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# FEDERAL INCOME TAX CONSEQUENCES OF INCORPORATING THE FIRM

Robert C. Bramlette\*

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I. INTRODUCTION

This article is designed to be a practical guide to the federal income tax factors concerning the organization of a corporation<sup>1</sup> and the planning of its initial capital structure.<sup>2</sup> Such tax factors are crucial to the initial decision of whether to incorporate, but there are other related tax<sup>3</sup> and non-

1. Some of the leading treatises and articles dealing with the organization of a corporation are: BITTKER & EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS*, Chapter 3 (3rd ed. 1971); GARIAN, *TAX GUIDE FOR INCORPORATING A CLOSELY HELD BUSINESS* (1969); Baldwin, *Section 351 of the Internal Revenue Code and "Mid-Stream" Incorporations*, 38 U. CIN. L. REV. 96 (1969); Benjamin, *Problems in Transition from Sole Proprietorship or Partnership to Corporation*, 26 N.Y.U. INST. ON FED. TAX 791 (1968); Henkel, *Corporate Organizational Problems: A Checklist of Actions, Elections, and Considerations*, 31 N.Y.U. INST. ON FED. TAX. 255 (1973); Kirby, *Tax Problems of the Close Corporation*, 1969 U. ILL. LAW FORUM 187; Weiss, *Problems in the Tax-free Incorporation of a Business*, 41 IND. L.J. 666 (1966); and White, *Sleepers that Travel with Section 351 Transfers*, 56 VA. L. REV. 37 (1970).

2. Some of the leading treatises and articles dealing with the planning of a corporation's capital structure are: BITTKER & EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS*, Chapter 4 (3rd ed. 1971); Doxsee, *Thin Incorporation and Section 385*, 30 N.Y.U. INST. ON FED. TAX. 1213 (1972); Landis, *Contributions to Capital of Corporations*, 24 TAX L. REV. 241 (1969); Plumb, *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX. L. REV. 369 (1971); and Note, *Taxation of Non-shareholder Contributions to Corporate Capital*, 82 HARV. L. REV. 619 (1969).

3. Some federal income tax considerations, which are not directly related to organizing a corporation or forming its initial capital structure, but which should be evaluated during the incorporation decision are: (1) corporate versus individual tax rates (i.e., consideration of the partnership form of business), *Internal Revenue Code of 1954* sections 1 and 11 [hereinafter the "Code," all sections cited are to the Code, unless otherwise specified.]; (2) double taxation of dividends (i.e., dividends, which the shareholder receives from the corporation, are included

tax<sup>4</sup> ramifications concerning the corporate form of business which should also be evaluated.

## II. GENERAL RULE OF RECOGNITION

A sale or other disposition of property is normally a taxable event under sections 1001 and 1002 of *Internal Revenue Code of 1954*.<sup>5</sup> Section 1001(a) of the Code provides that the difference between the amount realized<sup>6</sup> and the adjusted basis<sup>7</sup> of the item is the amount of gain or loss realized.<sup>8</sup>

Section 1002 provides that the amount of gain or loss realized on the disposition of the property is the amount of gain or loss recognized<sup>9</sup> for tax

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in his gross income by § 61(a)(7); however, § 116 provides for a \$100 exclusion. Dividends paid have been included in the corporation's gross income, thus they are doubly taxed.); (3) accumulated earnings tax, § 531; (4) personal holding company tax, §§ 541-547, 551-558; (5) Subchapter S election, §§ 1371-1379; (6) tax privileged income, which is given favored tax treatment only at the corporate level, such as (a) tax exempt income (e.g., profit on life insurance policies of key personnel, § 101; interest on state, local, and some federal obligations, § 103), (b) long term capital gains (e.g., sale or exchange of: land and depreciable property used in the trade or business, coal, iron ore, timber, and unharvested crops), § 631 and Treasury Regulation (hereinafter cited as Treas. Reg.) 1.631-1 (1957), and (c) percentage depletion income, § 613; (7) compensation to employee-stockholders, § 162; (8) deferred compensation plans, § 401; (9) non-taxable fringe benefits, such as: (a) group life insurance coverage, § 79, (b) death benefits, § 101(b), (c) sick pay, § 105(d), (d) medical insurance, § 106, (e) meals and lodging, § 119, (f) moving expenses, § 217; (10) sale or exchange of ownership interests, §§ 341, 351-368, 1231, 1244, 1245, and 1250; (11) liquidating ownership interests, §§ 331-334, 731, 751; (12) offsetting business income or losses against personal deductions or income, §§ 269, 270, 482; and (13) averaging taxable income, §§ 1301-1305. H. GARIAN, *TAX GUIDE FOR INCORPORATING A CLOSELY HELD BUSINESS*, pp. 13-70, 1969.

4. Some non-tax incorporation considerations are: (1) limited liability; (2) continuity of enterprise; (3) centralization of management; (4) restrictions on transferability of interests; (5) flexibility and freedom in doing business; (6) capital growth; (7) state and local taxes; (8) the image of the business (i.e., the effect on the customers, creditors, and employees due to the change in the form of the business). *Id.* at 71-84. For a more detailed discussion of these factors, see Clinton Bristow's article in this series.

5. INT. REV. CODE OF 1954, §§ 1-9021.

6. When property is sold or exchanged, a gain (or loss) is realized to the extent that the cash plus the fair market value (hereinafter referred to as "FMV") of property received, other than money, is greater than (or less than) the adjusted basis (see note 7) of the property transferred.

7. The adjusted basis may be determined by the § 1012 cost plus adjustments provided for by § 1016.

8. For example, if Mr. X sells his apartment building, which has a FMV of \$50,000 and an adjusted basis of \$10,000, to Mr. Y for \$45,000 and a car, which has a FMV of \$5,000, then Mr. X has realized a gain of \$40,000.

\$45,000	cash	
5,000	FMV car	
\$50,000	amount realized § 1001(a)	
-10,000	adjusted basis	
\$40,000	gain realized § 1001(a)	

If Mr. X had received only the car in exchange for his apartment building, then he would have realized a \$5,000 loss.

\$5,000	FMV car, amount realized § 1001(b)
-10,000	adjusted basis

\$5,000 loss realized § 1001(a).

9. When gain is recognized, it is included in taxable income. When loss is recognized, it is deducted from taxable income. Section 1002 provides that all gain or loss realized under § 1001 is recognized, unless otherwise provided.

purposes, unless otherwise provided<sup>10</sup> in Subtitle A<sup>11</sup> of the Code.

### III. SECTION 351 EXCEPTION TO THE GENERAL RULE OF RECOGNITION UNDER §1002

#### A. Scope of §351

Section 351 provides for nonrecognition of gain or loss on the transfer of property to a corporation in exchange solely for stock or securities of the corporation if immediately after the exchange the person or persons who transfer the property are in control of the corporation. Thus, the transferor or transferors of such property to the corporation have deferred the taxation<sup>12</sup> of the exchange. Section 1032 provides that a corporation does not recognize gain or loss on the receipt of money or other property in exchange for its stock. Thus, both the transferor shareholder and the transferee corporation receive nonrecognition treatment in the § 351 transaction.

#### B. Policy for §351 Nonrecognition Treatment

In an economic sense, Congress has viewed the §351 transfer to be merely a change in form of ownership without a cashing in of a gain or the closing out of a losing venture.<sup>13</sup> Congress has taken such a view in order to prevent a business from being locked into one form of organization and to facilitate business adjustments. Transfers of property, which otherwise qualify for §351 treatment, will be given such treatment only if prompted by a valid business purpose.<sup>14</sup>

#### C. Technical Requirements of §351

In order to qualify for nonrecognition under §351, the following requirements must be met:

- (1) property must be transferred to a corporation;
- (2) the transfer must be solely in exchange for stock of securities in such corporation; and
- (3) the transferor or transferors of the property must have control of at least 80% of the voting power of the voting stock and 80% of all other classes of stock immediately after the exchange.

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10. Section 351 expressly provides for nonrecognition of gain or loss, provided § 351 conditions are satisfied.

11. Subtitle A of the Code sets forth the income tax provisions in the federal government's scheme for revenue collection.

12. Taxation has merely been postponed to a later date, when the transferred property is involved in a taxable transaction. There is no escape of taxation because of the § 358 substituted basis provision for the items received by the transferor and the § 362 carryover basis provision for the property received by the corporation.

13. *Portland Oil v. Commr.*, 109 F.2d 479, 488 (1st Cir. 1940).

14. S. Rep. No. 275, 67th Cong., 1st Sess., reprinted in 1939-1 C.B. (Part 2), 181, 188-189; Treas. Reg. § 1.351-1(a)(1)(ii) (1967); Rev. Rul. 55-36, 1955-1 C.B. 340, (A shareholder of X Corporation transferred his shares to the newly organized Y Corporation in exchange for bonds and stock. He donated the Y stock to a tax-exempt corporation, which liquidated the Y Corporation. The transfer by the shareholder was held to lack substance and reality so as not to be within the scope of § 351's predecessor.); cf. *Gregory v. Helvering*, 293 U.S. 465 (1935) (valid business purpose discussed).

## 1. *Property Requirement*

### a. Incorporation of a New Business

When incorporating a new business, a person or group of persons will transfer property to the newly formed corporation. The property problems, which arise when incorporating a new business, also arise when incorporating a going business.

### b. Incorporation of a Going Business

When incorporating a going business, whether it be a sole proprietorship or a partnership, the owner will probably transfer to the new corporation most of the items on the balance sheet, such as cash, accounts receivable and other income tabulation items,<sup>15</sup> capital assets (e.g., cars, buildings), and accounts payable.<sup>16</sup> Such items received by the transferee-corporation must fall within the statutory term "property." The items received by the transferor must qualify as stocks or securities, otherwise the items are "other property" (i.e., boot).<sup>17</sup>

#### (1) Cash

Cash is necessary in most new corporations to satisfy working capital needs. Thus, cash has been realistically included within the meaning of "property."<sup>18</sup> For example, assuming Mr. X transferred to a new corporation \$20,000 and an apartment building with an adjusted basis of \$10,000 and a FMV of \$20,000 in exchange for all of its stock, then the transfer would qualify for §351 nonrecognition treatment. Mr. X does not recognize the gain on the transfer of the apartment building because the presence of money does not break the §351 transaction.<sup>19</sup>

#### (2) Capital Assets and Section 1231 (b) Assets

The transferor may also transfer capital assets<sup>20</sup> and 1231 (b) assets,<sup>21</sup>

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15. Income tabulation items include accounts receivable, inventory, raw materials, work-in-process, installment obligations, and contract rights.

16. Accounts payable, which are assumed by the transferee corporation, are discussed in the text accompanying note 124.

17. Under § 351(b), if boot (i.e., money or other property) is received by the transferor, then he shall recognize gain, which has been realized, to the extent of the amount of money received plus the FMV of such other property received. However, no loss is recognized. Boot is discussed in the text accompanying note 68.

