boot would be applied.

VIII. "SOLELY"—RECEIPT OF BOOT

A. General

No gain or loss is recognized under section 351 if an exchange is solely

¹⁶⁸ 27 T.C. 27 (1956), *acquiesced in*, 1957-2 CUM. BULL. 4.

¹⁶⁹ See *United States v. Hertwig*, 398 F.2d 452 (5th Cir. 1968) (12½-year installment notes held to be securities); *George A. Nye*, 50 T.C. 203 (1968), *acquiesced in*, 1969-2 CUM. BULL. xxv (10-year installment notes held to be securities).

¹⁷⁰ See *John W. Harrison*, 24 T.C. 46 (1955).

¹⁷¹ Section 483, requiring imputed interest on obligations received upon the sale or exchange of property where no interest (or insufficient interest) is stated, would appear to apply to securities issued under § 351.

for stock and/or securities of the transferee corporation. If the transferees receive, in addition to stock and/or securities, cash or other property, section 351(b) provides that any gain, as computed under section 1001, must be recognized to the extent of the boot received.

The operation of section 351(b) may be illustrated by a simple example. Assume that a taxpayer transfers property having a tax basis of \$50,000 and a fair market value of \$150,000 to a corporation under section 351 in exchange for stock having a value of \$100,000 and cash and other property (boot) having a total value of \$50,000. Under section 1001, the transferor would realize a gain of \$100,000 (value of stock, cash, and other property received of \$150,000 minus basis in property surrendered of \$50,000). Under the rule of section 351(b), however, the transferor would recognize a gain of only \$50,000, since that is the amount of boot received. On the other hand, if the stock received had a value of only \$25,000 and the cash and other property had a total value of \$125,000, the transferor would have recognized gain of \$100,000, since that amount is his total gain under section 1001 and it is less than the amount of boot received. If the property had a basis of more than \$150,000 to the transferor, the transferor would have realized a loss under section 1001, but under section 351(b)(2), the loss would not have been recognized. Even if section 351(b)(2) allowed recognition of loss, section 267(a)(1) would, in many cases, prevent such recognition.

B. Nature of Gain

In determining the nature of the gain recognized under section 351(b), the taxpayer should not assume that such gain is automatically capital gain, because the underlying nature of the transferred assets will be determinative of the nature of the gain recognized.¹⁷² Perhaps the most dangerous provision which must be considered in determining the nature of gain recognized under section 351(b) is section 1239, which provides that gain recognized on the transfer of depreciable property to a corporation cannot be treated as capital gain if more than eighty per cent *in value* of the transferee corporation's stock is owned by the transferor, his spouse, his minor children, or his minor grandchildren.¹⁷³

The regulations under section 1239 state that a corporation is controlled when more than eighty per cent in value of all outstanding stock is *beneficially* owned by the transferor, his spouse, his minor children, or his minor grandchildren.¹⁷⁴ In *Mitchell v. Commissioner*,¹⁷⁵ however, the Fourth Circuit held these regulations invalid. There, the taxpayer, his spouse, and his minor children owned 79.54 per cent of the stock directly, and 12.21 per cent was owned by two irrevocable trusts for the benefit of his minor

¹⁷² Cf. *Williams v. McGowan*, 152 F.2d 570 (2d Cir. 1945).

¹⁷³ See Rev. Rul. 60-302, 1960-2 CUM. BULL. 223. In Rev. Rul. 59-210, 1959-1 CUM. BULL. 217, the Internal Revenue Service held that patents constituted "depreciable property" for purposes of § 1239. Presumably, therefore, the Service views all intangibles subject to amortization, such as leasehold interests, as "depreciable property" subject to § 1239.

¹⁷⁴ Treas. Reg. § 1.1239-1 (1957).

¹⁷⁵ 300 F.2d 533 (4th Cir. 1962), *rev'g* 35 T.C. 550 (1961).

children. The Commissioner asserted that stock owned beneficially by the taxpayer's children should be included in determining the taxpayer's stock ownership. The court found that the legislative history of section 1239 and its sparse statutory language, as contrasted to other attribution sections which do intend to include beneficial ownership, indicated that beneficial ownership was not intended to be included under section 1239. It is submitted that the holding of the Fourth Circuit is correct, and should be followed by other courts.¹⁷⁶ It appears, therefore, that a well-advised taxpayer may generally plan his family ownership in such a manner as to avoid section 1239.

In *Trotz v. Commissioner*¹⁷⁷ a taxpayer owning seventy-nine per cent of the stock of a corporation, and having an option to acquire the remaining twenty-one per cent, sold depreciable assets to the corporation. The Commissioner asserted that the stock subject to the option was effectively owned by the taxpayer so as to give him 100 per cent ownership of the corporation. The Tax Court held that the taxpayer's rights to the twenty-one per cent stock interest were so complete that they were tantamount to ownership. The Tenth Circuit reversed the Tax Court, holding that a contract right to acquire stock was not ownership and that "tantamount to ownership" was not sufficient for purposes of section 1239. The Tenth Circuit left open the question whether the shares owned by the taxpayer represented more than eighty per cent in value of the corporation's stock and remanded the case to the Tax Court for such determination. On remand, the Tax Court held that the taxpayer did not own more than eighty per cent in value of the outstanding stock.¹⁷⁸ The Tax Court found that the fact that the taxpayer had "control" of the corporation did not increase the value of his stock. This finding appears to have been based on the fact that the court found that the corporation had no value as a going concern, and that its only value related to its underlying assets.

In *United States v. Parker*¹⁷⁹ the Fifth Circuit found that a taxpayer owning exactly eighty per cent of the stock of a corporation actually owned more than eighty per cent in value because of restrictions on the sale of the twenty per cent interest and the control position of the eighty per cent stockholder. Whether the control element alone would have been sufficient to find that the taxpayer held more than eighty per cent in value is not clear from the court's opinion. Apparently, however, the restrictions on sale were the most important element, because the effect of such restrictions on value was more determinable than the control element. In Revenue Ruling 69-399,¹⁸⁰ the Service followed *Parker* by holding that a restriction on the sale of twenty per cent of the stock of a corporation effectively increased the value of eighty per cent of the stock to more than eighty per cent for purposes of section 1239.

¹⁷⁶ See *United States v. Rothenberg*, 350 F.2d 319 (10th Cir. 1965), in which the Tenth Circuit followed the *Mitchell* case.

¹⁷⁷ 361 F.2d 927 (10th Cir. 1966), *rev'd* 43 T.C. 127 (1964).

¹⁷⁸ 26 CCH Tax Ct. Mem. 632 (1967).

¹⁷⁹ 376 F.2d 402 (5th Cir. 1967).

¹⁸⁰ 1969-1 CUM. BULL. 203.

It appears that if only the control element is present and the minority interest is unrestricted, the courts will have a difficult time finding that such element alone increases the value for purposes of section 1239. Although the control element can determine the course of corporate actions upon liquidation or merger, it has no more value on a per share basis than does the minority interest. Of course, such a block of stock could command a higher price if sold to a third party interested in gaining control of the corporation, but absent a firm bid which would determine such value, it would be difficult for a court to "peg" the value of control. If control alone is sufficient to increase value for purposes of section 1239, application of that statutory provision would be extremely difficult and taxpayers owning sufficient stock to constitute control of a corporation would face unforeseen problems in dealing with such corporations.

If a taxpayer is considering transferring depreciable property to a corporation in exchange for stock and boot, he should carefully consider taking debt obligations which constitute securities under section 351, in lieu of the boot. Gain recognized upon redemption of such securities should be treated as long-term capital gain under section 1232, rather than as ordinary income under section 1239, which is how such gain would have been treated had boot been received in the original section 351 transaction.

Other provisions which must be carefully considered include section 617 (relating to recapture of certain mining exploration expenditures), section 1245 (relating to recapture of depreciation on certain types of property other than real property), section 1250 (providing for recapture of depreciation on real property), section 1251 (relating to recapture of certain farm losses), and section 1252 (relating to recapture of certain expenditures on farm land). Any of these provisions may have the effect of converting what appears to be capital gain into ordinary income.

C. Allocation of Boot

When more than one item of property is transferred and boot is received, a substantial question has existed concerning the determination of the amount and nature of the gain recognized under section 351(b). Prior to the issuance of Revenue Ruling 68-55,¹⁸¹ no specific authority existed as to the method to be used in allocating boot.¹⁸² In that ruling, the IRS took the position that an asset-by-asset approach must be used in determining the amount of gain recognized. The ruling justifies the use of this approach on the theory that any other treatment would have the effect of allowing losses that are specifically disallowed by section 351(b)-(2).

Under Revenue Ruling 68-55, the total value of the consideration received by the transferor is allocated among the transferred assets in proportion to the relative fair market value of such assets. A separate computation of gain or loss is made with respect to each asset transferred, and such gain is classified in accordance with the character of the asset. The

¹⁸¹ 1968-1 CUM. BULL. 140.

¹⁸² See Rabinovitz, *Allocating Boot in Section 351 Exchanges*, 24 TAX L. REV. 337 (1969).

boot received is then allocated ratably among the assets transferred in accordance with the ratio of the value of each asset to the total value of all assets. After the boot is allocated, the amount of gain with respect to each asset is recognized to the extent of its allocable share of the boot. Losses are not allowed. As a result, the total gain recognized is the sum of the gains recognized on the individual assets without reduction for losses.

The application of Revenue Ruling 68-55 can be illustrated as follows (assuming that the assets described below are transferred to a corporation in exchange for stock worth \$150,000 and cash in the amount of \$50,000):

	Tax basis	Fair market value	Percentage of total fair market value	Gain or loss realized	Alloca- tion of boot	Gain recog- nized under section 351(b)
Land (capital asset held more than six months)	\$ 50,000	100,000	50.0%	\$ 50,000	25,000	25,000
Equipment (section 1245 property)	50,000	25,000	12.5%	(25,000)	6,250	—
Inventory (not capital asset)	50,000	75,000	37.5%	25,000	18,750	18,750
Total	<u>\$150,000</u>	<u>200,000</u>	<u>100.0%</u>	<u>\$ 50,000</u>	<u>50,000</u>	<u>43,750</u>

In the above illustration, if the aggregate approach had been used, the total gain recognized would have been \$50,000, rather than \$43,750. In most cases, the asset-by-asset approach of Revenue Ruling 68-55 will provide the best result for the transferors.

Two important questions are not considered in Revenue Ruling 68-55. The first relates to treatment of goodwill in situations where boot is received, and the second concerns the treatment of specific liens and mortgages in the allocation of boot.

Although there is no direct authority on the point, it is generally accepted that goodwill is property for purposes of section 351.¹⁸³ Upon incorporation of a going business, goodwill is transferred to the corporation. Without question, valuation of goodwill is a difficult problem. If such an asset is present in an incorporation transaction, boot should nevertheless be allocated thereto. Normally, goodwill will have no tax basis, and since goodwill is generally a capital asset, any boot which can be allocated to it will create capital gain income to the transferors.¹⁸⁴ Of course, the corporation will be acquiring a nondepreciable asset.¹⁸⁵

Revenue Ruling 68-55 merely indicates that all consideration received by the transferors should be allocated among the assets on the basis of their relative fair market values. Presumably, unsecured liabilities should be treated in the same manner as any other form of consideration and

¹⁸³ Cf. Rev. Rul. 65-180, 1965-2 CUM. BULL. 279 and Rev. Rul. 64-235, 1964-2 CUM. BULL. 18, relating to treatment of goodwill as property.

¹⁸⁴ *Ensley Bank & Trust Co. v. United States*, 154 F.2d 968 (5th Cir. 1946).

¹⁸⁵ See *ThriftyCheck Serv. Corp. v. Commissioner*, 287 F.2d 1 (2d Cir. 1961).

should be allocated among the assets. With respect to specific liens and mortgages, however, it would seem appropriate to allocate such liabilities directly to the assets to which they attach. Since the assumption of specific liens and mortgages is part of the consideration for the assets to which they attach, it appears logical to reduce the fair market value of such assets by the amount of their liens or mortgages. After making such a reduction, the boot would be allocated on the basis of relative fair market values.¹⁸⁶

Since the IRS has specifically provided a method by which boot is to be allocated, it is doubtful that an agreement in the exchange contract setting forth a specific allocation will be recognized. However, if there is an allocation resulting from valid arm's-length negotiations, it is possible that such allocation could be recognized.¹⁸⁷

D. Boot Versus Dividend

The regulations under section 351 specifically recognize that a distribution of stock or securities in connection with a section 315 transaction may have the effect of a distribution of a taxable dividend,¹⁸⁸ but they do not elaborate on situations in which such a result might occur. Though the regulations mention only a distribution of stock or securities in connection with possible dividend treatment, it is equally possible that a purported boot distribution might fall in the same category.