18. Rev. Rul. 69-357, 1969-1 Cum. Bull. 101; George M. Holstein, 23 T.C. 923 (1955).

19. For a discussion of an item which is not property, see the discussion of services in the text accompanying note 26.

20. Section 1221 defines "capital asset" as property held by the taxpayer, whether or not connected with his business, but which is not: (1) property which is stock in trade, inventory, or primarily for sale to customers in the ordinary course of his trade or business; (2) realty or depreciable property used in his trade or business; (3) certain copyrights, a literary, musical, or artistic composition, a letter or memorandum, or similar property; (4) accounts or notes receivable acquired in the ordinary course of trade or business from services rendered or from the sale of property described in (1); or (5) a government obligation issued after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue. Capital gains are given preferential tax treatment under § 1201. The capital gains are taxed at a 25% rate for an amount not exceeding \$50,000, but a portion of this may be subject to a § 56 tax preference tax of 10%. The total capital gains

either tangible or intangible, to the corporation. Tangible assets, such as cars or buildings (i.e., plant)<sup>22</sup> and intangible assets, such as patents,<sup>23</sup> goodwill, secret formulas, and maybe "know how"<sup>24</sup> qualify as §351 property. The key issue involving these assets is determination of basis, which will be subsequently discussed.<sup>25</sup>

### (3) Services

A transferor may also perform services for the corporation. However §351 (a) explicitly provides that "stock or securities issued for services shall not be considered as issued in return for property." The person providing solely services will not benefit from §351, but rather §83(a) provides that the fair market value of the stock less any amount paid for such stock is includible in gross income under §61 (a)(1) as compensation for services.<sup>26</sup> The amount of stock paid to the services person will also affect the determination as to whether control<sup>27</sup> is held by the property transferors.<sup>28</sup>

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tax will be preferential in comparison to § 1 ordinary income tax if the taxpayer is in a § 1 tax bracket greater than the capital gains rate. Capital losses are treated under the § 1211 provisions.

21. Section "1231(b) property" is property used in the taxpayer's trade or business, which has been held for more than 6 months and is either depreciable property or realty. However, § 1231(b) property does not include: (1) inventory; (2) property held primarily for sale to customers in the taxpayer's ordinary course of business; or (3) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property described in § 1221(3). Section 1231(a) provides that if the taxpayer recognizes gains on the sale or exchange of trade or business property and on compulsory or involuntarily converted trade or business property, which are greater than the losses recognized on such property, then the net gain will be given long term capital gain treatment. However, § 1231(a) provides that if the losses exceed the gains, then the net loss will be given ordinary loss treatment.

22. Treas. Reg. § 1.351-1(a)(2) Example 1 (1967).

23. Treas. Reg. § 1.351-1(a)(2) Example 1 (1967).

24. Rev. Rul. 71-564, 1971-2 Cum. Bull. 179; Rev. Rul. 64-56, 1964-1 Cum. Bull. 133 (The Service will look behind "know how" to determine to what extent the item constitutes "property" transferred to the corporation in exchange for stock.).

25. See text accompanying note 111.

26. This result is reached provided, that at the time of receipt, the stock is transferable and not subject to substantial risk of forfeiture. § 83(a). Section 83(c) provides that a substantial risk of forfeiture exists if the right to full enjoyment of the stock is conditioned upon the future performance of substantial services by any individual. If the stock is (1) not transferable, or (2) subject to a substantial risk of forfeiture, then the performer of the services is not taxed until neither condition exists. However, he may elect to be taxed in the year of the transfer under § 83(b), thus attempting to avoid taxation on an appreciated value. The risk is that if the stock decreases in price, then there is no allowance for an ordinary loss deduction when the above-mentioned conditions cease to exist.

27. See text accompanying note 93.

28. A related problem is whether the corporation receives a deduction for the compensation, which it has paid in the form of stock. If the services qualify as organizational expenditures, then the corporation may take a deduction under § 248. If the services are to be performed in the future and are not organizational in nature, then it is unclear as to the deductibility of the compensation paid. Revenue Ruling 62-217, 1962-2 Cum. Bull. 59, permits a § 162 business expense deduction for the FMV of stock issued as compensation for past services, thus negatively implying that there is no deduction for payments in stock for future services. If the corporation is an accrual basis taxpayer, then income is recognized when all events have occurred which fix the corporation's right to the payment, and expenses are deductible when all events have occurred which fix the corporation's obligation to pay. See Treas. Reg. § 1.451-1(a) (1971). [Thus, it would seem that a deduction can be taken upon incurring the obligation to pay for the future services. If the corporation is a cash basis taxpayer (i.e., income is recognized when received, and expenses are deductible when paid, see Treas. Reg. § 1.451-1(a) (1971)), then it seems that a deduction can be taken upon payment for the serv-

#### (4) Income Tabulation Items

A "mid-stream" incorporation usually involves accounts receivable, inventory, raw materials, work in process, installment obligations,<sup>29</sup> and contract rights. Such items constitute the income tabulation elements of the going-concern, for these items §351 may be subordinated to the doctrines of (1) assignment of income; (2) business purpose; (3) tax benefit; and (4) clear reflection of income.<sup>30</sup> These four doctrines enable the Commissioner to prevent abuse of §351 by restricting nonrecognition to transactions where the property will not be converted into income in the ordinary course of business prior to the incorporation. Consequently, if any of these doctrines are applicable, the transferor's receipt of stock and securities, in respect thereof will not be within §351 (a), and recognition will attach. If such income items were granted §351 treatment, incorporation might be undertaken merely to split income between the owners of the business property or to take advantage of lower corporate income tax treatment for ordinary income.

#### 2. *Solely for Stock or Securities Requirement*

##### a. General Discussion of Stock and Securities

A transferor will receive §351 nonrecognition treatment only if he transfers property in exchange solely for stock and securities of the transferee corporation. "Stock" means any equity interest or investment of risk capital in a corporation.<sup>31</sup> "Securities" refers to a debt obligation of the corporation; however, not all corporate obligations are securities. An overall evaluation of the nature of the debt<sup>32</sup> must be made to determine if such instrument falls within the classification of a security.<sup>33</sup> Treasury regulations 1.351-1 (a) (1) (ii) (1967) provides that stock rights and stock warrants are not "stock or securities," thus the receipt of such may give rise to recognition of gain under §351 (b).

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ices.] However, the tax problem is moot where the shares are issued by the corporation in states which have a provision similar to the Model Business Corporation Act § 19, which provides that ". . . future services shall (not) constitute payment . . . for the issuance of shares of a corporation."

29. Treasury Regulation § 1.453-9(c)(2) (1971) provides that installment obligations escape the gain or loss recognition of § 453(d) if the transfer falls within § 351. Treasury Regulation § 1.453-9(c)(3) (1971) provides that as an asset of the corporation, the installment obligation must assume the same character as it had prior to the exchange by the transferor.

30. For a detailed discussion of the theories of (1) assignment of income, (2) business purpose, (3) tax benefit, and (4) clear reflection of income, see BITTKER & EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS*, 3-59 to 3-62 (3rd ed. 1971) [hereinafter cited as Bittker & Eustice].

31. For discussion of equity v. debt, see text accompanying note 42.

32. *Camp Wolters Enterprises, Inc. v. Commr.*, 22 T.C. 737 (1954), aff'd, 230 F.2d 555 (5th Cir. 1956) (The court provided that an overall evaluation of the debt instrument was necessary to determine if the instrument could be classified as a security. Notes maturing in 5 to 9 years were held to be securities.).

In making a determination as to whether debt is a security, the crucial factor is the length of time to maturity. The general rule is that a debt instrument with a maturity value of 5 years or more will be regarded as a security. BITTKER & EUSTICE, ch. 3, at 15 (1971); *United States v. Herwig*, 398 F.2d 452 (5th Cir. 1968) (Twelve and one-half year installment notes were held to be securities.); *Cortland Specialty Co. v. Comm'r.*, 60 F.2d 937 (2d Cir. 1942) (Notes due from one to fourteen months were held not to be securities.); see note 69.

33. For discussion of equity v. debt, see text accompanying note 42.



## b. Capital Structure of the Corporation

### (1) General Rule of Section 1032 and Treasury Regulation § 1.61-12(c)(1) (1968)

Section 1032(a) provides that "[N]o gain or loss shall be recognized by a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation." However, §1032 nonrecognition is not available if the transaction is a disguised receipt of income by the corporation.<sup>34</sup> Treasury regulation §1.61-12 (c)(1) (1968) provides that "[I]f bonds are issued by a corporation at their face value, the corporation realizes no gain or loss." However, if the bonds are issued for a premium, the corporation will recognize some ordinary income.<sup>35</sup>

The corporation will also receive §1032 nonrecognition treatment if it transfers stock in cancellation of debt or as compensation for past services.<sup>36</sup> Also, if the corporation attempts to increase its capital by trading in its own stock, as it would trade in the stocks of other corporations held for investment purposes, such transactions qualify for nonrecognition under Treas. Reg. §1.1032-1 (a)(1956).

#### (i) Application of Section 351

If the businessman arranges to have co-incorporators or if subsequent investments by third parties are within the "series of interdependent steps-single transaction" doctrine, then the entire exchange of property for stock would be given nonrecognition treatment under §1032(a) (i.e., for the corporate transferee) and §351 (i.e., for the transferors). For example, in *Stanley, Inc. v. Schuster*,<sup>37</sup> an individual exchanged money for Stanley stock, and four years later a corporation exchanged realty for Stanley stock. The transaction was held to be within §351 due to the interdependence of the steps as integral parts of the total financing scheme, which made Stanley financially capable of carrying on business. However, if the transferors had subsequently disposed of stock necessary to maintain 80% control, then the interdependent steps-single transaction doctrine might also have been applied to deny §351 treatment.<sup>38</sup>

#### (ii) Disguised Receipt of Income

Section 1032 treatment will not be available if the transaction is really a receipt of income by the corporation.<sup>39</sup> For example, in *Community T.V.*

34. See text accompanying note 41.

35. See Treas. Reg. § 1.61-12(c)(2), (3), (4), (5) (1968).

36. *Comm'r. v. Fender Sales, Inc.*, 338 F.2d 924 (9th Cir. 1964) (The corporation recognized no income tax liability upon issuance of stock to employees for accrued salary indebtedness; however, the employees recognized § 61 income.); Treas. Reg. § 1.1032-1(a)(1) (1956); The party providing services has § 61(a)(1) ordinary income for compensation received.

Section 248 permits the corporation to take a deduction for organizational expenditures, and Rev. Rul. 62-217, 1962-2 Cum. Bull. 59 permits a § 162 business expense deduction for the FMV of stock issued as compensation for past services. See note 28 for a discussion of the possibility of a § 162 business expense deduction for the FMV of stock issued as compensation for future services.

37. 295 F. Supp. 812 (S.D. Ohio 1969), *aff'd per curiam*, 421 F.2d 1360 (6th Cir. 1970).

38. See text accompanying note 107.

39. The corporation may also be denied § 1032 treatment to the extent of imputed interest, if the payment for the stock is to be over a period of time.

*Assn. v. United States*,<sup>40</sup> the corporation was denied §351 treatment and charged with §61 ordinary income for payments on "Class B Stock," whose purchase was a condition precedent to receiving cable television services. The court held that such "stock" possessed no ordinary attributes of common stock since it had no right to participate in dividends, no voice in management, and could be redeemed at par at any time. Rather, the payment for the "stock" was disguised compensation to the corporation, thus subject to §61 ordinary income treatment.<sup>41</sup>

## (2) Equity v. Debt

Before becoming enmeshed in the stock and security requirement of §351, the businessman and his lawyer must consider the type of capital structure best suited for the new corporation. The desired capital structure may dictate constraints upon the methods to acquire assets necessary for the business. The corporation may acquire its assets by a §351 transaction, a purchase (i.e., sale to the corporation), or a contribution of capital. The purchase method and the contribution method are discussed in the collateral problems section of this article.<sup>42</sup>

### (i) Tax Considerations

No matter how or why capital is acquired, consideration must be given to tax consequences. The normal methods of acquiring capital are by issuance of stock (i.e., equity) or incurrence of debt. The following are some of the relevant tax considerations:<sup>43</sup>

#### DEBT

1. Section 163(a) provides for a deduction by the corporation on interest paid.
2. Interest is fully taxable to the recipient.
3. Accumulation of funds for the payment of debt at maturity will constitute a § 533(a) reasonable business need, which will help avoid the § 531 penalty for excessive accumulation of earnings.<sup>44</sup>

#### STOCK

1. Dividends paid are not deductible by the corporation.
2. Dividends are entitled to a § 116 \$100 exclusion for individual shareholders, and either the § 243 85% deduction or 100% deduction is available to corporate shareholders.
3. Accumulation of funds for redemption

Section 483's sweeping language will impute interest on deferred payments if the contract does not provide for an adequate rate of return, thus preventing interest income from being received under the guise of capital gains. Treas. Reg. § 1.483-1(b)(6) Example 6 (1971).

40. 203 F. Supp. 270 (D. Mont. 1962).

41. In *Affiliated Government Employees Distribution Company v. Commr.*, 322 F.2d 872 (9th Cir. 1963), fees were paid for "stock," which permitted the holders to vote and share in assets upon liquidation. The court denied § 1032 treatment, and it imposed § 61 ordinary income on the corporation because the amount paid was for the privilege of purchasing goods at a discount, rather than being an equity investment in the corporation.

42. See text accompanying note 145.

43. BITTKER & EUSTICE, ch. 4 at 2-3 (1971).

44. Sections 531 through 537 deal with the accumulated earnings tax. The general rule is that to the extent which accumulated earnings exceed the reasonable needs of the business, there will be a tax imposed. The general formula is:

Amount of accumulated earnings

- The greater of \$100,000 or the amount of accumulated earnings necessary for the reasonable needs of the business

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Subtotal

- Excess accumulated earnings up to \$100,000, which are subject to a 27½% tax

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BALANCE OF EXCESS ACCUMULATED EARNINGS, WHICH ARE SUBJECT TO A 38½ TAX

See Treas. Reg. § 1.537-1 (1972) for a discussion of what constitutes reasonable needs of a business.

4. Payment of principal on debt is a tax free recovery of basis to the creditor, unless payments exceed the adjusted basis of the debt, thus yielding a § 1232 capital gain.
  5. Transfer of a debt to outsiders does not dilute the insiders' control of the corporation.
  6. If the debt becomes worthless, then § 165(g)(1) permits a capital loss, subject to the limitations imposed by § 165(f). However, § 166(d) provides for capital loss treatment of nonbusiness bad debts.
  7. Only debt which qualifies as a security will receive § 351(a) treatment, while non-security debt will be taxable as boot under § 351(b).
- of stock is less likely to qualify as a reasonable business need.<sup>45</sup> Consequently, such accumulation may subject the corporation to a penalty tax by application of §§ 531-537.
  4. The redemption of stock is often treated as a dividend to the redeemed shareholders.
  5. Transfer of common stock dilutes the insiders' control of the corporation.
  6. If the stock becomes worthless, § 165(g)(1) permits a capital loss, subject to the limitations imposed by § 165(f). However, § 1244 permits ordinary losses to be taken in some situations.
  7. Common stock and preferred stock will qualify for § 351(a) treatment.

The tax advantages of debt should cause the businessman and his attorney to seriously consider the use of debt, in addition to stock, in funding the corporation. Concern as to the consequences for failure to pay fixed charges of debt (i.e., initiation of bankruptcy proceedings or unwise management policies) will probably be minimal since the shareholders will normally hold a large percentage of the debt. However, under such circumstances the Commissioner would be in a strong position to reclassify the "debt" as equity.<sup>46</sup>

#### (ii) Determinative Factors

Judicial history<sup>47</sup> indicates that the question as to whether the instrument is equity or debt appears when one of the prior mentioned tax factors is under consideration. Assume that there is a §351 transaction in which an individual transfers assets, with an adjusted basis of \$7000 and a FMV of \$10,000, to a newly formed corporation. The transferor receives \$2000 worth of stock, \$5000 worth of long term notes, and \$3000 worth of short term notes. The long term notes would probably be classified as securities, while the short term notes would probably be boot. Thus, by reason of the application of §351 (b), the transferor would recognize a \$3000 gain.

If the Commissioner subsequently argues that all of the interest, which is being paid on both the long term and the short term notes, is really disguised dividends; then the corporation would not be entitled to a §163 interest deduction. As for the issue of whether the short term debt (i.e., boot) is really equity, it seems that the taxpayer would have a relatively easy burden of proof. By recognizing gain to the extent of the FMV of the boot in the §351 transaction, the Commissioner implicitly classified the short term notes as debt. If they were equity, then they should have received nonrecognition treatment in the §351 transaction. As for the issue of whether the long term debt (i.e., securities) is really equity, such is a question of fact with vague guidelines, which ultimately refer to the "intent" of

45. The corporation's accumulation of funds for a § 303 redemption of stock to pay death taxes, funeral expenses, and administration expenses would seem to be a reasonable business need.

46. See text accompanying note 57.

47. This discussion does not purport to be an extensive summary of judicial history of the equity v. debt issue.

the parties and the "substance" of the transaction.<sup>48</sup> The Service will usually refuse to render a ruling as to this issue.<sup>49</sup> Because of the stakes involved, the classification should be determined at the inception of the incorporation. The courts have been forced to look beyond the face of the instrument (i.e., the long term debt in the above example) in order to determine whether the investment represents risk capital or a debtor-creditor relationship.<sup>50</sup> The "classic debt" is defined as

" . . . an unqualified obligation to pay a sum certain at a reasonably close fixed maturity payable date along with a fixed percentage in interest regardless of the debtor's income or lack thereof. While some variation from this formula is not fatal to the taxpayer's effort to have the advance treated as a debt for tax purposes, . . . too great a variation will of course preclude such treatment. . . ."<sup>51</sup>

Usually, debt is not subordinated in priority to general creditors, nor are debt holders entitled to voting rights, except possibly on default of payment. Conversely, the characteristics of equity are: (1) distant or no maturity date; (2) interest payable upon contingent earnings or the corporate directors' discretion; (3) subordination of "principal" and/or "interest" to the claims of general creditors; (4) voting rights; and (5) restrictions on assignability.<sup>52</sup> Unfortunately, the courts and legal scholars have become carried away in their listings of factors which indicate whether the instrument is debt or equity, thus causing relative confusion rather than certainty. In *Fin Hay Realty Co. v. United States*<sup>53</sup> 16 factors were listed: (1) intent of parties;

48. In determining whether the instrument is equity or debt, form is not controlling, but the outward appearances of true debt are: (1) adequate interest; (2) fixed maturity date; (3) maturity date which is not unreasonably distant; (4) language on the face of the note and book entries indicating a debt; (5) face amount not exceeding the value of the property transferred to the corporation; (6) payment of interest and principal not contingent upon future earnings; and (7) obligations not subordinated to general creditors' claims. Ellis, *Tax Problems in Sales to Controlled Corporations*, 21 VAND L. REV. 196, 218-219 (1968).

The factors mentioned in § 385 must also be considered in determining if the instrument is equity or debt. See text accompanying note 55 for discussion of § 385.

49. Rev. Proc. 69-6, 1969-1 Cum. Bull. 396.

50. See, e.g., *Fin Hay Realty Co. v. U.S.*, 398 F.2d 694, 697 (3rd Cir. 1968) (Unsecured "loans" were made in equal amounts by the 2 shareholders to the corporation for purchase of an apartment. The court held the "loans" to be contributions to capital, thus no interest deduction was allowed.). *Harbour Properties, Inc.* P-H 1973 T.C. Mem. ¶ 73,134 (Transfers of real estate were made by four taxpayers to ten corporations in exchange for "debt" obligations. The taxpayers were the shareholders of the newly formed corporations. The court found that (1) the sales prices to the corporations of the real estate parcels were in excess of the FMV of the property; (2) each of the corporations was substantially undercapitalized; (3) repayment of the notes was contingent upon the resale of the property as individual lots; (4) payment of principal and interest was never completed on time; and (5) legal action was never initiated to require repayment. The court held that the transfer was not a sale, but rather a § 351 exchange and the instruments received by the shareholders constituted stock. The payments made by the corporations were reclassified as dividends, thus the corporations were not permitted to take § 163 interest deductions.).

51. *Gilbert v. Commr.*, 248 F.2d 399, 402-403 (2d Cir. 1957) (The case was remanded to determine if advances by the shareholders were capital contributions or loans.).

52. BITTKER & EUSTICE, ch. 4, at 8-9 (1971).

53. 398 F.2d 694, 696 (3rd Cir. 1968). See *W.B. Kilhour Sons, Inc.*, P-H 1973 Memo T.C. Mem. ¶ 73,134 where the court applied the 16 *Fin Hay* factors in reclassifying debt, which was used in the purchase of assets, as equity.

In Rev. Rul. 68-54, 1968-1 Cum. Bull. 69, the Service found subordinated debentures to be true debt even though there was: (1) thin capitalization, and (2) the obligation was considered proprietary for nontax purposes. Holzman, *The Interest-Dividend Guidelines*, 47 TAXES 4 (1969) (listed 38 factors upon which the courts have relied); Plumb, *The Federal*

(2) identity between creditors and shareholders; (3) the extent of participation in management by the holder of the instrument; (4) the ability of the corporation to obtain funds from outside sources (5) the "thinness" of the capital structure in relation to the debt<sup>54</sup> (6) the risk involved; (7) the formal indicia of the arrangement; (8) the relative position of the obligees; (9) the voting power of the holder of the instrument; (10) the provision for a fixed rate of interest; (11) a contingency on the obligation to repay; (12) the source of the interest payments; (13) the presence or absence of a fixed maturity date; (14) a provision for redemption by the corporation; (15) a provision for redemption at the option of the holder; and (16) the timing of the advance with reference to the organization of a corporation.

The Tax Reform Act of 1969 gave the Commissioner the authority to promulgate regulations with regard to the issue of equity v. debt. In dealing with this problem, §385 focuses on the definition of "debt", §385(b)(1), and subordination, §385(b)(2), which are discussed above. Section 385 also provides that the following may be evaluated: the ratio of debt to equity of the corporation, §385(b)(3); the convertibility features of the debt, §385(b)(4);<sup>55</sup> and the proportion of stock to debt, §385(b)(5). The regulations for §385 are still being prepared. Upon their finalization, determination as to whether an item is debt or equity should be easier.

If the ratio of debt to equity is large, indicating thin capitalization, then the Commissioner may be put on notice that the arrangement might be solely for tax avoidance purposes and in accordance with the realities of an equity investment. However, there is no magic ratio.

If the purported debt is held substantially in proportion to the corporate stock holdings of the shareholders, then the Commissioner will scrutinize whether the debt is really an equity investment.<sup>56</sup> If the shareholder never

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*Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX. L. REV. 369, 411-412 (1971) (lists 30 factors).

54. Sam Schnitzer, 13 T.C. 43, 62 (1949), *aff'd*, 183 F.2d 70 (9th Cir. 1950), *cert. denied*, 340 U.S. 911 (1951) (The debt to equity ratio was 3:1 and the loans were not to be paid until a \$700,000 loan was fully repaid. The court held the debt to constitute a contribution to capital.); Harbour Properties, Inc. P-H 1973 T.C. Mem. ¶ 73,134 (The corporations had debt to equity ratios varying between 26:1 and 392:1. The "debt" instruments were reclassified as equity. See note 50 for a more detailed explanation of the case.); Anthony v. Donisi, P-H 1967 T.C. Mem. ¶ 67,062 *aff'd* 405 F.2d 481 (6th Cir. 1968) (The taxpayer advanced funds to the corporation, which merely recorded such as accounts payable. There was no schedule for repayment. The debt to equity ratio ranged between 4:1 and 5:1. The court reclassified the "debt" as equity, and it stated that there was no single characteristic that is decisive in making such a determination.); Plumb, *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369, 509 (1971).