Dividend treatment might result from a distribution of securities, and possibly stock, substantially in excess of the value of the property transferred to the corporation. This situation appears most likely to occur in the liquidation-reincorporation area whereby an old corporation is liquidated and its assets are transferred by the shareholders to a new corporation in exchange for stock and securities. In such a situation, a court would probably ignore the liquidation and the subsequent reincorporation and hold that the distribution of securities was a dividend. Such a conclusion seems to be supported by the regulations under section 301.¹⁸⁹ In any situation where the consideration paid by the corporation is substantially in excess of the value of the property transferred, it appears that the IRS may raise the dividend question.

In one case, *Davis v. United States*,¹⁹⁰ the transferors conveyed property to a new corporation in exchange for all of its stock. Prior to the incorporation, the parties agreed to a value for the property conveyed by one transferor, and provided that if a subsequent audit reflected a different value, a cash adjustment would be made. A later audit indicated that the actual value exceeded the agreed value, and a cash distribution was made to the transferor in the amount of the excess. The Service contended that the

¹⁸⁶ See Treas. Reg. § 1.334-1(c)(4)(viii) (1955); *id.* § 1.334-2, in which specific liens and mortgages are accorded the treatment suggested in the text.

¹⁸⁷ See Carl L. Danielson, 44 T.C. 549, 556 (1965), for a discussion of the effect of written documents on allocations by the parties.

¹⁸⁸ Treas. Reg. § 1.351-2(d) (1955).

¹⁸⁹ *Id.* § 1.301-1(1).

¹⁹⁰ 255 F.2d 48 (6th Cir. 1958).

cash payment was a dividend. The Sixth Circuit, however, held that the distribution was part of the initial transfer and should be taxed as boot under section 351(b). In *Davis* the corporation had substantial earnings and profits at the time of the cash distribution, but since the delayed distribution was the result of an arm's-length agreement among the transferors at the time of incorporation, the court recognized its validity. If the facts had shown that the agreement was merely a sham to pay the transferor compensation or a share of the earnings of the corporation, no doubt the IRS would have been successful.

E. Section 351 Versus Section 304

Section 304 was enacted to ensure that the sale of stock by a shareholder to a related corporation would be governed by section 302, rather than be treated as a sale to a third party. In order to avoid dividend treatment on such a transaction, the seller must be able to meet the test of section 302 relating to stock redemptions. The strength of section 304 was recently tested against the strength of section 351. Oddly enough, section 351 prevailed.

In *Henry McK. Haserot*¹⁹¹ an individual owning substantially all of the stock of three corporations transferred the stock of two to the other in exchange for additional stock of the transferee corporation, plus cash. The Tax Court held that section 351 took precedence over section 304 in such a case, thereby producing capital gain under section 351(b), rather than dividend income under sections 304, 302, and 301. The court relied upon the fact that since both sections 301(a) and 302(d) provide that "except as otherwise provided," Congress intended that section 351 take precedence in the event of overlapping jurisdiction. The Sixth Circuit reversed the Tax Court and remanded the case to determine whether the transaction was "essentially equivalent to a dividend." Upon remand, the Tax Court found that the transaction was essentially equivalent to a dividend, but it remained firm in its conclusion that section 351 prevailed over sections 304, 302, and 301. Surprisingly, upon appeal, the Sixth Circuit affirmed. It appears that the IRS will have to resort to Congress to resolve this technical destruction of section 304. Nevertheless, taxpayers should be wary of relying upon the *Haserot* decision if they desire sound tax planning.

F. Boot Versus Loans

Generally, if a short-term note is received as part of the consideration in a section 351 transaction, it is treated as boot. However the Tax Court, in two cases, has held that where cash or accounts receivable were loaned to a corporation in return for a short-term note, the note was not boot. In *Enola C. Hartley*¹⁹² the Tax Court found that a taxpayer had loaned \$100,000 of receivables to a corporation in exchange for a short-term note,

¹⁹¹ 41 T.C. 562 (1964), *rev'd and remanded*, 355 F.2d 200 (6th Cir. 1965), *on remand*, 46 T.C. 864 (1966), *aff'd sub nom.* Commissioner v. Stickney, 399 F.2d 828 (6th Cir. 1968).

¹⁹² 26 CCH Tax Ct. Mem. 186 (1967).

and held the loan and a section 351 transfer to be separate transactions. In *Sylvan Makover*¹⁹³ the court reached the same conclusion where \$130,000 (\$30,000 in the form of accounts receivable and \$100,000 in the form of cash) was loaned to the corporation. In that case, it was shown that loans from other sources were available, and based upon this fact, the court concluded that there had been a loan in exchange for the short-term note. It is difficult to rationalize the decisions of the Tax Court in these two cases because of the generally-understood treatment of property distributed to the transferors as part of a section 351 transaction. If, of course, the loan transaction can be separated, as it was in *Hartley* and *Makover*, the result can be justified. After considering the number of cases under section 351 which have combined a multitude of steps to disqualify a section 351 transaction,¹⁹⁴ *Hartley* and *Makover* must be viewed as cases which will be relied upon only by the most optimistic taxpayers.

G. *Installment Reporting of Boot*

There is no authority relating to the reporting of a section 351 transaction involving boot on the installment basis under section 453,¹⁹⁵ and at least one commentator has indicated that this method of reporting may not be available.¹⁹⁶ Of course, only on rare occasions will the value of the stock, which should constitute "other property" under section 453, be less than thirty per cent of the consideration received in the section 351 transaction. It would seem, however, in cases where the value of the stock and other property not constituting obligations of the transferee corporation was less than thirty per cent of the total consideration, and the boot received was in the form of short-term notes not qualifying as securities, but qualifying as obligations of the corporation under section 453, that a taxpayer might attempt to report the collection of the boot on the installment method.¹⁹⁷ If securities, as well as short-term notes, were received, it would seem that the securities should qualify as obligations of the corporation under section 453, and that they should not be part of the thirty per cent payment in the year of sale.

If the value of stock and other property not qualifying as obligations of the corporation exceeded thirty per cent of the total consideration received by the transferor, the transferee might well argue that the notes, particularly notes of a new corporation, had no readily-ascertainable value. If a taxpayer could sustain the absence of an ascertainable value, gain would be reported only if payments were actually made and only after payments, plus the value of stock and other property received, exceeded the transferor's basis in the property transferred.¹⁹⁸

¹⁹³ 26 CCH Tax Ct. Mem. 288 (1967).

¹⁹⁴ See, e.g., text accompanying notes 94-98 *supra*.

¹⁹⁵ INT. REV. CODE OF 1954, § 453(b), which applies to sales of real property and casual sales of personalty.

¹⁹⁶ Goldstein, *Corporate Indebtedness to Shareholders: "Thin Capitalization" and Related Problems*, 16 TAX L. REV. 1, 54 (1960).

¹⁹⁷ Cf. Rev. Rul. 65-155, 1965-1 CUM. BULL. 356, allowing installment reporting for boot received in a § 1031 exchange where the requirements of § 453 were met.

¹⁹⁸ *Burnet v. Logan*, 283 U.S. 404 (1931). *But cf.* Rev. Rul. 58-402, 1958-2 CUM. BULL.

IX. ASSUMPTION OF LIABILITIES¹⁹⁹

A. General

Until the Supreme Court announced its decision in *United States v. Hendler*²⁰⁰ in 1938, most tax practitioners felt that in an incorporation or reorganization the assumption of debts by a transferee corporation did not constitute boot requiring recognition of gain by the transferor or transferors.²⁰¹ In *Hendler*, however, the Court held that the assumption and payment of a transferor's liabilities by a transferee corporation in a corporate reorganization constituted boot to the transferor. The same result was reached with respect to the assumption of debt in a tax-free incorporation under the predecessor of section 351.²⁰²

In the Revenue Act of 1939, *Hendler* was effectively reversed, and, subject to certain exceptions, Congress restored the tax-free status of incorporations and corporate reorganizations involving the assumption of, or acquisition of property subject to, the transferor's liabilities.²⁰³ Congress provided, by statutory language now found virtually unchanged in section 357(a), that the transferee corporation's assumption of, or taking property subject to, debt in incorporations and reorganizations would not be treated as boot to the transferor.

Section 357(a), standing alone, would allow transferors to borrow against the property immediately prior to the exchange, retain the borrowed funds, and cause the corporation either to assume the liability or take the property subject to such liability. Although the transferor in this situation clearly would have received the equivalent of boot, section 357(a) would not require that gain be recognized. In order to prevent such tax avoidance, what is now section 357(b) was enacted. That provision requires that if, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for assumption or acquisition was made, it is determined that the principal purpose of the taxpayer for causing the assumption or acquisition was to avoid federal income tax, or, if not for such purpose, was not a bona fide business purpose, then such assumption or acquisition is treated as money received by the taxpayer in the exchange.

In the 1954 Code, Congress added section 357(c). This new provision becomes operative if the sum of the amount of liabilities assumed plus the amount of the liabilities to which the property is subject exceeds the total of the adjusted tax basis of the property transferred. If such facts exist, the excess is considered as gain on the sale or exchange of a capital asset, or property which is not a capital asset, as the case may be. It should be noted that section 357(c) is inapplicable if section 357(b) applies.²⁰⁴

15, which provides that, "except in rare and extraordinary cases," the Internal Revenue Service will require valuation of contracts and claims.

¹⁹⁹ The discussion in this part follows closely Burke & Chisholm, *Section 357: A Hidden Trap in Tax-Free Incorporations*, 25 TAX L. REV. 211 (1970), which covers the subject in greater depth.

²⁰⁰ 303 U.S. 564 (1938).

²⁰¹ See R. PAUL, *STUDIES IN FEDERAL TAXATION* 137 n.420 (3d ser. 1940).

²⁰² Walter F. Haass, 37 B.T.A. 948 (1938).

²⁰³ Int. Rev. Code of 1939, § 112(k).

²⁰⁴ INT. REV. CODE of 1954, § 357(c)(2)(A).

B. Operation of Section 357(b)

The general rule of section 357(a) excludes liabilities from the definition of boot. That provision does not apply if, after considering the nature of the liability and the circumstances attendant to its assumption or acquisition, it is determined that the taxpayer's principal purpose is to avoid federal income tax on the exchange, or is not a bona fide business purpose.²⁰⁵ If section 357(a) does not apply with respect to *any* liability assumed by the corporation, section 357(b) requires that the *total* amount of liabilities assumed or acquired pursuant to the exchange be treated as boot.²⁰⁶

In addition to treating all liabilities as boot, section 357(b) also provides that in any case where the taxpayer otherwise has the burden of proof, the burden with respect to proper purpose must be sustained "by the clear preponderance of the evidence."²⁰⁷ In fact, the regulations require the taxpayer to prove his case by such a clear preponderance that the absence of any improper purpose or the presence of a business purpose is "unmistakable."²⁰⁸ It is not clear from the statute just whose purpose is in question under section 357(b). Although several cases have dealt with the problem, it has not been completely resolved at this time.²⁰⁹

Only eight cases have been considered by the courts under section 357(b) or its predecessor under the 1939 Code. In the first case considered under the 1939 Code, *Bryan v. Commissioner*,²¹⁰ the taxpayer had constructed a number of houses and borrowed funds in excess of the construction costs. While constructing the houses, the taxpayer formed four new corporations. Upon completion of construction, the houses and land were transferred to the new corporations, subject to loans, in exchange for stock. The Fourth Circuit, affirming the Tax Court, held that the excess of the loans over the transferor's basis in the transferred assets was taxable income on the grounds that the transferor's principal purpose with respect to the assumption of the loans by the corporations was tax avoidance.

In *Easson v. Commissioner*²¹¹ the taxpayer owned a highly-appreciated apartment house. The taxpayer borrowed \$250,000, encumbering the apartment house with a mortgage in the same amount. Approximately four months later, the taxpayer transferred the apartment, subject to the mortgage, to a new corporation for stock. At the time of transfer, the mortgage exceeded the taxpayer's basis in the apartment house by approximately \$160,000. The Tax Court found that the taxpayer's desire to retain the proceeds of the mortgage for investment was an adequate busi-

²⁰⁵ *Id.* §§ 357(b)(1)(A), (B).

²⁰⁶ By contrast, the 1939 Code stated that in such a case, only the amount of the tainted liability constituted boot. Int. Rev. Code of 1939, § 112(k).

²⁰⁷ INT. REV. CODE of 1954, § 357(b)(2).

²⁰⁸ Treas. Reg. § 1.357-1(c) (1955) (last sentence).