55. Convertible securities are not automatically reclassified as stock; however, if the conversion is part of the original plan or if the corporation has a choice to satisfy the debt by delivering stock, then the obligation should be viewed as equity. To be classified as debt, the convertible instrument must satisfy the debt criteria. There are three situations, which have tax consequences, that the businessman should focus on when dealing with convertible securities:

- (1) issuance of convertible debt for cash;
- (2) issuance of convertible debt for property; and
- (3) conversion itself.

56. Saylos Finishing Plants, Inc. v. U.S., 399 F.2d 214, 221 (Ct. Cl. 1968) (Bonds issued as a result of a reorganization were held to be contributions to capital rather than loans, since

intended to collect the debt,<sup>57</sup> or if the collection would financially weaken the business,<sup>58</sup> or if collection would impair the credit rating of the corporation,<sup>59</sup> then such would create a presumption for classifying the instrument as equity. Also, the shareholder must be certain to get debt, which is payable to himself, in the capital structure in the early stages of the incorporation (i.e., up front). If the shareholder subsequently attempts to make "loans" to the corporation, then he will have a difficult time overcoming the Commissioner's argument that the "loans" are a recapitalization of the corporation and their repayment is an attempt to bail out corporate profits without paying the corporate tax. The shareholder may counter by arguing that the loans are *bonafide* debt.<sup>60</sup>

### (iii) Capital Asset Status

Since the stock or debt instruments normally qualify as 1221 capital assets, then the investor will usually be entitled to 1222 capital gain or loss treatment upon sale or exchange. However, there are some exceptions in which capital gain treatment will not be allowed.<sup>61</sup>

### (iv) Repayment and Redemption

Upon repayment of debt or redemption of stock, the Commissioner is wary that such payments may constitute disguised dividends (i.e., ordinary income). Section 1232 (a)(1) permits capital gain or loss treatment upon retirement of debt by classifying the transaction as an exchange. The taxpayer may incur some ordinary income upon the repayment of the loan, which he made to the corporation. Section 1232(a)(3)<sup>62</sup> provides that

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no new capital had been advanced and the ownership interests remained identical. Also, the bonds were more than 30 years past due.).

57. Plumb, *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369, 509 (1971).

58. Burr Oaks Corp., 43 T.C. 635 (1965), aff'd, 365 F.2d 24 (7th Cir. 1966), cert. denied, 385 U.S. 1007 (1967) (Three shareholders transferred realty to the corporation in exchange for \$330,000 in notes. The corporation only had \$4,500 in paid-in-capital, and the land was the only income producing asset of the corporation, which was an untried and uncertain business. The court held the notes to be equity contributions.); Harbour Properties, Inc., P-H 1973 T.C. Mem. ¶ 73,134 (Some of the corporations were under capitalized to the extent that they were unable to commence business without further borrowing. Thus, collection of the "debt" would have financially weakened the business. The court reclassified the "debt" instruments as equity. See note 50 for a more detailed explanation of the case.).

59. Gooding Amusement Co., 23 T.C.408, 418-419 (1954), aff'd, 236 F.2d 159 (6th Cir. 1956), cert. denied, 452 U.S. 1031 (1957) (The shareholders held notes, which were between 3 and 5 years past due and whose collection would seriously impair the corporation's credit rating. The court reasoned that the notes were really equity contributions.). Harbour Properties, Inc., P-H 1973 T.C. Mem. ¶ 73,134 (See note 50.).

60. See text accompanying note 51.

61. The sale or exchange of stock or debt will not be entitled to capital gain or loss treatment when for instance: (1) dealers in securities hold stock or debt instruments as inventory under § 1236; (2) corporate debt, which is issued after 1954, is purchased at a discount or with interest coupons detached under § 1232(a)(2)(B) and 1232(a)(2)(C); (3) § 341 "collapsible corporation" stock situations exist; (4) § 306 stock situations exist; (5) stock or debt is acquired as an integral part of a regular business transaction, Corn Products Refining Co. v. Comm'r., 350 U.S. 46 (1955); (6) stock, securities, and debt claims are subject to assignment of income principles; and (7) § 1244 stock losses exist.

62. V. David Leavin, 37 T.C. 766 (1962) (The excess of the amount realized on redemption over the amount paid for the debentures was held to be ordinary income.).

holders of discount bonds,<sup>63</sup> issued after May 27, 1969, must accrue the original issue discount as ordinary income ratably, in monthly segments, over the life of the bonds.<sup>64</sup> Upon the retirement of the bond, the taxpayer may incur an additional amount of ordinary income if the obligation was issued with an intention to recall it before maturity.<sup>65</sup> Such treatment prevents the corporate debtor from issuing long term obligations with the intention of calling the debt substantially in advance of maturity in order to reduce the ordinary income treatment of the discount. If the debt is not evidenced by a written agreement, then §1232 is not applicable and ordinary income treatment is given to the transaction.<sup>66</sup>

Where there is a redemption of stock, if the transaction fails to qualify under §302(b), then the payment will be treated as a dividend under §301 and taxed to the extent of corporate earnings under §316. Section 302(b) lists certain redemptions, which are treated as exchanges and thus entitled to capital gain treatment. Some transactions which provide capital gain treatment are: (1) §302(b)(1) redemption that is not essentially equivalent to a dividend; (2) §302(b)(2) non prorata redemption; (3) 302 (b) (3) redemption of all the stock of one or more shareholders; and (4) §346 redemption that constitutes a partial liquidation, which is due to shrinkage of the corporation's business.

If the Commissioner reclassifies the repayment of "debt" as a redemption of stock, then the taxpayer must satisfy the §302 requirements in order to receive capital gain treatment.<sup>67</sup> Generally, the statutory provisions make it easier for the businessman to bail out corporate earnings under §1232, dealing with repayment of debt, than under §302, dealing with redemption of stock.

### (3) Other Property: Boot—The Exception to the Exception

The receipt of money or "other property" (i.e., property which is not stock, securities, or money) requires application of §351 (b). Section 351(b) provides for "boot"<sup>68</sup> recognition, that is recognition of gain to the extent of money received plus the FMV of "other property" received. Boot

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63. A discount bond is a bond which is sold for an amount less than its face value (i.e., maturity value).

64. Section 1232(a)(3)(E) provides that the basis of the indebtedness shall be increased by the amount of the original issue discount included in the taxpayer's gross income.

65. Treasury Regulation § 1.1232-3(a)(1)(i)(b) (1972) provides that in the case of an obligation, which was assumed with the intention of recalling it before maturity, the gain on redemption of the obligation is ordinary income to the extent that the original issue discount has not been included in the taxpayer's gross income. Treasury regulation § 1.1232-3(a)(1)(i)(a) (1972) provides that if the obligation was issued without any intention of recalling it before maturity, then the entire amount of the gain will be treated as capital gain.

66. Earnest A. Wilson, 51 T.C. 723 (1969) (Water refund contracts, in which there was a promise to repay based on a percentage of gross revenues, were held not to be registered evidences of indebtedness. The payments were deemed not to be repayments of the amounts due.); § 1232(a); Treas. Reg. § 1.1232-1(a), (d) (1971).

67. *Peterson v. Comm'r.*, 380 F.2d 1 (9th Cir. 1967) (Repayment of debt was held to be ordinary income where the debt instrument did not fix the amount of the debt or the maturity date, made no provision for payment of interest, and provided payments in the form of a percentage of gross sales.)

68. "Boot" is money and property, other than stocks and securities of the transferee corporation, which is received in a § 351 transaction. § 351(b).

recognition is the exception to §351 nonrecognition, which is an exception to §1002 recognition of gain realized. For instance, assume an individual transfers a building, which has a fair market value of \$10,000 and an adjusted basis of \$5000, to a newly formed corporation. The transferor receives in exchange all of the corporation's stock, which has a FMV of \$7500, and a \$2500 note payable, which is due in 2 years.<sup>69</sup> The transferor realizes a gain of \$5,000;<sup>70</sup> however, §351(b) limits the gain recognized to the extent of the money and the fair market value of the "other property" (i.e., boot) received. Assuming the fair market value of the note payable to be \$2500,<sup>71</sup> then the gain recognized would be \$2500.<sup>72</sup>

The transferee corporation may assume personal liabilities of the transferor or liabilities which are attached to property received without destroying the §351 nonrecognition treatment. The assumption of liabilities was originally considered to constitute boot to the transferor, thus requiring recognition treatment. However, Congress enacted §357 (a) which removed assumptions of liabilities from the category of boot. Section 357 is not a complete windfall for the transferor because there is a decrease in his basis of the property received by the amount of the liability assumed.<sup>73</sup> For example, if Mr. X transfers property, with an adjusted basis of \$25,000, a fair market value of \$75,000, and a mortgage of \$10,000 to corporation Y, in exchange for all of its stock worth \$65,000 and the assumption of the \$10,000 mortgage, Mr. X would recognize no gain on the transaction under §351 because §357 (a) provides that the assumption of liabilities is not boot. He would realize a gain of \$50,000:

$$\begin{array}{r}
 +\$65,000 \text{ value of the stock} \\
 + 10,000 \text{ assumed mortgage} \\
 \hline
 75,000 \text{ amount realized} \\
 - 25,000 \text{ adjusted basis} \\
 \hline
 50,000 \text{ gain realized §1001(b)}^{74}
 \end{array}$$

69. Assuming that the note is classified as debt, it will receive "boot" treatment. The note will probably be classified as other property, rather than as a security because it is due in less than 5 years. See note 32.

70. \$7,500 FMV stock  
2,500 FMV note

$$\begin{array}{r}
 \$10,000 \text{ amount realized § 1001(b)} \\
 -5,000 \text{ adjusted basis} \\
 \hline
 \end{array}$$

\$5,000 gain realized § 1001(a)

71. In determining the FMV of the note, the interest rate and the maturity date must be considered.

72. The gain would be ordinary income because it qualifies under § 1239 as an exchange between an individual and a controlled corporation.

The theory of § 1239 is to prevent a person from depreciating an asset; selling the asset to a corporation, of which the person owns greater than 80%, at a capital gain rate (n.b., § 1245 recapture); and then permitting the corporation to depreciate the same asset at its stepped-up § 1012 cost basis. For further discussion of § 1239, see text accompanying note 151.

73. Treas. Reg. § 1.358-(3) (1955).

74. Under § 358 (see text accompanying note 113), Mr. X will take a substituted basis in the stock received of:

$$\begin{array}{r}
 \$25,000 \text{ property} \\
 -10,000 \text{ assumed liability (mortgage)} \\
 \hline
 \end{array}$$

\$15,000 adj. basis § 358(a)



There are two additional areas of importance in relation to assumption of liabilities. The first, §357 (c), provides that the amount by which the aggregate liabilities assumed plus the total liabilities to which the property is subject exceed the basis of the property transferred constitutes gain from the sale or exchange of the property transferred.<sup>75</sup> Such gain may be capital or ordinary depending upon the nature of the asset. The Service has ruled that §357(c) applies to each transferor separately; thus an individual transferor may be subject to the gain, regardless of the amount of the liabilities assumed for the other transferors.<sup>76</sup> Basis offsets income, thus the basis should only include the amounts which have been previously included in income. Since the accounts receivable of an accrual basis taxpayer have been included in income, they have a basis.<sup>77</sup> For example, a sole proprietor-transferor, who was on the accrual basis and who had no assets except for \$30,000 of accounts receivable and \$20,000 of accounts payable which were assumed by the corporate transferee, would incur no gain under §357 (c) since the basis of assets transferred (\$30,000) exceeded the amount of liabilities assumed (\$20,000).<sup>78</sup> However, for a cash basis taxpayer, assumption of liabilities by the corporation is a treacherous crossing in a §351 transaction because his accounts receivable have a zero basis. Basis offsets income, thus the basis should only include the amounts which have been previously included in income. Since the accounts receivable of a cash basis taxpayer have not been included in income, they have a zero basis.<sup>79</sup> Prior to the Second Circuit decision of *Bongiovanni v. Comm'r.*,<sup>80</sup> a cash basis taxpayer transferor with no assets except for \$30,000 of accounts receivable and \$20,000 of accounts payable, which were assumed by the corporate transferee, would incur \$20,000 of gain from the sale or exchange of the property transferred. Since the character of the gain is determined by the nature of the assets, then in the above example, the taxpayer-transferor would incur \$20,000 of ordinary income.<sup>81</sup> A similar tax disaster

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Corporation Y will take a carryover basis (see text accompanying note 136) for the property of \$25,000 under § 362(a)(1).