²⁰⁹ See discussion of this point in Burke & Chisholm, *Section 357: A Hidden Trap in Tax-Free Incorporations*, 25 TAX L. REV. 211, 216-17 (1970).

²¹⁰ 281 F.2d 238 (4th Cir. 1960).

²¹¹ 33 T.C. 963 (1960), *nonacquiesced in*, 1964-2 CUM. BULL. 8, *aff'd in part and rev'd in part*, 294 F.2d 653 (9th Cir. 1961).

ness purpose and allowed the corporation to assume the debt. Nevertheless, the Tax Court was perplexed by the negative basis problem, and, relying on the tax principle that property cannot have a negative basis, held that the taxpayer realized gain of \$160,000 on the exchange.

On appeal, the Ninth Circuit rejected the Commissioner's argument that a corporate business purpose was required for assumption of the debt. The Ninth Circuit further held that the desire for liquidity during an expected business recession was an adequate business purpose under the predecessor of section 357(b). The Ninth Circuit, however, reversed the Tax Court on its holding that the taxpayer realized a taxable gain. The reversal was based on the clear language of sections 112(b)(5) and 112(k) of the 1939 Code that no taxable income resulted from the exchange. As a result of the reversal by the Ninth Circuit, the taxpayer achieved an economic gain of \$160,000 without being taxed thereon. It appears from a careful review of the facts in *Easson* that both the Tax Court and the Ninth Circuit should have found that the debt assumption had as its principal purpose the avoidance of federal income tax.

In *Estate of John G. Stoll*²¹² a publisher transferred the operating assets of two newspapers to a new corporation for stock. In addition, the corporation assumed a loan (refinancing earlier loans) received just prior to incorporation which was secured by mortgages on properties assigned to the corporation, and a loan secured by life insurance policies which were not assigned to the corporation. A substantial part of the mortgage loan was used to discharge the transferor's income tax liabilities for the year of transfer. The Tax Court found that the taxpayer's principal purpose for creating the corporation was to preserve the ownership of his newspapers. The court found that no tax avoidance motive was present with respect to the assumption of either loan, and that there was a valid business purpose for the assumption of the mortgage loan. However, the taxpayer could not support the assumption of the loan secured by insurance policies with a bona fide business purpose. Presumably, the fact that the insurance policies were not assigned to the corporation was the determining factor in the Tax Court's view.

In *Jewell v. United States*²¹³ the taxpayer purchased stock of a corporation, giving a promissory note for the balance of the purchase price. The taxpayer and the holder of the remaining stock liquidated the corporation and distributed its assets in proportion to their stock holdings. The assets were immediately transferred to a partnership, and the taxpayer's promissory note was recorded on the books of the partnership as a liability. Approximately six months later, the partnership was dissolved. On the following day, the taxpayer formed a corporation and transferred his share of the partnership assets to it. The new corporation assumed the promissory note and thereafter executed its own note to the original seller of the

²¹² 38 T.C. 223 (1962), *acquiesced in on another issue and not acquiesced in on this issue*, 1967-1 CUM. BULL. 3. The acquiescence relates to the Tax Court's summary finding that there was a valid assumption of debt so that the subsequent principal and interest payments made by the corporation did not constitute dividends to the transferor.

²¹³ 330 F.2d 761 (9th Cir. 1964), *rev'g* 217 F. Supp. 572 (D. Idaho 1963).

stock, thereby cancelling the taxpayer's note which it had assumed. The corporation subsequently paid the new note. The Ninth Circuit, reversing the district court, held that payment of the note was not a constructive dividend to the taxpayer. The court then determined that avoidance of personal liability, and not avoidance of federal income tax, was the taxpayer's principal purpose for having the note assumed by the corporation. The court further held that since the debt assumption made good business sense, there was a bona fide business purpose for the assumption.

The first case decided under section 357(b) of the 1954 Code was *Campbell v. Wheeler*.²¹⁴ There, the taxpayer owned a small interest in a partnership. He assigned one-third of the interest and a three per cent interest in an existing corporation to a new corporation, subject to a loan incurred to pay his personal income tax on his share of partnership profits. The Fifth Circuit held that the taxpayer did not sustain his burden of proving, by a clear preponderance of the evidence, that there was a valid business purpose for the assumption of the loan.²¹⁵ The court indicated that the payment of personal income tax, even if resulting from participation in a business enterprise, was a purely personal obligation.

In the first case considered by the Tax Court under section 357(b) of the 1954 Code, *W. H. B. Simpson*,²¹⁶ the taxpayer transferred to a corporation assets which were subject to liabilities totaling slightly less than the tax basis of the property transferred. The liabilities were not incurred immediately prior to the transfer, but were incurred over a period of time in connection with business operations. The Tax Court found that the taxpayer sustained his burden of proof under section 357(b).

In the most recent case under section 357(b), *Drybrough v. Commissioner*,²¹⁷ the taxpayer transferred real estate, subject to liabilities, to five new corporations. The mortgage assumed by four of the corporations had been incurred several years prior to the exchange. The fifth corporation, however, assumed a mortgage incurred shortly before the transfer. The proceeds of such mortgage were invested in tax-exempt securities. The Sixth Circuit, on the basis of the *Simpson* case, found that the purpose to avoid income tax under section 357(b) was narrowed to a purpose with respect to the assumption *on the exchange*. Therefore, the court found it unnecessary to trace the use of the proceeds from the mortgage incurred in prior years. The court did find, however, that with respect to the loan assumed by the fifth corporation, the taxpayer failed to prove that his purpose was not avoidance of income tax.

It appears on the basis of the decided cases that the "avoidance of income tax" clause of section 357(b) has been limited significantly, and as long as the debt is not incurred as part of the plan under section 351, the courts probably will not find tax avoidance as a purpose. The business purpose clause has not been as effective as it should have been, presumably

²¹⁴ 342 F.2d 837 (5th Cir. 1965).

²¹⁵ See also *Thompson v. Campbell*, 353 F.2d 787 (5th Cir. 1965).

²¹⁶ 43 T.C. 900 (1965), *acquiesced in*, 1965-2 CUM. BULL. 6.

²¹⁷ 376 F.2d 350 (6th Cir. 1967).

because a finding that business purpose is not present with respect to one liability causes all liabilities assumed to be treated as boot.²¹⁸ Because of this rule, the implications of section 357(b) can be disastrous. For example, if a taxpayer causes a new corporation to assume a \$100,000 mortgage on property transferred, and also causes it to assume a \$100 personal liability for which there is no business purpose, the entire \$100,100 would be treated as boot under section 357(b). No doubt section 357(b) would be more effective if only the tainted liability were treated as boot.²¹⁹

C. Operation of Section 357(c)

Under section 357(c), a transferor recognizes gain in an amount equal to the excess of the sum of (1) his liabilities assumed by the corporation, and (2) liabilities to which the property transferred is subject, over the adjusted basis of the property transferred to the corporation.²²⁰ Each transferor's gain is determined separately by comparing the liabilities of that transferor assumed by the corporation with the total tax basis of the property transferred by such transferor.²²¹

With respect to determining the amount of liabilities assumed, the Tax Court held in *Arthur L. Kniffen*²²² that if the transferor is indebted to the transferee corporation, and the transferee corporation assumes that debt and subsequently extinguishes it, such indebtedness is deemed to have been assumed by the transferee for purposes of section 357. The *Kniffen* case involved a situation in which an individual transferred all of the assets and liabilities of his sole proprietorship to a controlled corporation. One of the liabilities assumed was a debt owed by the sole proprietorship to the corporation. The Commissioner argued that discharge of the indebtedness was boot under section 351(b). The Tax Court held that section 357 was concerned only with the assumption of the transferor's liabilities, and not with the subsequent extinguishment. Therefore, the debt to the corporation was held to have been assumed for purposes of section 357, and did not constitute boot.

One device which has been suggested to avoid the application of section 357(c) is the execution of a note by the transferor to the transferee corporation in an amount equal to the excess of liabilities assumed by the transferee corporation over the transferor's total tax basis in the transferred property. The IRS has ruled that this procedure does not avoid section 357(c), since the taxpayer has no cost basis in the note under section 1012.²²³ Hence, the transfer of such a note to the corporation does not serve to increase the total tax basis of the transferred assets.²²⁴

²¹⁸ See BITTKER & EUSTICE 82-83 n.26.

²¹⁹ Re-enactment of Int. Rev. Code of 1939, § 112(k), would effectively achieve this result.

²²⁰ See DeFelice v. Commissioner, 386 F.2d 704 (10th Cir. 1967); Testor v. Commissioner, 327 F.2d 788 (7th Cir. 1964).

²²¹ Rev. Rul. 66-142, 1966-1 CUM. BULL. 66.

²²² 39 T.C. 553 (1962), *acquiesced in*, 1965-2 CUM. BULL. 5.

²²³ Rev. Rul. 68-629, 1968-2 CUM. BULL. 154.

²²⁴ As an alternative, a taxpayer might borrow money, transfer the borrowed funds to the corporation, and retain and pay the debt personally. In today's money market, few transferors will find this alternative desirable.

Section 357(c) makes incorporation of a cash-basis taxpayer extremely delicate. In *Peter Raich*²²⁵ a cash-basis transferor incorporated a proprietorship which had assets of \$88,613, including \$77,361 of unrealized receivables and liabilities of \$45,992, including \$37,719 of unpaid cash-basis payables. The Tax Court held that since the basis of the unrealized receivables was zero, the taxpayer realized gain on the transfer equal to the difference between the liabilities assumed and the taxpayer's basis in the other property transferred. Therefore, cash-basis taxpayers should be extremely careful in determining the amount of basis being transferred and the amount of liabilities being assumed in order to avoid the problem of the *Raich* case.

If gain is recognized under section 357(c), such gain must be reported as ordinary income, long-term capital gain, or short-term capital gain according to the nature of the transferred property, and the regulations require that the total gain be allocated among the assets on the basis of their relative fair market values.²²⁶ Further, special provisions, such as sections 617, 1239, 1245, 1250, 1251, and 1252, cause gain allocated to assets subject to those provisions to be ordinary income, rather than capital gain income. This method of allocating gain can easily distort the nature of gain recognized by the transferor. For example, assume a taxpayer transfers accounts receivable having a basis and a fair market value of \$20,000 and investment land having a basis of \$5,000 and a fair market value of \$80,000 to a corporation in exchange for stock and the assumption of liabilities in the amount of \$100,000. Under section 357(c), the taxpayer would recognize gain of \$75,000 (\$100,000 of liabilities assumed less basis in accounts receivable of \$20,000 and basis in land of \$5,000). Under the allocation method described above, \$15,000 of the gain would be allocated to accounts receivable (twenty per cent of \$75,000), and, hence, would be ordinary income, and \$60,000 would be allocated to the land (eighty per cent of \$75,000), and, hence, would be capital gain income. Clearly the entire gain is attributable to the land and should be taxed accordingly. The requirement that gain under section 357(c) be recognized based on the relative fair market values of the assets transferred to the corporation directly conflicts with the more realistic method adopted under section 351(b)²²⁷ and should be corrected.

X. BASIS AND HOLDING PERIOD OF TRANSFEROR

A. General

As is the general rule with all nonrecognition provisions,²²⁸ under section 351, the transferor's basis in the property surrendered is preserved and becomes the basis in the property received in the exchange. This rule is applied to section 351 transactions by virtue of section 358. With respect to

²²⁵ 46 T.C. 604 (1966), appeal dismissed (9th Cir. 1968). See also Rev. Rul. 69-442, 1969-2 CUM. BULL. 53.

²²⁶ Treas. Reg. § 1.357-2 (1955).

²²⁷ Rev. Rul. 68-55, 1968-1 CUM. BULL. 140.

²²⁸ Cf. INT. REV. CODE of 1954, § 1031.

the holding period of the stock or securities received, in most cases section 1223(1) will cause the holding period for such stock or securities to include the period during which the transferred property was held by the transferor, provided such property was either a capital asset or a section 1231(b) asset in the hands of the transferor. These general rules become somewhat more difficult to apply when the transferor receives boot in the incorporation transaction, or when mixed property is transferred to the corporation.

B. Basis Determination—No Boot

When the transferor receives only stock or securities in the section 351 transaction, the total basis of all such stock or securities is the same as the basis of the property transferred.²²⁹ If more than one class of stock is received or if both stock and securities are received, the basis of the property transferred is allocated among the stock and securities in proportion to the fair market values of each class of stock and each class of securities.²³⁰ There is authority for the proposition that where the fair market values of two classes of stock are not ascertainable, the transferor is entitled to recover his entire basis before recognizing gain.²³¹ No part of the basis is required to be allocated to the class of stock retained.

Where the transferor conveys only one asset to the corporation and receives only a single class of stock or securities in return, no problem arises with the basis allocation provision. In addition, if the transferor conveys only one asset to the corporation and receives in return more than one class of stock or stock and securities, it appears logical to allocate the transferor's basis in such asset among the stock and/or securities received on the basis of their relative fair market values.

If more than one asset is transferred by a transferor to a corporation, the basis allocation outlined above may not be proper. For example, if a transferor receives 100 shares of stock in exchange for two assets, one having basis of \$1,000 and value of \$2,000 and the other having basis and value of \$2,000, it would seem permissible for the transferor to designate that fifty shares had been received for the asset having a basis of \$1,000, and that the remaining fifty shares had been received for the asset having a basis of \$2,000. Under the general rule of section 358, however, it would appear that the basis would be allocated equally among the 100 shares received.

The specific identification theory would seem justified because it merely allows the transferor to have some control over his subsequent gain or loss on the sale of stock, just as he would have had control over such gain or loss had he retained the assets and sold them. If, however, all the shares have the same basis, he has lost control of gain or loss on subsequent sales of stock. On the other hand, if the taxpayer has an asset which has depreciated in value and which is essential to the business, and therefore

²²⁹ *Id.* § 358(a)(1).

²³⁰ Treas. Reg. § 1.358-2(b)(2) (1955).

²³¹ Edwin D. Axton, 32 B.T.A. 613 (1935), *acquiesced in*, 1939-1 CUM. BULL. 3.

could not be sold, he might use this approach to realize the loss by selling the stock to which he allocated the high basis. Of course, a sale of the entire block of stock at one time would make specific identification meaningless. The cases in which the use of specific identification has been urged have generally adhered to the average basis theory suggested by the regulations.²³² There are, however, two cases in the reorganization area which permit specific identification by matching particular shares received with particular shares transferred.²³³ The theory of these cases has never been applied to section 351. It is suggested that the specific identification rule should be permissible under section 351, provided the allocation is made by the taxpayer at the time the section 351 transaction occurs. Perhaps the allocation should be an election allowed the taxpayer at the time of incorporation. Certainly, the rule should not be so flexible that the taxpayer could choose his method of allocation after he has decided to sell part of the stock or securities received in the section 351 transaction.

If the transferee corporation assumes a liability of the transferor or acquires property from such transferor subject to a liability, the amount of the liability, for purposes of determining basis, is treated as money received by the transferor in exchange. This reduction in basis is required whether or not the recognition of gain is required under section 357.²³⁴

C. Basis Determination—Boot Received

Section 358 also applies to determine basis when a transferor receives boot in a section 351 transaction. Section 358(a)(2) provides that boot, other than money, receives a basis equal to its fair market value, and section 358(a)(1) provides that the stock or securities received have the same basis as the basis of the property given up, reduced by the amount of money and the fair market value of the boot received and increased by the gain recognized on the exchange.

The provisions of section 358(a) can be illustrated if it is assumed that a transferor conveys property having an adjusted basis of \$80,000 in exchange for stock and bonds worth \$160,000, cash in the amount of \$30,000, and other property valued at \$10,000. The transferor would realize a gain of \$120,000 (value of stock, bonds, cash, and other property received of \$200,000 minus basis in property transferred of \$80,000), and such gain would be recognized under section 351(b) to the extent of the boot received, or \$40,000. The transferor would receive a basis in the other property equal to its fair market value of \$10,000, and the basis

²³² See *Commissioner v. Bolender*, 82 F.2d 591 (7th Cir. 1936); *Commissioner v. Von Gunten*, 76 F.2d 670 (6th Cir. 1935); *P.L. Wheeler*, 32 B.T.A. 917 (1935); cf. *Nassau Lens Co., Inc. v. Commissioner*, 308 F.2d 39 (2d Cir. 1962), implying this result under § 351.

²³³ See *Curtis v. United States*, 336 F.2d 714 (6th Cir. 1964); *Bloch v. Commissioner*, 148 F.2d 452 (9th Cir. 1945).

²³⁴ If the transferor remains personally liable and subsequently is required to pay the debt, such payment probably constitutes additional basis in the stock or securities received in the § 351 transfer, although the taxpayer could argue that such payment constituted a deductible loss. If the stock or securities have been sold when the payment is made, presumably the loss deduction would have the same character as the gain or loss on the sale of the stock or securities under the doctrine of *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952).

of the stocks and bonds would be \$80,000 (basis of property transferred of \$80,000, less cash received of \$30,000 and value of other property received of \$10,000, plus gain recognized of \$40,000). Such resulting basis would be allocated between the stock and bonds in proportion to their respective values unless specific identification could be sustained.

D. *Holding Period of Transferor*

As a general rule, a transferor under section 351 determines the holding period of the stock or securities received by including the period during which he held the transferred property, provided such property was either a capital asset or a section 1231(b) asset in his hands. The holding period of stock or securities in exchange for property which does not so qualify begins on the date of the section 351 transaction.

If both capital assets (and/or section 1231 assets) and non-capital assets are transferred, it appears that an allocation of holding period is necessary. There is no definitive rule as to whether some of the stock or securities received will have a holding period beginning on the date of the section 351 transaction, while the balance will have longer holding periods, or whether the holding period for each share of stock or for each security will be divided. The same problem could result, of course, where several capital or section 1231 assets with different holding periods to the transferor were transferred to a corporation under section 351. There is a decision, involving the sale of all the stock received in a section 351 transaction, which indicates that if the entire block of stock or securities received is sold, the holding period allocation is made by reference to the basis of the assets transferred.²³⁵ Such a result does not seem proper, since the basis of an asset transferred under section 351 generally bears little relationship to its fair market value and, hence, to its contribution to the gain or loss recognized on the subsequent sale.

If boot is received in a section 351 transaction, the holding period of the boot does not include the period for which the transferred property was held, since section 1223(1) allows "tacking" only if the property received has the same basis "in whole or in part" as the property exchanged. Since the basis of boot is its fair market value at the time of the section 351 transaction and bears no relationship whatsoever to the basis of the property transferred, there is no "tacking" of the holding period.

The applicability of section 1223(1) to stock or securities received in a section 351 transaction in which boot is also received is not entirely clear. As discussed above, the basis of such stock or securities is the same as the property transferred, decreased by the fair market value of the boot and increased by the amount of gain recognized. It would seem logical that section 1223(1) would apply and "tack" the holding period of transferred properties to the stock or securities, since the basis of such stock or securities is "in part" determined by the basis of the property transferred.

²³⁵ Harry M. Runkle, 39 B.T.A. 458 (1939).

XI. BASIS AND HOLDING PERIOD OF TRANSFEREE CORPORATION

A. *Basis Determination*

Under section 362(a), the transferee corporation receives a basis in property transferred in a section 351 transaction equal to the transferor's basis, increased by the amount of gain recognized by the transferor in exchange. Therefore, if the exchange is tax free, each asset retains the same basis that it had to the transferor before exchange.²³⁶

In a section 351 transaction in which boot is received, the basis of the transferee corporation in the assets received is increased by the amount of gain recognized by the transferor. No authority exists, however, for allocating the increase among the various items. Presumably, the rule of Revenue Ruling 68-55,²³⁷ relating to allocation of boot for determination of gain, should also apply to determination of basis of the transferee corporation. Hence, boot should be allocated ratably among the various items in accordance with their fair market values.

B. *Holding Period of Transferee Corporation*

Under section 1223(2), the holding period of the transferee corporation includes the period during which property received in the section 351 transaction was held by the transferor, regardless of the character of the asset received. Presumably "tacking" of a holding period would be permitted to the transferee corporation even though the transferor received boot in the transaction, since section 1223 permits "tacking" where the transferee corporation's basis is the same "in whole or in part" as the transferor's basis. Since, under section 362, the basis of all property is determined "in part" by reference to the basis of the transferor, section 1223(2) should apply.

XII. PROBLEMS OF ALLOCATING INCOME AND DEDUCTIONS

A. *General*

As stated above, the legislative purpose for section 351 is to provide insulation against recognition of gain upon a mere change in form of ownership. Generally, this intent is accomplished by the deferral of gain on the transfer of appreciated assets until such time as the stock or securities received in the exchange are sold. Significant problems may arise, however, in determining the effect of section 351 on the taxation of income and expense items transferred to a corporation.

B. *Transfers of Unrealized Receivables*

It is not clear from the legislative history what effect Congress intended section 351 to have on the transfer of property representing income earned by the predecessor, such as cash basis accounts receivable, which will be realized and taxed to the transferee corporation. The courts, when faced

²³⁶ See *P.A. Birren & Son v. Commissioner*, 116 F.2d 718 (7th Cir. 1940).

²³⁷ 1968-1 CUM. BULL. 140.

with the question, have generally allowed the transfer to qualify under section 351 and the income to be taxed to the corporation. In *Thomas W. Briggs*²³⁸ the taxpayer transferred unrealized, cash-basis receivables to a corporation under section 351. The Commissioner argued that either such transfer constituted an assignment of income, or the predecessors of sections 446(b) and 482 applied and the receivables should be taxed to the transferor. The court summarily disposed of this issue and held that section 351 provided nonrecognition to the transferor. The *Briggs* case, however, does not resolve the question whether section 351 overrides the well-established judicial principle of assignment of income and the provisions of sections 446(b) and 482.²³⁹ Obviously, many income rights constitute property which can be transferred under section 351, although the subsequent collection of the income may not be properly taxed to the transferee corporation. For example, in *H. B. Zachry Co.*²⁴⁰ the Tax Court held that the carved-out oil payment, representing a "pure income" right, was property which could be transferred to the corporation under section 351, although the court properly left open the question as to whom such income would be taxed.²⁴¹

A proper analysis of the question requires that a court first recognize that a right to receive income may be property²⁴² and therefore no taxable event occurs at the moment of the transfer of such property right under section 351. If the income right is found to be property, then the questions to be resolved are whether the income resulting from such property right should be taxed to the transferor or the transferee corporation, and when such taxation should occur. As indicated in *Briggs*, the IRS may attempt to apply both the assignment-of-income doctrine and clear-reflection-of-income doctrine to tax the transferor on unrealized income transferred to a corporation under section 351.

C. Assignment-of-Income Doctrine

The assignment-of-income doctrine is well entrenched in the tax law.²⁴³ Generally, the doctrine is applied either where a taxpayer earns income by performing services and assigns the right to such income to a third party prior to collection, or where a taxpayer has a right to receive income from property and assigns such right while retaining the underlying property. The IRS has been successful in applying the assignment-of-income doctrine to overcome section 351 in only one case. In *Brown v. Commissioner*²⁴⁴ a lawyer who had rendered legal services transferred his right to the fee from

²³⁸ 15 CCH Tax Ct. Mem. 440 (1956).

²³⁹ See also *P.A. Birren & Son v. Commissioner*, 116 F.2d 718 (7th Cir. 1940); *Arthur L. Kniffen*, 39 T.C. 553 (1962), *acquiesced in*, 1965-2 CUM. BULL. 5. Both these cases also seem to accept the principle that income can be effectively transferred from one taxpayer to another by assigning unrealized receivables to a corporation under § 351.

²⁴⁰ 49 T.C. 73 (1967).

²⁴¹ 49 T.C. at 80 n.5.

²⁴² For an example of a situation in which this step was not applied properly in a situation analogous to a § 351 transfer, see *Tatum v. Commissioner*, 400 F.2d 242 (5th Cir. 1968).

²⁴³ See *Helvering v. Eubank*, 311 U.S. 122 (1940); *Helvering v. Horst*, 311 U.S. 112 (1940); *Lucas v. Earl*, 281 U.S. 111 (1930).

²⁴⁴ 115 F.2d 337 (2d Cir. 1940).

such services to his wholly-owned corporation prior to collection of the fee. The fee claim was the corporation's only asset. The taxpayer argued that he should realize no income from collection of the receivable under the predecessor of section 351. The Second Circuit concluded that although no gain was realized *on the exchange* for stock under the predecessor of section 351, the taxpayer was nevertheless taxable on the income from the receivable when collected by the corporation. It is indeed difficult to reconcile the result of *Brown* with the result of *Briggs*. It must be concluded that the *Briggs* decision, which involved the transfer of a going business into a new corporation, is founded upon the assumption that the assignment of accounts receivable in that case was an integral part of a valid business transaction and did not have as one of its principal purposes the avoidance of tax. In *Brown* the transfer was obviously to avoid tax. Nevertheless, if the assignment-of-income doctrine is a valid tax principle, it appears that it might well be applied in all cases, regardless of intent.