75. *George W. Wiebusch*, 59 T.C. 777, aff'd, (32 Am. Fed. Tax R.2d) ¶ 73-5371 (8th Cir. Nov. 26, 1973). (The taxpayer incurred a recognizable gain to the extent that the assumed liabilities exceeded the adjusted basis of the assets transferred in the § 351 transaction. The court applied § 357(c).)

76. Rev. Rul. 66-142, 1966-1 Cum. Bull. 66.

77. *Spring City Foundry Co. v. Comm'r.*, 292 U.S. 182 (1934), rehearing denied, 292 U.S. 613 (1934); Treas. Reg. § 1.446-1(c)(1)(ii) (1970); Treas. Reg. § 1.451-1(a) (1971).

78. Other examples of tax incurred in the same situation, but with different amounts of accounts receivable and accounts payable are:

	Accounts Receivable (i.e., total assets)	Accounts Payable (i.e., total Assumed Liabilities)	Taxable Amount
1.	\$30,000 basis	\$20,000	\$ zero
2.	20,000 basis	20,000	zero
3.	5,000 basis	20,000	15,000

*Alderman v. Comm'r.*, 55 T.C. 662. (1971) (An accrual basis taxpayer was taxed for the amount by which the liabilities assumed exceeded the basis of the transferred assets.)

79. *Ray Franconi*, P-H 1965 T.C. Mem. ¶ 65,087; Treas. Reg. § 1.166-1(e) (1969).

80. 470 F.2d 921 (2d Cir. 1972).

81. Other examples of tax incurred in the same situation, but with different amounts of accounts receivable and accounts payable are:

was incurred by taxpayers in *Peter Raich*.<sup>82</sup> In *Bongiovanni*, the Second Circuit held that the fortuitous difference between cash basis and accrual basis taxpayers, in relation to the effects of §357(c), was to be eliminated. *Bongiovanni* was on the cash basis, and the accounts payable (\$17,237), which were assumed by the newly organized corporation, exceeded the basis in the assets transferred (\$1,383) by \$15,854. The Tax Court held that the taxpayer's attempt to switch to the accrual basis was unsuccessful, thus the *Peter Raich* rationale was applied. The Second Circuit reversed, holding that: ". . . [T]here is no justification for making an accounting method inadvertently chosen by the taxpayer determinative of the tax benefits and disadvantages of that taxpayer. . . ."<sup>83</sup> The rationale used in the reversal was that "liability" in §357 (c) was not meant to be synonymous with accounting liabilities, such as those transferred by *Bongiovanni*. Rather, ". . . [s]ection 357 (c) was meant to apply to what might be called 'tax' liabilities, i.e., liens in excess of tax costs, particularly mortgages encumbering property transferred in a Section 351 transaction. . . ."<sup>84</sup> The court also quoted from *United States v. American Trucking Associations, Inc.*,

When . . . [plain] meaning has led to absurd or futile results . . . this court has looked beyond the words to the purpose of the act. Frequently . . . even when the plain meaning did not produce absurd results but merely an unreasonable one 'plainly at variance with the policy of the legislation as a whole' this court has followed that purpose, rather than the literal words.<sup>85</sup>

The court reasoned that since the *Raich* result is absurd as applied in this case and since there was no tax avoidance purpose evident, *Bongiovanni* should not be subject to a tax imposed by 357(c).

However, in two recent cases the accounts receivable of a cash basis taxpayer have been given a zero basis, thus *Bongiovanni* has not been followed.

In *Wilford E. Thatcher*,<sup>86</sup> a cash basis partnership transferred all of its assets, including accounts receivable, and all of its liabilities, including accounts payable, to a newly formed corporation. The court held that the accounts receivable had a zero basis and that the excess of the liabilities assumed, including the accounts payable, over the assets was taxable to the partnership under §327 (c). The court applied *Peter Raich* and treas.

	Accounts Receivable (i.e., total assets)	Accounts Payable (i.e., total Assumed Liabilities)	Taxable Amount
1.	\$30,000 (zero basis)	\$20,000	\$20,000
2.	20,000 (zero basis)	20,000	20,000
3.	5,000 (zero basis)	20,000	20,000
4.	any amount (zero basis)	X amount	X amount

82. 46 T.C. 604 (1966), appeal dismissed (9th Cir. 1968); *Testor v. Comm'r.*, 327 F.2d 788 (7th Cir. 1964); (In both of the above cases, cash basis taxpayers were taxed for the amount by which the liabilities assumed exceeded the basis of the transferred assets.); *White, Sleepers that Travel with Section 351 Transfers*, 56 VA. L. REV. 37, 42, n. 27 (1970); NOTE, *Section 357(c) and the Cash Basis Taxpayer*, 115 U. PA. L. REV. 1154 (1967); Rev. Rul. 69-442, 1969-2 Cum. Bull. 53; Treas. Reg. § 1.357-2(b) (1961).

83. *Bongiovanni v. Commr.*, 470 F.2d 921, 924 (2d Cir. 1972).

84. *Id.* at 924.

85. *Id.* at 924.

86. 61 T.C. No. 4 (Oct. 4, 1973).

Reg. § 1.461-1 (a)(1)(1976) (i.e., description of cash basis), and it noted that *Bongiovanni* could not be reconciled with §357(c). However, five judges dissented in *Thatcher* on the basis that the intent of Congress was to permit accounts receivable to be included in the amount of assets, which are netted against liabilities to determine the gain under §357 (c). In *Hempt Bros., Inc. v. United States*,<sup>87</sup> the court held that a cash basis transferor's accounts receivable, which were exchanged solely for stock in a §351 transaction, had a zero basis to the corporate transferee. Thus, it seems questionable whether the cash basis taxpayer has gained equality with the accrual basis taxpayer.

The second area of importance involves §357(b)(1),<sup>88</sup> which provides that if the principal purpose of the transferor with respect to the assumption of liabilities (a) seeks to avoid federal income taxes, or (b) fails to have a bona fide business purpose, then the total amount of the liabilities assumed will be treated as money received by the transferor on the exchange. This provision was designed to prevent the evasion of boot recognition by means of a liability "bail-out." The bail-out is a method by which, just prior to the exchange, funds are borrowed against the property with the intention of keeping the funds and having the corporate transferee assume the liability or take the property subject to it. Treasury regulations §1.351-3 (a)(6)(iii) (1965) and §1.351-3(b)(7)(iii) (1955) require the transferor to state "the corporate business reason" for the assumption of any liability. The vast breadth of "corporate business reason" has dulled section 357 (b)'s *in terrorem* effect. Treasury regulation § 357-1 (c) (1961) provides that if there is an improper purpose with respect to *any* liability then the total amount of *all* liabilities involved in the exchange will be considered as money received by the taxpayer-transferor. For example, in *Easson*<sup>89</sup> the court upheld the transferor's object of retaining a liquid position as a sufficient business purpose for the assumption of liabilities. In *Drybrough v. Commr.*,<sup>90</sup> four years prior to incorporation of the business, the taxpayer procured loans which were secured by mortgages on realty, and the proceeds of the loan were primarily invested in tax-exempt securities. The parcels of realty, subject to the mortgages, were transferred to several newly formed corporations in §351 transactions. The Sixth Circuit reasoned that even though part of the motivation for incorporation was to allow the long term retirement of the taxpayer's debt out of corporate earnings, there was not a purpose to avoid federal income tax on the exchange of the four year old mortgages. The four year old mortgages were not given boot recognition because they constituted bona fide transactions designed to rearrange business affairs so as to minimize future taxes. However, boot recognition was assessed by the *Drybrough* court for the mortgage incurred in the year prior to incorporation because the debt was incurred ". . . directly in anticipation of, and connected in purpose with, having the corporation assume the debt, thus releasing to Drybrough \$150,000 of the value of this asset without a present realization of taxable gain on the

87. 354 F. Supp. 1172 (M.D. Penn. 1973)

88. See also Treas. Reg. § 1.357-1(c) (1961).

89. 33 T.C. 963 (1960), rev'd. on other grounds, 294 F.2d 653 (9th Cir. 1961).

90. *Drybrough v. Commr.*, 42 T.C. 1029, rev'd on other grounds, 376 F.2d 350, 358 (6th Cir. 1967).

exchange. . . ." There was a tax avoidance purpose for the one year mortgage, but the court failed to categorize all such assumptions of liabilities as boot.

Section 357(b)(2) gives the transferor taxpayer an opportunity to escape having all of the assumed liabilities classified as boot by proving, by the clear preponderance of the evidence, that there was no intent to avoid federal income taxes and that there was a corporate business reason for their assumption by the corporation.<sup>91</sup> If the transferor can establish a business purpose for that liabilities, such as: bank loans, customers' deposits, mortgages, and trade obligations, then likelihood of a violation of §357(b) is remote. However, if the assumption of liabilities is made just prior to the §351 transaction, for the purpose of acquiring cash without being taxed as boot, or if there is an assumption by the transferee corporation of personal obligations, such as alimony, car payments, or rent, then usually this would fall within §357(b), resulting in all of the assumed liabilities being classified as boot.<sup>92</sup>

### 3. Control Requirement

The transferor or transferors must be in "control"<sup>93</sup> of the corporation immediately after the exchange in order to qualify for §351 nonrecognition. The "control" issue is more complex than it may seem at first glance. The issues involved are: (1) what constitutes control; (2) who may have control; (3) when must the control be acquired; and (4) how long must the control be maintained.

#### a. What Constitutes Control

Section 351(a) provides that control must be achieved as defined in §368(c). The latter mentioned section provides that control consists of ownership of ". . . 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation." In identifying the stock

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91. For cases holding § 357(b) applicable (i.e., tax avoidance purpose or non-business purpose results in boot treatment) see: *Thompson v. Campbell*, 353 F.2d 787 (5th Cir. 1965) (assumption of a personal liability); *Wheeler v. Campbell*, 342 F.2d 837 (5th Cir. 1965) (assumption of taxpayer's personal liability by new corporation in order to permit the taxpayer to avoid embarrassment from asking permission of a partner to withdraw a share of the undistributed profit.). For cases holding § 357(b) not applicable (i.e., no tax avoidance purpose, thus avoidance of boot treatment) see: *W.H.B. Simpson*, 43 T.C. 900 (1965) (A corporation assumed a liability in an amount slightly less than the taxpayer's basis in the transferred property. The court held that a desire to minimize future taxes by § 531 and § 541 nonrecognition provisions was a valid business purpose and not a tax avoidance purpose.); *Jewell v. United States*, 330 F.2d 761 (9th Cir. 1964) (A corporation assumed a partner's personal note, which had been incurred 6½ months prior to the incorporation. The note was used to purchase the company which was incorporated.); *Arthur L. Kniffen*, 39 T.C. 553 (1962) (A corporation assumed a personal liability, which was owed to it, in a transfer of assets to the corporation.); *Burke & Chisolm, Section 357: A Hidden Trap in Tax Free Incorporations*, 25 TAX L. REV. 211 (1970); *Surrey, Assumption of Indebtedness in Tax Free Exchanges*, 50 YALE L.J. 1 (1940).

92. BITTKER & EUSTICE, ch. 3 at 25 (1971).

93. Section 351(a) incorporates the § 368(a) definition of "control", which is ownership of 80% of the total combined voting stock and 80% ownership of all other classes of stock in the corporation.

entitled to vote, the articles of incorporation must be reviewed. Stock with contingent voting rights, such as preferred stock which may vote if dividends are not distributed or if there is to be a major change in the company, is generally not "voting" until the contingency occurs.<sup>94</sup> Also, voting agreements, warrants, options, rights, and convertible debentures are not "voting securities."<sup>95</sup> The purpose in determining whether any of the above mentioned items are "stock" is to calculate the amount of shares which are required to have "control."

After determining what constitutes voting stock, the transferors must have ownership of 80 percent of such "combined voting power."<sup>96</sup> For all other classes of stock (i.e., non-voting stock), §368(c) also requires 80 percent ownership. This means that the transferors must own 80 percent of each such class of stock.<sup>97</sup>

Section 351 does not require that the controlling person receive *only* stock for property. Thus, it seems that §351 treatment is still available if stock is received partially for property and partially for services, even if the value of the services exceeds 20% of the outstanding stock. However, Treas. Reg. §1.351-1(a)(1)(ii)(1967) has opened a loophole by providing that:

stock or securities issued for property which is of relatively small value in comparison to the value of the stock and securities . . . (. . . to be received for services) . . . shall not be treated as having been issued in return for property if the primary purpose of the transfer is to qualify under this section the exchanges of property by other persons transferring property. . . .

#### b. Who Must Possess Control

Section 351(a) refers to "one or more persons", thus a group of transferors may meet the control test. For example, if Mr. X and Mr. Y each transferred \$25,000 of assets for 50% of the stock issued by a corporation, then the 80% rule would be satisfied. In such situations, the rule would seemingly be satisfied even if one transferor received all of the voting stock while the other received all of the nonvoting stock.<sup>98</sup> However, if Mr. X received all of the stock and Mr. Y received only debt instruments, then Mr. X would qualify for §351 treatment, but Mr. Y has merely received debt instruments, which fail to meet the control requirement.<sup>99</sup> Thus, Mr. Y is

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94. Treas. Reg. § 1.302-3(a)(3) (1955).

95. See Rev. Rul. 66-339, 1966-2 Cum. Bull. 274.

96. The literal interpretation of "combined voting power" implies that shareholders' voting agreements may be taken into consideration, but "ownership of stock" connotes that ownership, rather than possession of voting rights is required.

97. Rev. Rul. 59-259, 1959-2 Cum. Bull. 115.

98. BITTKER & EUSTICE, ch. 3, at 31 (1971).

99. Rev. Rul. 73-472, 1973-2 Cum. Bull.

Even if Mr. X and Mr. Y were related, the control requirement would not be satisfied because § 318 is not made specifically applicable to either § 351 or § 368. See § 318(a). In Revenue Ruling 73-473, 1973-2 Cum. Bull. —, stockholders, who each owned an equal amount of the stock of a corporation, each transferred property of equal value in exchange for *bona fide* indebtedness. The debt constituted securities of the corporation, and the debt had a face value equal to the FMV of the transferred property. Since the stockholders were in control immediately after the transfer, § 351 nonrecognition treatment was applicable to the stockholders.

not entitled §351 treatment, but rather he will have recognition under §1002.

Another trap for the unwary occurs if a transferor, in a multi-transferor situation, receives a disproportionate amount of the stock or securities in comparison to the assets contributed in the exchange. Treasury regulation §1.351-1(b)(1)(1967) provides that the stock and securities received by each transferor need not be substantially in proportion to his interest in the property immediately prior to the transfer. However, if the stock and securities are received in disproportion to such interest, then the regulation provides that the transaction will be given a tax effect in accordance with its true nature. The Senate Finance committee stated that in such situations there may be taxable events under other provisions of the Code.<sup>100</sup> Thus, the transaction may be "realigned" by the Commissioner so that the amount of stock is proportionate to the value of the assets contributed by each transferor. The disproportionate amount of stock or securities may be classified as:

(1) a gift, which is subject to gift tax under §2501; or (2) compensation, which is taxable as income under §61(a)(1);<sup>101</sup> or (3) satisfaction of an obligation of the transferor.

For example, a father and son may transfer assets to a corporation. If the father transfers \$9,000 worth of assets in exchange for 50% of the stock, and the son transfers \$1,000 worth of assets for 50% of the stock, then the Commissioner may assess a gift tax on the value of the 40% extra stock which the son received. The Commissioner would realign the transaction by having the father receive 90% of the stock in the incorporation, which would be followed by a gift of 40% of the stock to the son. However, if the stock was in payment of services, rather than a gift, §351 treatment would still be available since the control requirement was satisfied by the father. The corporation would be entitled to a §162 trade or business deduction for the amount of stock deemed to be compensation for the son's services.<sup>102</sup>

### c. When Must the Control Be Acquired?

Section 351(a) requires the control to be achieved "immediately after the exchange." Treasury regulation 1.351-1(a)(1)(1967) which provides a more realistic approach, does not require simultaneous exchanges by the multi-transferors, but rather permits the exchanges to proceed ". . . with an expedition consistent with orderly procedure."<sup>103</sup>

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100. S. Rep. No. 1622, 83rd Cong., 2d Sess., p. 264 (1954).

101. If the stock is viewed as compensation paid by the corporation, then a § 162 trade or business expense would be available to the corporation. § 351(e)(4); Treas. Reg. § 1.351-1(b)(1)(1967).

102. For discussion of issuance of stock for services, see text accompanying note 26.

103. In family gift situations the control problem can easily be avoided. In *Wilgard Realty Co., Inc. v. Comm'r*, 127 F.2d 514 (2d Cir.), cert. denied, 317 U.S. 655 (1942), a subsequent gift by the transferor to his wife and children which broke the 80% control, was held not to disqualify § 351 treatment. However, in *Fahs v. Florida Mach. & Foundry Co.*, 168 F.2d 957 (5th Cir. 1948) after the § 351 exchange, the transferor-father issued more than 20% of the stock directly to his donee-son. The court did not allow § 351 treatment; however, the transaction could have been restructured so that either the donee contributed the property. The

d. How Long Must Control be Retained?

The fourth issue concerns the length of time which 80% control must be maintained. This is the "immediately after" requirement. A loss of 80% control may result from:

- (1) disposition of stock by transferors through sale or by gift;
- (2) issuance of additional stock by the corporation by a new issue of stock, a stock dividend in lieu of cash dividend, or a profit sharing plan for employees;
- (3) satisfaction of an obligation by the corporation or by the transferors; or
- (4) some other action.<sup>104</sup>

Formerly, only momentary control was required to satisfy the 80% requirement.<sup>105</sup> Today, however, momentary control is not sufficient if the transferors have a prior agreement to dispose of stock or if an integral part of the plan of incorporation is to dispose of stock, provided there is a loss of 80% of control.<sup>106</sup> The current test for holding control focuses on whether a series of steps should be treated as a single transaction or whether the steps should retain their separate identity.

If the steps retain their separate identity, by having the initial incorporation transaction become "old and cold" before subsequent disposition of shares necessary to keep 80% control, then § 351 nonrecognition is achieved. In *American Bantam Car Co. v. Commr.*<sup>107</sup> transferors exchanged assets for all the common stock. There was also a plan to have underwriters sell preferred stock, for which they were to receive common stock in addition to underwriting commissions and discounts. Five days after the exchange, the transferors executed a contract with the underwriters. Four months after the execution of the contract, the underwriters received the common stock payment thus causing the transferors to hold less than 80% of the common stock. The Tax Court held that the series of steps were independent even though they were contemplated under the same general plan, thus the transaction was classified as a nontaxable exchange under §351's predecessor. The sale of preferred stock was secondary to the principal goal of the plan, which was to organize the new corporation and to exchange the stock

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donor could have given the property to the donee prior to the exchange so that the donee would have been a transferor, or the donee could have been given the stock in a subsequent transaction which was independent of the § 351 exchange.

104. However, § 351(c) provides that if a corporate transferor (i.e., the "parent" corporation, who transfers assets in exchange for stock of another corporation (subsidiary)), distributes all or part of the stock received in the exchange to its shareholders, then such distribution shall not be taken into account in determining control.

105. *Portland Oil Co. v. Comm'r.*, 109 F.2d 479 (1st Cir. 1940) (A pre-existing family agreement, to acquire control and then to immediately dispose of control, was held not to prevent § 351 treatment.)

106. Rev. Rul. 70-140, 1970-1 Cum. Bull. 73 (incorporation followed by planned disposition of stock was deemed to break control); Rev. Rul. 70-225, 1970-1 Cum. Bull. 80 (spin-off of a new subsidiary, followed by the planned disposition of distributed stock was deemed to break control); Rev. Rul. 70-522, 1970-2 Cum. Bull. 81 (the reciprocal agreement to exchange 49% of the stock of newly organized subsidiaries was deemed to break control for both transferors).

107. 11 T.C. 397 (1948), *aff'd per curiam*, 177 F.2d 513 (3rd Cir. 1949), *cert. denied*, 339 U.S. 920 (1950).

for the transferor's assets. Several other factors indicated that the steps were independent: (1) the contract with the underwriters contained a cancellation clause, thus there were no binding legal relations with the underwriters necessary to the organization of the corporation; (2) the additional capital may have been raised by another method; and (3) the written agreement was not executed until after the exchange, even though there was an informal oral understanding before the exchange.

If, however, the series of steps is treated as a single transaction then §351 nonrecognition is not permitted. The Commissioner was successful in arguing for the "single" classification in *Manhattan Bldg. Co. v. Commr.*<sup>108</sup> There, a transferor exchanged assets for 250,000 shares of common stock and \$3 million in bonds. Prior to the exchange, the transferor had borrowed funds with which to purchase the exchanged assets. The loan agreement required the transferor to: (1) transfer such assets for stocks and bonds of the corporation; (2) deliver the bonds and 75,000 shares of common stock to the lender; and (3) contribute 49,000 shares of common stock to the new corporation's capital. The transferor retained only 50.4% of the common stock. The Tax Court held that since the transferor entered into a binding contract before the exchange with the corporation and could not have completed the purchase of the assets without the loan from the lenders, the steps were a single transaction and the 80% control requirement was never achieved. Thus, the transaction was deemed taxable.

Some key factors<sup>109</sup> which may be considered determining if the steps retain their separate identity or if they are interdependent are: (1) the intent of the parties; (2) the time between steps (3) the ultimate result; (4) the mutual interdependence of the steps; (5) the presence of a binding commitment at the time of the original transfer to make subsequent issuance or disposal of stock;<sup>110</sup> and (6) the holder of the legal title to the stock.

#### D. Basis Problems

The cost of §351 nonrecognition treatment is that the transferor and the corporate transferee may not take a §1012 cost basis for the items exchanged. Section 358 determines the substituted basis, which the transferor takes as a result of the §351 transaction, while the corporate transferee looks to §362 to determine its carryover basis in the assets received. Due to the current prevailing inflation, §1012 cost basis, which reflects current fair market value, would probably be higher than the §358 basis or the §362 carryover basis. Thus, the advantages of the higher bases, which are not available in the §351 transaction, are (1) increased depreciation, depletion, and

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108. 27 T.C. 1032 (1957).