The application of the assignment-of-income doctrine to unrealized income rights transferred under section 351 can be extremely burdensome and, in fact, disastrous to the transferor. The income would not be taxed to the transferor until collected or received by the transferee corporation. The proceeds of the income are, at that point, corporate property. By the time the IRS is successful in applying the assignment-of-income doctrine, whether by administrative or judicial proceedings, the corporation may have substantial earnings and profits, and withdrawal of funds to pay the tax on the assigned income would be taxed as a dividend. Such a result, of course, is untenable.²⁴⁵ Therefore, in the section 351 area, the assignment-of-income doctrine is not a satisfactory solution, at least from the transferor's standpoint. Furthermore, the doctrine is not consistent with the purpose of section 351, which is to facilitate incorporations without uncertainty.

D. Clear-Reflection-of-Income Doctrine

Both sections 446(b) and 482 embody the clear-reflection-of-income doctrine and may be used to tax the transferor on the unrealized income.

Under section 446(b), the Service can require use of a method of accounting which clearly reflects income. Thus, the transferor could be required to report income up to the date of transfer on the accrual method or percentage-of-completion method, even though the cash method or completed contract method had been used for operations prior to that time. In *Palmer v. Commissioner*²⁴⁶ the predecessor of section 446(b) was

²⁴⁵ If it appears that the assignment-of-income doctrine might apply, it may be advisable for the predecessor entity to withhold sufficient liquid assets so that any future tax asserted under the assignment-of-income doctrine could be paid. In the alternative, the incorporation agreement could require that the corporation remit collections of accounts receivable to the predecessor to the extent the Internal Revenue Service held such receivables taxable to the predecessor. Such a pre-existing agreement would at least offer some basis for arguing that the post-incorporation remittances should not be treated as dividends to the predecessor. See Vincent E. Oswald, 49 T.C. 645 (1968), *acquiesced in*, 1968-2 CUM. BULL. 2, where a similar agreement was upheld with respect to excessive compensation.

²⁴⁶ 267 F.2d 434 (9th Cir. 1959), *cert. denied*, 361 U.S. 821 (1960).

applied to require a taxpayer who had been reporting on the completed contract method to report income earned to the date of incorporation on the percentage-of-completion method. Although in many cases a change in method of accounting will not tax income to the transferor (*e.g.*, transfer of growing crops before sale and after the expense of raising are incurred, or transfer of depreciated property for sale by the corporation), section 446(b) appears to be the proper tool for taxing transfers of unrealized, cash-basis receivables. Under that provision, all uncollected income and unpaid expenses could be accrued on the date of transfer and taxed at that point.²⁴⁷ Presumably, the corporation could assume the resulting tax liability and pay such liability from the collection proceeds of the accrued receivables.²⁴⁸

If section 446(b) does not provide an effective remedy, section 482 could be applied. In *National Securities Corp. v. Commissioner*²⁴⁹ the predecessor of section 482 was applied to re-allocate a loss on the sale of securities from a subsidiary corporation to the parent since the depreciation in value had occurred during the period in which the parent corporation owned the securities. The Third Circuit found that section 482 took priority over section 351 in that case. In *Central Cuba Sugar Co. v. Commissioner*²⁵⁰ expenses of raising a crop were allocated from the transferor to the transferee corporation, which realized the income from the crop.²⁵¹ Section 482, like the assignment-of-income doctrine, could create problems for the transferor if income were allocated to him after the proceeds had become corporate property. It is submitted, however, that section 482 is a policing provision, much like the assignment-of-income doctrine, and should be used only when there is abuse of section 351. Therefore, a taxpayer abusing section 351 must take the attendant risk that repatriation of funds to pay the tax he attempted to avoid may be taxable as a dividend and, hence, make his adventure more costly than if he had not attempted to avoid tax.

E. Assumption of Unpaid Expenses

Invariably, upon incorporation, liabilities, whether known or unknown, will exist with respect to the predecessor entity. Of course, if the amount of liability is ascertainable and the predecessor used the accrual method of accounting, the deduction for such items will already have been accrued

²⁴⁷ It would appear inappropriate to accrue income which otherwise could be reported on the installment method under § 453, since the Internal Revenue Service by its own regulations permits the transfer of installment obligations without "triggering" the unrealized income attributable thereto. See Treas. Reg. § 1.453-9(c)(2) (1958).

²⁴⁸ Assumption of a liability for federal income tax for a predecessor may give rise to problems under § 357(b). In *Estate of John G. Stoll*, 38 T.C. 223 (1962), the Tax Court did not apply § 357(b) to the assumption of a debt incurred to pay personal income taxes, but in *Campbell v. Wheeler*, 342 F.2d 837 (5th Cir. 1965), the court found that a loan to pay personal income taxes arising from operations other than those transferred to the corporation did come within the purview of § 357(b) for lack of business purpose. See generally *Burke & Chisholm, Section 357: A Hidden Trap in Tax-Free Incorporations*, 25 TAX L. REV. 211, 224-26 (1970).

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

²⁵⁰ 198 F.2d 214 (2d Cir.), *cert. denied*, 344 U.S. 874 (1952).

²⁵¹ See also *Rooney v. United States*, 305 F.2d 681 (9th Cir. 1962), reaching the same result.

for federal income tax purposes. If, however, the predecessor used the cash method of accounting or if the liabilities are not ascertainable in amount by an accrual basis predecessor, the deduction for such items will not have been taken at the date of incorporation.

If the predecessor retains such liabilities, it should be entitled to deduct those liabilities when paid or incurred (depending upon its method of accounting).²⁵² Many times, all liabilities of the predecessor are transferred to the transferee corporation. Substantial authority exists that the transferee corporation will not be entitled to a deduction upon payment of the liabilities.²⁵³ The assumption of an otherwise deductible liability is generally regarded as a capital expenditure incurred in acquiring the business. The predecessor may be allowed a deduction even if the corporation assumes the liability, if the predecessor can establish that a portion of the assets were transferred to the corporation to pay the assumed liability.²⁵⁴ When liabilities are to be assumed by the transferee corporation, it is suggested that a list of such liabilities and a list of the assets transferred for payment of such liabilities be included as part of the incorporation agreement.

In the event there is a contingent or contested liability, it is suggested that the predecessor retain and pay that liability even if it requires that some liquid assets be retained for such payment, if such liability will give rise to a deduction for federal income tax purposes.

F. Ruling Policy of the Internal Revenue Service

The private ruling policy of the IRS with respect to cash-basis taxpayers has changed several times in recent years. It is understood at the present time that the Service will issue a favorable ruling under section 351 on the incorporation of a cash-basis taxpayer if the transferee corporation will enter into a closing agreement by which it agrees to include the receivables in its taxable income upon collection, and in which the IRS agrees that the transferee corporation will be entitled to a deduction for the payables upon their payment. This ruling policy, of course, does not completely clear the *Raich* problem, because section 357(c) will continue to apply where liabilities exceed basis upon the transfer. The Service will not rule that a transferor may transfer receivables to a corporation and retain the payables, since such a procedure fails to result in a proper matching of income and deductions. It is understood, however, that the Service will rule favorably where payables are retained if an equal amount of accounts receivable are retained.

G. Recovery of Prior Deductions

Normally, a transferor is not required to recover prior deductions upon transfer of assets to a corporation under section 351. Special exception provisions throughout the Code preclude the recapture of depreciation and

²⁵² See Rev. Rul. 67-12, 1967-1 CUM. BULL. 29.

²⁵³ See note 67 *supra*.

²⁵⁴ Cf. *Pierce Oil Corp. v. United States*, 77 F. Supp. 273 (E.D. Va. 1947).

certain other special deductions which must be recaptured in taxable transactions.²⁵⁵ Hence, the recapture provisions of the Code do not generally create a problem under section 351, unless a portion of the transaction is taxable because of the receipt of boot. In the past, however, transferors have occasionally encountered problems with respect to the treatment of reserves for bad debts upon incorporation of a predecessor business.

In Revenue Ruling 62-128,²⁵⁶ the Service took the position that if a sole proprietor transferred a business under section 351, such proprietor was required to take his bad debt reserve (if any) into income to the extent that additions to such reserve had been deducted in prior years with a tax benefit. In *Nash v. United States*²⁵⁷ the Fifth Circuit followed the theory of Revenue Ruling 62-128 and held that a partnership which used the reserve method of accounting for bad debts had to include the bad debt reserve in income when it transferred its assets, including accounts receivable, to controlled corporations in exchange for stock. This result directly conflicted with the decision of the Ninth Circuit in *Estate of Schmidt v. Commissioner*,²⁵⁸ in which it was held that although the need for the reserve ended with the transfer, the end to such need did not make necessary the inclusion of the reserve in income. In order to resolve the conflict between the Fifth and Ninth Circuits, certiorari was granted by the Supreme Court in the *Nash* case.²⁵⁹ Before the Supreme Court, the IRS based its argument in *Nash* on the so-called tax benefit rule, under which recovery of an item that has produced an income tax benefit in a prior year is to be added to income in the year of recovery. It was argued that this rule applied in the *Nash* case because the unused portion of a bad debt reserve must be restored to income when the reserve is no longer necessary, such as when a business is terminated by transfer of its assets to a new corporation. The Supreme Court was not willing to make "end of need" synonymous with "recovery," as the latter term is used in the tax benefit rule. The Court found that the transferors in *Nash* received stock equal in value to the net value of the receivables.²⁶⁰ Hence, there was no recovery of the unused reserve when the receivables were transferred at net value. The decision of the Supreme Court in the *Nash* case is obviously a proper one, since accounts receivable do not increase in value to their face amount merely because they are transferred to a corporation.

Another problem which might arise with respect to prior deductions is the applicability of section 111 to the transferee corporation in the event it recovers prior deductions which did not result in a reduction of income tax to the transferor when incurred. Section 111 provides for the exclusion from income of recoveries of previously-deducted bad debts, taxes,

²⁵⁵ INT. REV. CODE OF 1954, §§ 617(d)(3), 1245(b)(3), 1250(d)(3), 1251(d)(3), 1252(b).

²⁵⁶ 1962-2 CUM. BULL. 139. See generally Note, *A Misunderstanding of the Function of a Bad Debt Reserve When Incorporating Under Section 351*, 24 SW. L.J. 372 (1970).

²⁵⁷ 414 F.2d 627 (5th Cir. 1969).

²⁵⁸ 355 F.2d 111 (9th Cir. 1966).

²⁵⁹ 396 U.S. 1000 (1970).

²⁶⁰ 398 U.S. 1 (1970).

and tax penalties, if the deduction did not result in a reduction of income tax in a prior year. Presumably, however, this privilege is not assignable by the transferor to the transferee. Hence if a transferee corporation recovers a bad debt which was previously written off by a predecessor entity, but which resulted in no tax benefit to such entity, such recovery would be taxable to the transferee corporation and not excludable under section 111. In planning an incorporation, therefore, if significant bad debts, taxes, or tax penalties which qualify for section 111 treatment have been deducted by the transferor, such transferor should retain the right to such items in the event of recovery.

H. *Recapture of Investment Credit*

Although the investment credit is now, for the most part, a dead issue, credits used in the past, or those used in the future as allowed by the Tax Reform Act of 1969, may create tax liability upon incorporation.²⁶¹ The tax liability for recapture of investment credit may result whether or not boot is received in the transaction.

Ordinarily, the transfer of a going business under section 351 will not give rise to recapture as long as: (1) the section 351 transaction is a mere change in the form of conducting the trade or business; (2) the property is retained in such trade or business as section 38 property; and (3) the taxpayer retains a substantial interest in such trade or business.²⁶² The regulations state that a transferor will be considered as having retained a substantial interest in the trade or business only if, after the change in form, his interest is substantial in relation to the total interest of all persons or is equal to or greater than his interest prior to the change in form.²⁶³ This rule was tested before the Tax Court in *James Soares*.²⁶⁴ In that case, the court held that a disposition occurred for purposes of section 47(a) where upon incorporation of a partnership in which the taxpayer held a forty-eight per cent interest, such taxpayer received only a 7.2 per cent interest in the new corporation. Even if a taxpayer avoids recapture on a transfer to a corporation, such transferor may be charged with recapture of investment credit in the event the transferee disposes of the property before the close of its estimated useful life, or if such transferor subsequently does not retain a substantial interest in the business.²⁶⁵

XIII. EFFECT OF REORGANIZATION PROVISIONS ON SECTION 351

A. *Business Purpose Doctrine*

The regulations under section 368 relating to tax-free reorganizations provide that a "scheme" whereby the reorganization procedures are used merely to avoid tax and "no business or corporate purpose" exists will not be treated as a tax-free reorganization.²⁶⁶ Such language, of course, is based

²⁶¹ See generally INT. REV. CODE of 1954, § 49.

²⁶² *Id.* § 47(b); Treas. Reg. § 1.47-3(f)(1)(ii) (1967).

²⁶³ Treas. Reg. § 1.47-3(f)(2) (1967).

²⁶⁴ 50 T.C. 909 (1968).

²⁶⁵ See generally Treas. Reg. § 1.47-3(f)(5) (1967).

²⁶⁶ *Id.* § 1.368-1(c).

upon the business purpose doctrine of *Gregory v. Helvering*. The regulations under section 351 do not require a business purpose for a transfer to a controlled corporation. Further, the legislative history of section 351 is silent on the point. Nevertheless, the courts and the IRS have, from time to time, applied the business purpose doctrine to cause a section 351 transaction to fail.

In *West Coast Marketing Corp.*²⁶⁷ the Tax Court indicated that the business purpose doctrine applied in a situation where the existence of the transferee corporation was transitory.²⁶⁸ In a much earlier case, however, the Board of Tax Appeals rejected application of the business purpose doctrine. In *W. & K. Holding Corp.*²⁶⁹ the controlling shareholders of a corporation transferred property which had depreciated in value to the corporation in exchange for additional stock. The property was sold by the corporation shortly after the exchange and it claimed a loss on the sale. The Board of Tax Appeals rejected the Commissioner's claim that the transfer had no business purpose, and allowed the loss to the corporation. It is interesting to note that the predecessor of section 482 was not applied in *W. & K. Holding Corp.*

In Revenue Ruling 55-36,²⁷⁰ the IRS imposed the business purpose requirement on a section 351 transaction in which an individual transferred stock to a new corporation in exchange for all of its stocks and bonds. The transferor immediately transferred the stock of the new corporation to a charity which, in turn, caused the new corporation to liquidate. The charity assumed the corporation's bond obligations. The individual planned to make subsequent periodic gifts of the bonds to the charity, thereby spreading his charitable deduction over a number of years. The IRS noted that the new corporation did not remain in existence after the transaction, and concluded that there was no business purpose for the transfer. Therefore, section 351 was held not to apply. The ruling also stated that the transferor was not in control of the new corporation, since his ownership of its stock was only transitory. It appears that this ground alone would have been sufficient to conclude that section 351 did not apply. However, it appears that the principal reason for the holding was the lack of business purpose.

In Revenue Ruling 60-331,²⁷¹ certain transferors transferred stock of a corporation to a second corporation shortly before a dividend was to be paid on such stock. The sole purpose of the transfer was to qualify the dividend for the dividend-received deduction under section 243. Because of the absence of business purpose, the transfer was held to be ineffective, and the dividend was taxed to the transferors. It appears that the same result might have been obtained by applying section 482. Under Revenue Procedure 70-17,²⁷² the IRS requires that the business reasons for a section 351 transaction be explained if an advance ruling is being requested. In

²⁶⁷ 46 T.C. 32 (1966).

²⁶⁸ See also *Electrical Sec. Corp. v. Commissioner*, 92 F.2d 593 (2d Cir. 1937).

²⁶⁹ 38 B.T.A. 830 (1938).

²⁷⁰ 1955-1 CUM. BULL. 340.

²⁷¹ 1960-2 CUM. BULL. 189.

²⁷² 1970 INT. REV. BULL. No. 27, at 40, §§ 3.06(1), (2).

addition, the future activities of the transferee corporation must be described.

In *Gregory v. Helvering*²⁷³ the taxpayer owned all of the stock of a corporation which held certain assets which the taxpayer wanted to sell to a third party. The existing corporation transferred such assets to a new corporation and caused the stock of the new corporation to be issued to the taxpayer. Shortly thereafter, the new corporation dissolved, its assets were distributed to the taxpayer, and the taxpayer sold the assets to a third party. In holding that the net result of the steps was a dividend to the taxpayer, the Supreme Court observed with respect to the new corporation that:

No doubt, a new and valid corporation was created. But that corporation was nothing more than a contrivance to [disguise the true character of the transaction]. . . . *It was brought into existence for no other purpose; it performed, as it was intended from the beginning it should perform, no other function. When that limited function had been exercised, it immediately was put to death*²⁷⁴

Even though *Gregory* involved a corporate reorganization, the principle should apply under section 351 to the extent that the transferee corporation is formed only to perform a transitory function in a section 351 transaction designed solely to avoid tax. If, however, the transferee corporation is a viable one and continues in existence after the section 351 transaction, the business purpose doctrine should not be used to attack the transaction. Therefore, it appears that the Tax Court in *West Coast Marketing Corp.* and the IRS in Revenue Ruling 55-36 properly applied the business purpose doctrine. It further appears that rejection of the principle in *W. & K. Holding Corp.* was correct, since sections 446(b) and 482 are readily available to correct improper allocations of income, deductions, and losses by use of section 351. Revenue Ruling 60-331, however, does not appear to be a proper case for application of the business purpose doctrine, and such a factual situation could be as easily, and more properly, attacked by application of section 482.

The most perplexing current problem for tax practitioners is the requirement of Revenue Procedure 70-17 that a business purpose be stated for a section 351 transaction in an advance ruling request. Does this mean that if the sole purpose for operating in the corporate form in the future is to reduce the proprietor's or partners' personal tax liabilities and to obtain the benefits of corporate profit-sharing and pension plans, as is usually the case at least with professional corporations, such a purpose is not a sufficient business purpose under section 351? Obviously, avoidance of the individual rate structure and the use of tax-favored corporate employee benefit plans can be classified as tax avoidance motives. However, it appears that this is the very type of tax avoidance that section 351 was enacted to implement by allowing simple transitions from a noncorporate to the

²⁷³ 293 U.S. 465 (1935).

²⁷⁴ *Id.* at 469-70.

corporate form of operation. Hopefully, the IRS will limit its application of the business purpose doctrine under section 351, so that the sole function of that doctrine will be to assure that the transferee corporation is a viable entity.

It may be implicit that Congress intended that a normal section 351 transaction could be consummated to allow tax avoidance through operation in the corporate form, since Congress has explicitly required a business purpose (other than tax avoidance) for certain aspects and types of section 351 transactions. For example, whenever liabilities are assumed, section 357(b) requires that a business purpose (other than tax avoidance) for the assumption be present in order to avoid recognition of gain as the result of such assumption.²⁷⁵ Furthermore, when the transfer is to a foreign corporation, it is required that a ruling be obtained reflecting that the transaction was for a business purpose. If such a ruling is not obtained under section 367, section 351 will not apply.²⁷⁶ Such specific references to business purpose for certain aspects and types of section 351 transactions certainly raise an inference that the applicability of the business purpose doctrine should be limited under section 351.

B. *Continuity of Interest*

The courts have developed a doctrine in the reorganization area which requires that the transferor have a continuity of interest in the surviving corporation.²⁷⁷ No authority exists relating to the applicability of this doctrine to section 351.

A question could be raised regarding continuity of interest, of course, where one of the parties to the transaction receives nothing but securities of the transferee corporation. However, since section 351 by its very terms requires continuity of interest within a group of transferors, the continuity-of-interest doctrine should not apply under section 351, even if one or more transferors receives only securities. In cases where a transferor or transferors already control a corporation and transfer additional property to such corporation in exchange for its securities, the continuity-of-interest doctrine might be applied to cause the transfer to be taxable. If section 351 can be avoided in this manner, it appears that the legislative purpose of section 351 would be frustrated, since in such a case there has been nothing more than a mere change in form of ownership.

XIV. ACCOUNTING PROBLEMS AND REPORTING REQUIREMENTS

A. *General*

As a general rule, the transferee corporation is treated as a new taxpayer for federal income tax purposes unless the transfer is made to a pre-existing corporation. Section 381, relating to the carryover of certain tax attributes in tax-free reorganizations and certain liquidations, does not

²⁷⁵ See text accompanying notes 205-19 *supra*.

²⁷⁶ See text accompanying notes 313-30 *infra*.

²⁷⁷ See *LeTulle v. Scofield*, 308 U.S. 415 (1940).

apply to section 351 transactions.²⁷⁸ Therefore, a new corporation may make new elections relating to accounting methods and period without regard to the methods or period of the predecessor business.

B. Depreciation

The transfer corporation is not considered to be the original user of depreciable assets which it receives in a section 351 transaction.²⁷⁹ Therefore, the corporation will not be entitled to use double declining or sum-of-the-year-digits methods in computing depreciation for such assets. Furthermore, additional first-year depreciation is not available, because a section 351 transaction is not a "purchase" for purposes of section 179.²⁸⁰

C. Accounting Methods and Period

Since the transferee corporation is regarded as a new taxpayer, it may elect any accounting method and period it chooses. The fact that the corporation is a new taxpayer may be burdensome if the Commissioner requires accounting adjustments in the first taxable year of a new corporation. In *Ezo Products Co.*²⁸¹ the predecessor partnership had not used inventories in computing its taxable income and had reported its taxable income using the cash method of accounting. After incorporation, the Commissioner asserted that inventories were required in order to properly reflect income, thereby necessitating a change to the accrual method of accounting. In computing its taxable income for the first year, the corporation had no basis in its beginning inventory because of the carryover of basis from its predecessor. No relief was available under section 481 because the new corporation did not have a "preceding taxable year" for purposes of section 481(a). Therefore, the corporation was deprived of benefits which might have been available to its predecessor under section 481.

The rule of *Ezo Products* also applies to other items which may be adjusted in the corporation's first taxable year. Accounts receivable received from a cash-basis predecessor, of course, have a zero basis to the corporation and are income when collected. If the Commissioner requires the corporation to adopt the accrual method for its first year, section 481 does not apply, and the corporation will have income both from collection of the zero basis receivables and from accrual of its own receivables.²⁸²

It appears that an exception may be developing if the new corporation is a subchapter S corporation in its first taxable year. The Tax Court has indicated that where subchapter S treatment is elected by the corporation, section 481 may be available, since the adjustments affect the income of the same taxpayers.²⁸³ This judicially-sanctioned exception to the statute

²⁷⁸ Cf. INT. REV. CODE of 1954, §§ 381(a)(1), (2).

²⁷⁹ Rev. Rul. 67-286, 1967-2 CUM. BULL. 101.

²⁸⁰ See INT. REV. CODE of 1954, §§ 179(d)(1)(B), 179(d)(2)(C)(i); Treas. Reg. § 1.179-3(c)(1)(iii) (1960).

²⁸¹ 37 T.C. 385 (1961).

²⁸² *Id.*

²⁸³ See Paul H. Travis, 47 T.C. 502 (1967), *rev'd in part, aff'd in part*, 406 F.2d 987 (6th

is extremely difficult to justify since a corporation, regardless of its subchapter S status, is a separate taxpayer.

D. *Installment Obligations*

A transfer of installment obligations to a corporation under section 351 does not "trigger" the unrealized gain attributable to such receivables.²⁸⁴ An exception to this rule might well occur where a taxpayer sells assets to a corporation on the installment basis and subsequently exchanges his installment note for additional stock of the corporation, thereby canceling the debt of the corporation. In this situation, the corporation would receive a stepped-up basis for the assets as a result of its purchase of them with an installment note, and the shareholder would never recognize the gain on the installment sale. In *Jack Ammann Photogrammetric Engineers, Inc. v Commissioner*²⁸⁵ the Fifth Circuit indicated that a stockholder, whose tax treatment was not in issue, might realize taxable income upon the transfer of an installment obligation to the debtor corporation in a section 351 transaction. It appears that an exception to the general rule should apply when a creditor holding an installment obligation transfers such obligation to the debtor in a section 351 transaction.

E. *Reporting Requirements*

The regulations under section 351 provide that each transferor must file with his individual income tax return for the year in which a section 351 transaction occurs, a statement of all pertinent facts, including a description of property transferred, the stock and/or securities received, any other property received, and any liability assumed by the controlled corporation.²⁸⁶ The transferee corporation must include in its return for the taxable year in which the exchange occurs a description of the property received, including a statement of the basis of such property to the transferors, information with respect to the stock and securities of the corporation, the amount of money, if any, paid to each of the transferors, the fair market value and basis of any other property paid to the transferors, and certain information relating to the liabilities assumed by the corporation.²⁸⁷ The regulations further require that all parties to a section 351 transaction retain permanent records relating to their participation in such transaction.²⁸⁸

XV. AVOIDING SECTION 351

A. *General*

As indicated above, if a transaction qualifies under section 351(a), the transferor's basis in the transferred property carries over and becomes the

Cir. 1969); E. Morris Cox, 43 T.C. 448 (1965), *not acquiesced in on this issue*, 1965-2 CUM. BULL. 7.

²⁸⁴ See note 247 *supra*.

²⁸⁵ 341 F.2d 466 (5th Cir. 1965).

²⁸⁶ Treas. Reg. § 1.351-3(a) (1955).