109. Mintz & Plumb, *Step Transactions in Corporate Reorganizations*, 12 N.Y.U. INST. ON FED. TAX. 247 (1954).

110. *Stephens, Inc. v. United States*, 464 F.2d 53 (8th Cir.), cert. denied, 409 U.S. 1118 (1972) (After a reorganization, the taxpayer sold the stock in the corporation. The court held that the control requirement was satisfied because the taxpayer was not obligated by a pre-existing contract or plan to divest of the shares immediately.); Henkel, *Corporate Organizational Problems: A Checklist of Actions, Elections, and Considerations*, 31 N.Y.U. INST. ON FED. TAXATION 255, 264 (1973).



amortization<sup>111</sup> and (2) lower amount of gain or higher amount of loss upon sale of asset.<sup>112</sup>

1. *Section 358: Basis of Property Received by Transferor Shareholders and Security Holders*

(a) *Stock Only Received*

Section 358 provides that the transferor substitute the basis of the property, which he transferred to the corporation, for the stock and securities received. For example, if the transferor transferred property with a fair market value of \$50,000 and an adjusted basis of \$10,000 in exchange for stock, which had a fair market value of \$50,000, then the transferor would take a \$10,000 basis (i.e., substituted basis) in the stock.

(b) *Stock and Securities Received*

If both stock and securities are received by the transferor in the §351 transaction, then the basis of the property transferred by the transferor is allocated between the stock and the securities in proportion to the relative fair market value of the stock and securities.<sup>113</sup> For example, if the transferor transferred property with a fair market value of \$50,000 and a basis of \$10,000 in exchange for stock with a fair market value of \$30,000, and securities (i.e., long term bonds) with a fair market value of \$20,000, then the basis of the stock would be \$6,000, calculated as follows:

$$\begin{array}{r} \text{FMV stock} \quad \frac{\$30,000}{\text{Total FMV of}} \\ \text{stocks and securities} \quad \frac{50,000} \end{array} \times \$10,000 \text{ Basis of transferred property} = \$6,000 \text{ Basis of Stock}$$

The basis of the securities would be \$4,000, calculated as follows:

$$\begin{array}{r} \text{FMV securities} \quad \frac{\$20,000}{\text{Total FMV of}} \\ \text{stocks and securities} \quad \frac{50,000} \end{array} \times \$10,000 \text{ Basis of transferred property} = \$4,000 \text{ Basis of securities}$$

If the transferror sells the stock and the securities at the same fair market values as when the transfer was made, then he will realize gains of:

	Stock	Securities
Amount received	\$30,000	\$20,000
Basis	6,000	4,000
Gain realized <sup>114</sup>	<u>\$24,000</u>	\$16,000

Thus, the prior nonrecognized gain of \$40,000<sup>115</sup> is realized and recognized in the subsequent sale.

111. Depreciation (§ 167), depletion (§§ 611-617), and amortization (§§ 169, 174, 178, 184, 185, 187, 188, and 248) are deductions, which are permitted in calculating taxable income.

112. The higher the basis of an asset, the lower the gain or the higher the loss realized. § 1001.

113. Treas. Reg. § 1.358-2(b) (1955).

114. § 1001(a).

115. \$30,000 FMV stock  
20,000 FMV securities

\$50,000 amount realized § 1001(b)  
- 10,000 adjusted basis of transferred property  
\$40,000 gain realized § 1001(a).

## (c) Stock, Securities, and Boot Received

The transaction becomes complicated when the transferor receives "boot" in the transfer. "Boot" consists of other property or money<sup>116</sup> which is received by the transferor in addition to stock or securities received from the corporate transferee. Section 351(b) provides that the gain realized<sup>117</sup> will be recognized to the extent of the amount of money received plus the fair market value of the other property received by the transferor.<sup>118</sup> For example, assume a transferor transfers an asset, with a fair market value of \$50,000 and an adjusted basis of \$10,000, to a corporation for stock, with a fair market value of \$30,000, and other property (i.e., short term debt)<sup>119</sup> with a fair market value of \$20,000. The gain realized (i.e., \$40,000)<sup>120</sup> would be recognized to the extent of the boot (i.e., \$20,000), thus \$20,000 gain would be recognized.<sup>121</sup>

Section 358 provides the following formula for determining the basis of property received in a case where boot is distributed:

(1) Basis of nonrecognition property (i.e., stocks and other securities received from the corporation =

basis of property exchanged by the transferor

minus the sum of:

(i) FMV of any other property (except money) received by the transferor

(ii) amount of money received by the transferor

(iii) amount of loss recognized on the exchange by the transferor

plus the sum of:

(i) amount of gain recognized on the exchange under §351(b) by the transferor (except the amount treated as a dividend)

(ii) amount treated as a dividend

(2) Basis of the other property (except money) = FMV

(3) money: basis is not applicable

For example, assume a transferor exchanged property worth \$50,000, with an adjusted basis of \$10,000. He received stock worth \$30,000, securities worth \$10,000, \$2,000 cash, and other property worth \$8,000. The application of the §358 formula would result in:

116. § 351(b).

117. FMV of assets transferred by transferor  
— adjusted basis of assets transferred by transferor  
gain realized § 1001(a).

Gain Recognized  $\leq$  Gain Realized  $\leq$  Boot

118. The formula is: the gain recognized is less than or equal to the gain realized, which is less than or equal to the amount of boot.

Gain Recognized  $\geq$  Gain Realized  $\geq$  Boot

119. See note 32.

120. \$30,000 FMV stock  
20,000 FMV other property

\$50,000 amount realized § 1001(b)  
— 10,000 adjusted basis

\$40,000 gain realized § 1001(a).

121. The gain realized is recognized only to the extent of the boot. § 351(b).

Gain Recognized  $\leq$  Gain Realized  $\leq$  Boot

?	$\leq$	\$40,000	$\leq$	\$20,000
\$20,000	$\leq$	\$20,000	$\leq$	\$20,000

	\$10,000	basis of the property exchanged by the transferor
—	8,000	FMV of any other property (except money) received by the transferor
—	2,000	amount of money received by the transferor
—	0	amount of loss recognized on the exchange by the transferor
+	10,000	amount of gain recognized on the exchange under §351(b) by the transferor <sup>122</sup> (except the amount treated as a dividend)
+	0	amount treated as a dividend
	<u>\$10,000</u>	Basis of nonrecognition property

(The basis of the nonrecognition property would be allocated between the stock and the securities in proportion to their fair market values.)<sup>123</sup>

(2) 8,000 Basis of other property (except money) = FMV.

(3) money: Basis is not applicable.

#### (d) Assumption of Liabilities

In a §351 transaction, the transferee corporation might assume a liability of the transferor or might take property subject to a liability.<sup>124</sup> The amount of the liability is treated as "money received"<sup>125</sup> by the transferor, whether the transferor recognizes gain from the exchange under §357 (b) or §357(c) or whether there is no recognized gain from the exchange under §357 (a).<sup>126</sup> For example, assume a transferor exchanged property with a FMV of \$50,000 and an adjusted basis of \$10,000, subject to a \$5,000 mortgage, for stock worth \$30,000, securities worth \$10,000, \$2,000 in cash and other property worth \$3,000.<sup>127</sup> Application of the §358 formula would result in:

	\$10,000	basis of property exchanged by the transferor
—	3,000	fair market value of any other property (except money) received by the transferor

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122.	\$30,000	FMV stock
	10,000	FMV securities
	2,000	cash
	8,000	FMV other property
	<u>\$50,000</u>	amount realized § 1001(b)
—	10,000	adjusted basis
	<u>\$40,000</u>	gain realized § 1001(a)
	\$2,000	cash
	8,000	FMV other property
	\$10,000	boot § 351(b)
	\$10,000	gain recognized to the extent of the boot received § 351(b).

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

124. If the transferor is required to pay the mortgage, due to the corporate transferee's failure to pay and the transferor's secondary liability, then the transferor would be entitled to increase the basis of the stock by the amount paid for the mortgage. In the alternative, the transferor might take a § 165 loss deduction or a § 166 bad debt deduction. If the transferor sold the stock in a capital gain transaction prior to his payment of the mortgage, then he would be entitled to a capital loss for the payment of the mortgage (i.e., the payment of the mortgage would increase the transferor's basis in the property).

125. § 358(d).

126. For discussion of § 357(b), (c), see text accompanying note 75.

127. The difference between this example and the prior example is that the corporate transferee is assuming the \$5,000 mortgage and transferring only \$3,000 worth of other property, instead of transferring \$8,000 worth of other property.

-	7,000	amount of money received by the transferor (includes \$5,000 assumed liabilities) <sup>128</sup>
-	0	amount of loss recognized on the exchange by the transferor
+	10,000	amount of gain recognized on the exchange under §351(b) by the transferor (except amount treated as dividend). <sup>129</sup>
+	0	amount treated as dividend
	\$10,000	Basis of nonrecognition property

(The basis of the nonrecognition property would be allocated between the stock and the securities in proportion to their fair market value.)<sup>130</sup>

(2) \$3,000 Basis of other property (except money) = FMV.

(3) money: Basis is not applicable.

(e) Holding Period

When the transferor sells stock or securities which were received in a tax-free §351(a) exchange, the determination as to whether he is entitled to short term<sup>131</sup> capital gain or long term capital gain<sup>132</sup> treatment is made by reference to the §1223(1) holding period. Section 1223(1) provides for "tacking" the period during which the transferor held the transferred property provided it was (1) either a capital asset<sup>133</sup> or a §1231(b) asset<sup>134</sup> and (2) that the property received has the same basis in whole or in part as the property exchanged.<sup>135</sup> Usually, the transferor will exchange a mixture of §1221 capital assets, §1231(b) assets, and noncapital assets; thus, the transferee will have (1) some assets with holding periods dating from the exchange, because such assets were neither capital assets nor §1231(b) assets to the transferor, and (2) other assets with longer holding periods because such assets qualified for tacking under §1223(1).

## 2. Section 362: Basis of Property Received by Transferee Corporation

### (a) Stock and Securities Transferred

Section 362 provides that the corporate transferee's basis in the prop-

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128. § 358(d).

129. \$30,000 FMV stock  
 10,000 FMV securities  
 2,000 cash  
 5,000 mortgage assumed  
 3,000 FMV other property

\$50,000 amount realized § 1001(b)  
 -10,000 adjusted basis

\$40,000 gain realized § 1001(a)  
 \$ 2,000 cash  
 5,000 mortgage assumed  
 3,000 FMV other property

\$10,000 boot § 351(b)  
 \$10,000 gain recognized to the extent of boot received § 351(b).

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

131. Short term capital treatment is applied if there has been a sale or exchange of a capital asset, which has been held for less than 6 months. § 1222(1), (2),

132. Long term capital treatment is applied if there has been a sale or exchange of a capital asset, which has been held for more than 6 months. § 1222(3), (4).

133. See note 20.

134. See note 21.

135. Section 1223(1) seems to include § 1231 assets even if such assets are subject to ordinary gain treatment under § 1245 or § 1250 recapture provisions.

erty received is the sum of the transferor's basis in such property (i.e., carryover basis) increased by the amount of gain recognized<sup>136</sup> by the transferor on the transfer. For example, assume that a transferor transferred the following assets:

ASSET	FMV	ADJUSTED BASIS
Land	\$25,000	\$4,000
Building	\$22,000	\$1,000
Car <sup>137</sup>	\$3,000	\$5,000
total	\$50,000.	\$10,000.

If the assets were exchanged solely for stock and securities worth \$50,000, the corporate transferee would take the same basis (i.e., carryover basis) in each of the assets received from the transferor. Since there was no boot,<sup>138</sup> the corporate transferee's basis in the assets received will not have to be increased to reflect recognized gain.