²⁸⁷ *Id.* § 1.351-3(b).

²⁸⁸ *Id.* § 1.351-3(c).

transferee corporation's basis in such property. From time to time, transferors attempt to avoid section 351 by "selling" property, hopefully at capital gain rates, to the transferee corporation in order to give the corporation a stepped-up basis which can be offset against subsequent ordinary income of the corporation.²⁸⁹ In many cases, this advantage has been partially or wholly laid to rest by sections 617, 1239, 1245, 1250, 1251, and 1252, which require treatment of at least part of the gain as ordinary income if certain types of property are sold.

The "sale" technique may still provide a valuable planning tool in a situation where sellers hold investment land which is to be subdivided. If the land can be sold to a corporation at capital gain rates, the corporation receives a stepped-up basis to offset against the ordinary income to be derived from subsequent sales of the subdivided land. The sale technique may also be used to realize a loss on property which has depreciated in value, if the problems created by section 267(a)(1) can be avoided.

In addition to the sale technique, section 351 may be partially or completely avoided by (1) use of boot; (2) intentionally failing the control test; and (3) transferring debts in excess of basis.

B. Sale Versus Section 351

Traditionally, a taxpayer, desiring that a portion of his property be sold to a new corporation, will transfer part of his property to such corporation for stock in an obvious section 351 transaction. The balance of the property is then sold to the corporation, generally in exchange for long-term notes.

The first test of a sale is whether the purported debt obligation is actually debt or is additional stock.²⁹⁰ Usually, the courts have reviewed the capital structure of the corporation to determine if it is "thin."²⁹¹ If it is, the debt is held to be stock and the purported sale falls within section 351(a).

In a recent case, *Burr Oaks Corp.*,²⁹² real property valued at \$165,000 was transferred by three individuals to a corporation controlled by their nominees in exchange for short-term notes totaling \$330,000. The corporation had total equity of \$4,500 at the time of transfer. The Tax Court found the corporation undercapitalized, its future speculative, and its debt-equity ratio unfavorable (approximately 80:1). As a result, the court held that the short-term notes were in the nature of preferred stock, thereby causing section 351 to apply to the purported sale. In an earlier case, *Aqualane Shores, Inc.*,²⁹³ three individuals purchased the stock of a corporation for \$600 and immediately sold appreciated real estate to the

²⁸⁹ See generally Ellis, *Tax Problems in Sales to Controlled Corporations*, 21 VAND. L. REV. 196 (1968).

²⁹⁰ See BITTKER & EUSTICE 121-27.

²⁹¹ See generally Caplin, *The Caloric Count of a Thin Incorporation*, N.Y.U. 17TH INST. ON FED. TAX. 771 (1959).

²⁹² 43 T.C. 635 (1965), *aff'd*, 365 F.2d 24 (7th Cir. 1966), *cert. denied*, 385 U.S. 1007 (1967).

²⁹³ 30 T.C. 519 (1958), *aff'd*, 269 F.2d 116 (5th Cir. 1959).

corporation. The corporation was obligated to pay the purchase price in five equal yearly installments. The Tax Court found that inadequate capital, failure to pay the installments when due, and the necessity of additional outside borrowing required that the debt be treated as stock and that section 351 apply.²⁹⁴ Even if the corporation is not "thin," if the property transferred does not produce income or does not produce sufficient income to amortize the debt, the courts may view the debt as an equity investment.²⁹⁵ On the other hand, if the property has sufficient income potential to pay the debt, this factor should not be considered.²⁹⁶ Another significant factor may be the treatment of the debt obligations by the parties. If payments are not timely and the debt is generally ignored, such treatment may infer that the debt is actually equity.²⁹⁷ It is hoped that the IRS will promulgate definitive regulations under section 385 (added by the Tax Reform Act of 1969) and help resolve the debt-equity mystery.

If the corporation passes muster on the debt-equity question, the court must then determine whether the debt is a security for purposes of section 351. In *Camp Wolters Enterprises, Inc.*²⁹⁸ property was conveyed to a new corporation in exchange for notes payable over a five-year period commencing in the sixth year after issuance. The notes were treated as the issuance of boot by the corporation, thereby giving the corporation a partially stepped-up basis. The Tax Court and Fifth Circuit treated the notes as securities under section 351 and denied the stepped-up basis to the corporation. In a recent case, *George A. Nye*,²⁹⁹ the Tax Court held that an installment note was debt, thus disposing of the debt-equity question.³⁰⁰ The debt was, however, a security for purposes of section 351.³⁰¹

A variety of cases have found that a "sale" existed despite close similarity to other cases where debt was found to be equity or a security. In *Sun Properties, Inc. v. United States*³⁰² the Fifth Circuit found, regardless of a high debt-equity ratio, that a sale occurred seemingly because of the form of the transaction. The *Sun Properties* case was distinguished by the Fifth Circuit in *Aqualane Shores, Inc.*³⁰³ on the theory that the property in *Sun Properties* yielded sufficient income to amortize the debt, whereas the property in *Aqualane Shores* did not. The *Sun Properties* case appears to be of little precedential value due to overemphasis of form, rather than substance.

²⁹⁴ See also *Truck Terminals, Inc.*, 33 T.C. 876 (1960), *aff'd*, 314 F.2d 449 (9th Cir. 1963).

²⁹⁵ See *Aqualane Shores, Inc.*, 30 T.C. 519 (1958), *aff'd*, 269 F.2d 116 (5th Cir. 1959).

²⁹⁶ See *Sun Properties, Inc. v. United States*, 220 F.2d 171 (5th Cir. 1955).

²⁹⁷ See, e.g., *Gooding Amusement Co. v. Commissioner*, 23 T.C. 408 (1954), *aff'd*, 236 F.2d 159 (6th Cir. 1956), *cert. denied*, 352 U.S. 1031 (1957). See also *Marsan Realty Corp.*, 22 CCH Tax Ct. Mem. 1513 (1963).

²⁹⁸ 22 T.C. 737 (1954), *aff'd*, 230 F.2d 555 (5th Cir.), *cert. denied*, 352 U.S. 826 (1956).

²⁹⁹ 50 T.C. 203 (1968), *acquiesced in*, 1968-2 CUM. BULL. xxv.

³⁰⁰ See also *United States v. Hertwig*, 398 F.2d 452 (5th Cir. 1968).

³⁰¹ See also *Parkland Place Co. v. United States*, 354 F.2d 916 (5th Cir. 1966); *Campbell v. Carter Foundation Prod. Co.*, 322 F.2d 827 (5th Cir. 1963); *Baker Commodities, Inc.*, 48 T.C. 374 (1967).

³⁰² 220 F.2d 171 (5th Cir. 1955).

³⁰³ 30 T.C. 519 (1958), *aff'd*, 269 F.2d 116 (5th Cir. 1959).

In a 1965 Tax Court case, *Charles E. Curry*,³⁰⁴ four family members sold an income-producing building to a corporation in which two of the sellers owned fifty-five per cent of the stock and the balance was owned by a son-in-law of one of the sellers. The sellers received two promissory notes for the building, the first for a period of ten years, secured by a first mortgage and payable in semi-annual installments, and the second, secured by a second mortgage, providing interest only for ten years with ten annual installments payable beginning in the eleventh year. Although the incorporation and sale were found to be interdependent steps, and despite the corporation's high, thirty-to-one debt-equity ratio, the Tax Court held section 351 inapplicable because of the disproportion between the ownership of the stock and the notes.³⁰⁵ The court, however, failed to consider whether the notes were securities. Presumably, the twenty-year note could have easily qualified as a security. The ten-year installment note should also have qualified as a security, despite the holding in the *Brown* case³⁰⁶ that installment notes do not maintain a sufficient continuity of interest. The *Curry* decision has led and will continue to lead to irreconcilable court decisions. Therefore, similar transactions will lead to different tax results. It is obvious that the courts must read section 351 literally and weld all parts of the incorporation transaction together so that interrelated incorporations and sales will be treated as a single transaction, and long-term notes, if any, received in the purported sale will be given the proper classification (whether as boot or securities) under section 351.

An attempted sale which subsequently is held to be a section 351 transaction may prove very unfavorable to all parties. For example, if the transferors treat the transaction as a sale, report the gain, and pay tax thereon, and the IRS later sustains that the corporation does not have a stepped-up basis because section 351 applied to the original transfer, the appreciation may be taxed twice. This result could occur where the statute of limitations had elapsed with respect to the transferor's years in which the gain was taxed. The mitigation provisions found in sections 1311-1315 appear to provide no relief in this situation. Hence, the transferor would be well-advised to defer receipt of note payments for several years until the issue of the corporation's basis can be resolved.³⁰⁷

One caveat which taxpayers attempting to avoid section 351 by the sale technique should carefully observe is that the sales price of the property must be at fair market value. Otherwise, sales proceeds in excess of the fair market value may well result in dividends in later years.

³⁰⁴ 43 T.C. 667 (1965), *acquiesced in*, 1965-2 CUM. BULL. 4, *acquiescence on section 351 issue withdrawn*, 1968-2 CUM. BULL. 3.

³⁰⁵ In an earlier case, the Tax Court disregarded disproportionate holdings within a single family. See *Zephyr Mills, Inc.*, 18 CCH Tax Ct. Mem. 794 (1959).

³⁰⁶ See text accompanying notes 168, 169 *supra*.

³⁰⁷ See BITTKER & EUSTICE 96 n.43, for a comprehensive discussion of the results of erroneous treatment of basis by either the transferor or the transferee. See also Burford, *Basis of Property After Erroneous Treatment of a Prior Transaction*, 12 TAX L. REV. 365 (1957).

C. Use of Boot

A partially taxable transaction may be readily accomplished under section 351(b) by the use of boot. The disadvantages of this approach are: (1) losses cannot be recognized; (2) the boot is allocated among *all* assets transferred; and (3) installment reporting may not be available.³⁰⁸ If, therefore, the transferors desire to recognize a loss or have gain recognized only with respect to certain assets, such as capital assets, the boot technique may be unsatisfactory.

D. Avoidance of Control

As discussed above, the transferors as a group must be in control of the transferee corporation immediately after the exchange. It appears clear that if a legally binding contract requiring sale of more than twenty per cent of the stock exists prior to the date of transfer under section 351, control would not be achieved (assuming that the contract is not a sham). Care should be taken not to convey an interest in the property to be transferred to the contracting party prior to the section 351 transaction. If such a transfer occurred, the third party might be deemed to be a transferor.³⁰⁹

Another avenue of avoidance would be to have the transferee corporation issue more than twenty per cent of its stock for services or to issue a separate class of nonvoting stock for such services. Any issuance of stock for the announced purpose of avoiding section 351 would, of course, be reviewed carefully by the Service. Avoidance of the control requirement would require recognition of the entire gain, which might not be advantageous. In addition, only in some cases would installment reporting be available.

E. Liabilities in Excess of Basis

Gain may be recognized by merely having liabilities in excess of the basis in property transferred to the transferee corporation.³¹⁰ Such gain presumably must be allocated among *all* assets on the basis of relative fair market values, regardless of the character of the assets. Further, installment reporting probably would not be available.³¹¹ It should be noted that if the liabilities are specifically created to be assumed by the transferee corporation, section 357(b) might well apply to cause all liabilities assumed to be treated as boot, rather than just that portion in excess of basis.³¹² Hence, great care should be exercised in choosing this avenue.

³⁰⁸ See generally text accompanying notes 172-97 *supra*.

³⁰⁹ Cf. *Fahs v. Florida Mach. & Foundry Co.*, 168 F.2d 957 (5th Cir. 1948), in which the taxpayer made such an argument, but the Fifth Circuit rejected it due to the absence of any evidence of a transfer prior to the exchange with the corporation.

³¹⁰ See generally text accompanying notes 199-227 *supra*.

³¹¹ The entire excess of debt over basis would be treated as "other property" received in the year of sale for purposes of § 453.

³¹² See text accompanying notes 206, 218, 219 *supra*.

XVI. SECTION 351 AND FOREIGN CORPORATIONS

A. *General*

Section 367 provides, in part, that:

In determining the extent to which gain shall be recognized in the case [of an exchange described in section 351], a foreign corporation shall not be considered as a corporation unless, before such exchange, it has been established to the satisfaction of the Secretary or his delegate that such exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.³¹³

Presumably, tax avoidance by clever use of section 351 prompted enactment of the predecessor of section 367 in 1932.³¹⁴ At that time, without section 367, a United States corporation could form a subsidiary in a foreign country imposing no tax on capital gains, transfer appreciated securities to such foreign subsidiary under section 351, cause the foreign subsidiary to sell the securities without incurring tax on the gain, have the foreign subsidiary transfer the funds to a new United States subsidiary, and then liquidate the foreign subsidiary. As a result, the United States parent could avoid tax on the appreciation and indirectly repatriate the funds.

Failure to obtain an advance ruling under section 367 will not result in a benefit to the taxpayer. If a ruling is purposefully not requested in order to achieve a taxable transaction, the IRS will ignore section 367 and treat the transaction as nontaxable.³¹⁵ On the other hand, if a ruling is not obtained in a transaction which the taxpayer desires to be tax-free, gain will be recognized.³¹⁶ Hence, section 367 is a one-way street, and the control of the direction of traffic is solely in the hands of the Service. One exception to the requirement of a section 367 ruling is where a United States taxpayer transfers only cash to a foreign corporation. In such a case, no gain is recognized, even if the value of the stock received exceeds the amount of cash paid.³¹⁷ As previously discussed, the IRS has attempted to extend section 367 to cover contributions to capital by treating such transactions as "constructive" section 351 transactions. This extension, in the author's view, has been properly rejected by the Tax Court and the Second Circuit.³¹⁸

Section 367 applies only to gains. Losses are not recognized under section 351 regardless of whether or not a section 367 ruling is obtained. Further, losses may not be netted against gains. Hence, all gains are recognized on an asset-by-asset basis if a favorable ruling is not obtained.³¹⁹

³¹³ The effect of the language of § 367 is to require the transferor to recognize gain on the exchange. However, the transferee does not lose corporate status for such matters as earnings and profits. See Rev. Rul. 64-158, 1964-1 CUM. BULL. 140.

³¹⁴ S. REP. NO. 665, 72d Cong., 1st Sess. (1932), reprinted at 1939-2 CUM. BULL. 515.

³¹⁵ Rev. Rul. 64-177, 1964-1 CUM. BULL. 141.

³¹⁶ See *Texas-Canadian Oil Corp.*, 44 B.T.A. 913 (1941).

³¹⁷ Rev. Rul. 68-43, 1968-1 CUM. BULL. 146. See also Rev. Rul. 70-433, 1970 INT. REV. BULL. NO. 34, at 11.

³¹⁸ See text accompanying notes 143-48 *supra*.

³¹⁹ Rev. Rul. 67-192, 1967-2 CUM. BULL. 140.

B. Section 367 Guidelines

For a number of years the IRS failed to develop any definite guidelines for section 367 rulings. Consequently, substantial confusion existed regarding such rulings. Finally, Revenue Procedure 68-23³²⁰ was issued, and, among other things, it provides some definite guidelines for section 351-367 rulings.³²¹

C. Transfer by United States Person to Foreign Corporation

Revenue Procedure 68-23 states that ordinarily a favorable ruling will be granted where property is transferred to a foreign corporation and such property will be used in the active conduct of a trade or business or consists of stock or securities of the type described in sections 3.02(1)(a)-(iii)(A) and (B) of the procedure.³²² In addition, it is contemplated by the procedure that the foreign corporation will require a substantial investment in fixed assets for its trade or business, or will be engaged in the purchase and sale abroad of manufactured goods.³²³ Presumably, the theory of the procedure is that if substantial property is required to conduct an active business, tax avoidance becomes a less likely motive for the transaction.

A favorable ruling will *not* be granted if the following types of assets are transferred:³²⁴

1. Inventory, other property held for sale to customers, a copyright, literary, musical, or artistic composition or similar property;
2. Accounts receivable or installment obligations, unless the income attributable thereto is or will be included in the year's income of the transferor for United States income tax purposes;
3. Most stocks or securities;
4. Other property, if it appears that the principal purpose of its transfer is its sale or other disposition by the foreign corporation.

It is obvious that all these classes of property are objectionable to the Service because of the diversion of income to foreign jurisdictions. With the exception of stock or securities, rather immediate realization of the income will result from sale or collection, and it is difficult to justify transferring such liquid assets outside the jurisdiction of the United States

³²⁰ 1968-1 CUM. BULL. 821.

³²¹ See generally Herskovitz, *New Objective Tests Established by IRS for Favorable Section 367 Rulings*, 29 J. TAXATION 158 (1968); Sitrick, *Section 367 and Tax Avoidance: An Analysis of the Section 367 Guidelines*, 25 TAX L. REV. 429 (1970).

³²² Stock or securities which may be transferred are: (1) stock or securities of "less developed country corporations" to a "controlled" corporation which is, or will be, and will continue to be, a "less developed country corporation holding company" owning 10% or more of the voting power in a "less developed country corporation"; or (2) stock of a foreign corporation which will be 80% "controlled" by the transferee foreign corporation, which must be more than 50% "controlled" by the transferor, who was in control of the corporation whose stock is being transferred. Rev. Proc. 68-23, 1968-1 CUM. BULL. 823. Further technical requirements for the qualification of such stock or securities are found in the Procedure.

³²³ Rev. Proc. 68-23, 1968-1 CUM. BULL. 821, § 3.02(1).

³²⁴ *Id.* § 3.02(1)(a).

income tax. Stock or securities are included, of course, due to the potential avoidance of United States tax on appreciation, if and when sold.

A favorable ruling *generally* will not be granted if the following types of assets are transferred:³²⁵

1. Property which is presently leased or licensed (except that licensed or leased to the transferee corporation), or which it is probable will be licensed or leased after the transfer;
2. United States patents, trademarks, and similar intangibles to be used in connection with (1) the conduct of a trade or business in the United States, or (2) the manufacture in the United States or a foreign country of goods for sale or consumption in the United States;
3. Foreign patents, trademarks, and similar intangibles to be used in connection with the sale of goods manufactured in the United States.

Presumably, the reason for the objection to the items mentioned in category (1) above is the taking of the rents or royalties outside the jurisdiction of the United States income tax. Obviously, there is usually no valid purpose, other than tax avoidance, to justify the transfer of intangible property included in category (2) to a foreign corporation where such corporation will use such property to conduct a trade or business in the United States. It appears that category (3) was included to prohibit a United States person from transferring valuable foreign intangibles to a related foreign corporation and thereby, by virtue of the regulations under section 482, transfer a major portion of the income generated from sales of the transferor's goods to such foreign corporation.

The procedure does provide with respect to all the prohibited transfers described above that a favorable ruling will be issued if, in addition to such property, other property which is to be devoted to the active conduct of a trade or business in any foreign country is being transferred, and the transferor agrees to take into income an amount equal to the appreciation in the tainted property being transferred. The gain is to have the same character it would have had if such property were sold in a taxable transaction.³²⁶ The guidelines do not refer to the treatment of transfers of know-how. Such items are discussed at some length above, and they are governed for purposes of section 351-367 rulings by the rules set forth in Revenue Ruling 64-56 and Revenue Procedure 69-19.³²⁷

D. Transfer by Foreign Corporation to Foreign Corporation

Revenue Procedure 68-23 provides that a favorable ruling will be issued where property is transferred from one foreign corporation to another foreign corporation in a section 351 transaction.³²⁸ The only excep-

³²⁵ *Id.* § 3.02(1)(b).

³²⁶ *Id.* § 3.02(1)(d).

³²⁷ See text accompanying notes 69-74 *supra*.

³²⁸ Rev. Proc. 68-23, 1968-1 CUM. BULL. 821, § 3.02(2).

tion is where part or all of the property to be transferred consists of stock of a controlled foreign corporation. In such a case, it appears that a favorable ruling would be issued only if section 1248, relating to gain on sale of controlled foreign corporations, cannot be avoided permanently as a result of the transaction.³²⁹

E. *Transfer by Foreign Person to United States Corporation*

The procedure does not discuss transfers by a foreign corporation to a United States corporation, since no gain or loss would be recognized in such a transaction under section 351 regardless of whether or not the transferor is a corporation.³³⁰

XVII. TRANSFERS TO INVESTMENT COMPANIES

A. *General*

For several years, section 351 was used as a basis for formation of swap-funds, whereby investors diversified their portfolio by exchanging appreciated stock or securities for stock of a newly-formed investment company.³³¹ Private rulings were issued to the effect that such exchanges qualified under section 351. In Revenue Procedure 62-32, however, the IRS stated that it would no longer issue advance rulings under section 351 when there was a transfer of appreciated stock or securities to a newly-organized investment company, and the transfer was made as a result of solicitation by a professional broker or similar person.³³² Such transactions continued, notwithstanding the fact that a ruling could not be obtained. As a result, the Service took certain steps to prevent such transactions and Congress followed with strong (perhaps too strong) remedial legislation by amending section 351 (a) and adding section 351 (d).³³³

B. *The Statute and Regulations*

Section 351(a) was amended to provide that it applied to transfers "to a corporation (including, in the case of transfers on or before June 30, 1967, an investment company)."³³⁴ As a result, transfers to an "investment company," which is not defined in the statute, will not qualify if made after June 30, 1967. Section 351(d) was added to define application of the June 30, 1967 date in situations where a registration statement had to be filed with the Securities and Exchange Commission. In such situations, the transfer was deemed to have been made by that date only if: (1) it was made on or before such date; (2) the registration statement was filed at the Securities and Exchange Commission before

³²⁹ *Id.* § 5.02.

³³⁰ See Rev. Rul. 55-45, 1955-1 CUM. BULL. 34.

³³¹ See generally Shechtman, *Economic and Equity Implications of the Recent Legislation Concerning Swap Funds*, 45 TAXES 550 (1967).

³³² Rev. Proc. 62-32, 1962-2 CUM. BULL. 527, § 3.01(14)(b).

³³³ Act of Nov. 13, 1966, Pub. L. No. 89-809, § 203, 80 Stat. 1539.

³³⁴ *Id.*

January 1, 1967, and the aggregate issue price of the investment company's stock or securities issued in the transaction did not exceed the aggregate amount specified in the registration statement as of December 31, 1966; and (3) the transfer includes only property deposited before May 1, 1967.³³⁵

The absence of a definition of investment company in the statute caused substantial concern because of the potential far-reaching effect of the new provision on section 351 transactions not intended to be covered. The regulations, however, substantially limited the applicability of the statute.³³⁶ The regulations provide that in order to be an investment company, the transferee corporation must be: (a) a regulated investment company; (b) a real estate investment trust; or (c) a corporation more than eighty per cent of whose assets (excluding cash and certain debt obligations) consist of (i) readily marketable stocks or securities that are held for investment, or (ii) interests in regulated investment companies or real estate investment trusts.³³⁷ If one corporation owns fifty per cent or more of the voting power or value of the stock of another corporation, such other corporation will be deemed to be a subsidiary and its stock held by the first corporation will be disregarded.³³⁸ In place of such stock, the first corporation will be deemed to own its ratable share of such subsidiary's assets. In order to be readily marketable, stocks and securities must be traded on a stock exchange or on the over-the-counter market.³³⁹ Convertible debentures, convertible preferred stock, warrants, and other stock rights will be treated as readily marketable if the underlying stock is readily marketable.

It should be noted that a transfer will be deemed to be a transfer to an investment company only if it results in a diversification of the transferor's interest.³⁴⁰ Hence, although the statute might well apply to closely-held corporations, it is necessary that two or more transferors contribute non-identical property so that the interests of each are diversified. Therefore, the incorporation of investments held by a single owner should not preclude application of section 351.

XVIII. CONCLUSION

It is impossible, of course, for any article to deal effectively with all possible variations which may occur in a section 351 transaction. Hopefully, however, a reader of this Article will conclude that a section 351 transaction is not "routine." Many of the problems which may be encountered can readily be resolved by the tax practitioner through a careful study of his particular facts within the framework of section 351. There are, how-

³³⁵ See Rev. Rul. 67-122, 1967-1 CUM. BULL. 78.

³³⁶ Treas. Reg. § 1.351-1(c) (1967).

³³⁷ *Id.* § 1.351-1(c) (1) (ii).

³³⁸ *Id.* § 1.351-1(c) (4).

³³⁹ *Id.* § 1.351-1(c) (3).

³⁴⁰ *Id.* §§ 1.351-1(c) (1) (i), -1(c) (5).

ever, certain areas in which Congress and/or the IRS should take corrective or clarifying action. These areas include:

1. The applicability of section 351 to contributions to capital.
2. The problem of allocation of income and expenses between the predecessor entity and the transferee corporation.
3. The problem of whether specific identification can be used in determining basis of stock or securities received in a section 351 transaction.
4. The problem of a section 351 transaction followed by a public offering of stock.
5. The confusion as to the applicability of the business purpose doctrine to section 351 transactions.
6. The need for definitive regulations under section 385 in order to distinguish debt from equity.

With clarification of the above major problems by Congress and the Internal Revenue Service, tax practitioners would find section 351 to be a more useful mechanism in their repertoire of tax planning tools.