#### (b) Stock, Securities, and Boot Transferred

If, in the above example, the transferor had received stock worth \$30,000, securities worth \$10,000, and other property worth \$10,000, then the transferor would have had boot recognition of \$10,000.<sup>139</sup> The Code and the regulations are silent as to how the corporate transferee should allocate the transferor's recognized gain to the carryover bases of the assets received.<sup>140</sup> Two possible methods<sup>141</sup> to allocate the gain to the bases would be:

- (1) Carryover basis for each asset, or
- (2) Allocation based on the appraised value of each asset.

The carryover basis approach provides that the corporate transferee's basis

136. If the transferor made an error by either recognizing too much or too little gain, then the transferee uses the recognizable gain, rather than the gain actually recognized, in calculating its basis. Burford, *Basis of Property After Erroneous Treatment of a Prior Transaction*, 12 TAX. L. REV. 365, 370 (1957).

Treasury regulation § 1.1312-7(c) Example 1 (ii) (1962) assumes that the transferee corporation is not estopped to claim a stepped-up basis, but this will not open up the statute of limitations as to the transferor. If the transferor takes a stepped-up basis in the property received (i.e., he fails to recognize gain, which is more likely than recognizing too much gain), then the Commissioner may assess an additional tax against him for the year of the exchange, notwithstanding the running of the statute of limitations. Section 1314(d) prevents an assessment for a pre-1932 tax year.

137. The car was for personal needs, thus no depreciation was taken.

138. Since there is no boot, the transferor has no recognized gain on the § 351 transaction. § 351(b).

139. \$30,000 FMV stock  
 10,000 FMV securities  
 10,000 FMV other property

\$50,000 amount realized § 1001(b)  
 - 10,000 adjusted basis

\$40,000 gain realized § 1001(a)  
 \$10,000 § 351(b) boot  
 \$10,000 gain recognized to the extent of the boot received. § 351(b).

140. Section 1223(2) provides that the transferee corporation can "tack" the transferor's holding period for the transferred assets, since the basis of the assets received by the corporation is a carryover basis. The holding period is used to determine if long term or short term capital treatment is applicable. § 1222.

141. BITTKER & EUSTICE, ch. 3 at 44-45 (1971).

in an asset received would consist of the transferor's basis in that asset plus an amount equal to the transferor's §351(b) gain recognized, multiplied by the percentage that the transferor's basis in the asset bears to the transferor's total basis for all of the property transferred which is subject to a basis change.<sup>142</sup> For example, assume that a corporate transferee exchanged stock worth \$10,000, securities worth \$3,000, and other property worth \$2,000 for:

<u>Asset</u>	<u>FMV</u>	<u>adjusted basis</u>	<u>gain or (loss) realized</u>
A	\$ 5,000	\$ 6,000	(\$1,000)
B	10,000	4,000	6,000
	<u>\$15,000</u>	<u>\$10,000</u>	<u>\$5,000</u>

The gain recognized by the transferee is \$2,000.<sup>143</sup> The corporate transferee would determine its basis in each of the received assets in the following manner:

<u>ASSET</u>	(1) <u>Transferor's Basis</u>	(2) <u>Gain Recognized by Transferor</u>	(1) + (2) <u>New Basis</u>
A	\$6,000	*	\$6,000
B	4,000	\$2,000	\$6,000
	<u>\$10,000</u>	<u>\$2,000</u>	<u>\$12,000</u> §362(a) <sup>144</sup>

However, if there was goodwill in the business, part of the \$2,000 gain would be attributable to such goodwill, thus increasing the basis of the goodwill to the corporation.

#### IV. COLLATERAL PROBLEMS OF INCORPORATION

##### A. *Alternative Methods for a Corporation to Acquire Assets*

##### 1. *Purchase of Assets by the Corporation (i.e., Sale to the Corporation)*

##### a. Advantages of "Sale"

The businessman may want to avoid the disadvantages of having the corporate transferee, in the §351 transaction, realize all the gain from sale

$$142. \quad \frac{\text{Transferor's basis for the asset} + \text{Transferor's gain recognized}}{\text{Transferor's basis for the property exchanged, which is subject to a basis change}} \times \text{Transferor's basis in the asset}$$

##### New Basis

Cash and liabilities (i.e., accounts payable and notes payable) are not subject to a basis change because neither will increase via the "paper" gain.

$$143. \quad \begin{array}{l} \$10,000 \text{ FMV stock} \\ 3,000 \text{ FMV securities} \\ 2,000 \text{ FMV other property} \\ \hline \$15,000 \text{ amount realized } \S 1001(b) \\ -10,000 \text{ adjusted basis} \end{array}$$

$$\begin{array}{l} \$ 5,000 \text{ gain realized } \S 1001(a) \\ \$ 2,000 \text{ } \S 351(b) \text{ boot} \\ \$ 2,000 \text{ gain recognized to the extent of the boot received.} \end{array}$$

144. Section 362(a) makes no provision for the corporate transferee to make a basis adjustment when the transferor realizes a loss. Section 351(b)(2) provides that the transferor shall not recognize any loss.

of a noncapital asset as ordinary income, or he may want the corporate transferee to have increased §167 depreciation deductions by stepping up the basis of the transferred depreciable property. If such are his goals, then the businessman may attempt to structure the transfer of the appreciated property as a "sale" rather than a §351 exchange. For example, assume a businessman, who is in the 50% tax bracket, owns land, which has a §1012 cost basis of \$20,000 and which has appreciated in value to \$50,000 due to its marketability as a residential neighborhood. Since he has never developed the property, he can avoid the §1221(1) pitfall of having the property classified as inventory, which would result in ordinary gain upon sale. If he personally develops the property, then such land may also be inventory, thus resulting in ordinary income.<sup>145</sup> Therefore, he may want to form a new corporation, which will purchase the property for the FMV of \$50,000.<sup>146</sup> If the corporation gives its promissory note, payable over 5 years plus interest;<sup>147</sup> then the businessman will realize a total capital gain of \$30,000 which could be deferred under a §453(b) installment sale treatment<sup>148</sup> assuming such treatment is elected. The corporation would have the benefits of the §1012 costs basis, thus reducing gain on sale of the plots. Also, the corporation would have a §163 interest expense deduction.

#### b. Constraints to Prevent Sale Treatment

Sections 1239, 267, 351 and 362 have been used by the Commissioner to prevent the taxpayer from taking the tax advantages of the "sale."

##### (1) Section 1239

Section 1239 provides that the gain from a sale or exchange of depreciable property between spouses or between an individual and a controlled corporation<sup>149</sup> shall be treated as ordinary income. The purpose of §1239

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145. However, § 1237 provides that parcels of real property are not deemed to be sold in the ordinary course of business merely because of subdividing the property, provided that: (1) the realty was not prior held by the taxpayer for sale in the ordinary course of business; (2) no substantial improvement has been made on the realty pursuant to a contract between the taxpayer and the buyer; and (3) the realty has been held by the taxpayer for 5 years, unless acquired by inheritance or devise. However, if more than 5 parcels are sold or exchanged, then any gain in or after any tax year in which the sixth parcel is sold is deemed to be sold in the ordinary course of business to the extent of 5% of the selling price. Section 1237 is not applicable to corporations.

146. If the businessman sold depreciable property to his controlled corporation, then he would incur ordinary income instead of capital gain income due to the provisions of § 1239. However, in this example, realty, which is not depreciable property, is sold to the controlled corporation; thus § 1239 is not applicable. See note 149 for further discussion of § 1239.

147. If the maturity date is far into the future, the Commissioner may attempt to reclassify the loan as an equity investment. Thus, the payment to the "creditor" would be dividends, which would be given ordinary income treatment. The equity v. debt issue is discussed in the text accompanying note 42.

148. Section 453 permits each installment payment to be reported as income in the year in which actually received, provided certain requirements are satisfied. (See § 453).

149. Section 1239 is applicable to a sale or exchange between an individual and a corporation, more than 80% *in value* of the outstanding stock of such corporation is owned by the individual, his spouse, his minor children, and his minor grandchildren. Section 1239's 80% *in value* stock requirement gives the Commissioner more potential for attributing stock ownership to the taxpayer than does the 80% *in number* stock requirement of § 351. In H.R. Rep. No. 586, 82d Cong., 1st Sess. 120-121 (1951), there was no explanation as to why "value"

is to prevent the corporation from taking a stepped-up basis in the property, while the seller incurs only capital gains.<sup>150</sup> However, §1239 (b) limits the provision to depreciable property, thus creating a loophole for land and other non-depreciable property.<sup>151</sup>

## (2) Section 267

Whereas §1239 gives ordinary income treatment to the gain on a sale of property between an individual and a corporation in which the individual owns more than 80% in value of the corporation's outstanding stock, section 267 prohibits the deduction of a loss where there is a sale to a corporation of which the seller owns more than 50% of the value of the outstanding stock.<sup>152</sup> Section 267 is similar to §1239 in that §267 also has an attribution rule, which includes the seller's parents, brothers, sisters, and lineal descendants, whether minors or adults.<sup>153</sup> However, §267 applies not only to de-

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was used. In *United States v. Parker*, 376 F.2d 402 (5th Cir. 1967), the taxpayer owned 80% in number of the outstanding shares, while a corporate employee owned the remaining 20%: subject to two restrictions: (1) a right of first refusal, which required the employee to offer his stock to the corporation before selling it to a third party; and (2) a provision requiring the employee to sell his stock to the majority shareholder at a particular price upon termination of employment. The court reasoned that the restrictions caused the taxpayer to hold more than 80% in value of the outstanding shares. It seems that the *Parker* rationale could apply to a shareholder who owned only 51% of the outstanding shares of the corporation, thus giving the Commissioner an *in terrorem* weapon to combat "sales" by majority shareholders to their controlled corporations. However, the businessman may be able to avoid both the *Parker* situation and § 1239 by giving a sufficient amount of stock to his parents, brothers, sisters, adult children, or a trust (i.e., not covered by the § 1239 attribution rules) in order to escape the 80% requirement. In *Mitchell v. Commr.*, 300 F.2d 533 (4th Cir. 1962), the taxpayer sold depreciable property to a corporation, and the court refused to apply § 1239 thus permitting him to take capital gains treatment. The court reasoned that the stock held in an irrevocable trust for the benefit of the businessman's wife and minor children was not includible in determining the 80% requirement because § 1239 did not take into account stock which was beneficially owned. The trustee was a bank; but if the taxpayer would have been named as trustee, then he would have retained legal title, thus falling within the constraints of § 1239. The court also mentioned that stock owned by the businessman's adult children would not be includible in determining the 80% requirement of § 1239. However, the Commissioner may attempt to set aside a gift of shares to adult children or to a trust as a sham transaction, but in *Drybrough v. Comm'r*, 42 T.C. 1029, 1048, rev'd on other grounds, 376 F.2d 350 (6th Cir. 1967), the court found that the taxpayer's gift of 40% interest in a corporation to his son was valid (i.e., not a sham as claimed by the Commissioner) ". . . whether or not the transfer was motivated by tax savings . . ." The taxpayer may avoid the Commissioner's sham argument by not making temporary transfers of shares. Since the taxpayer could retain control of the corporation with only 51% of the stock, then temporary transfer problem can easily be avoided.

150. H.R. Rep. No. 586, 82d Cong., 1st Sess. 26 (1951).

151. However, in *Tom F. Baker III*, 38 T.C. 9 (1962), and in *John P. McEnery*, P-H 1967 T.C. Mem. ¶ 67,213 the court held that the Congressional purpose behind § 1239 would be frustrated by technical distinctions between § 167 depreciation and § 162 amortization, thus any such distinction is irrelevant for § 1239 purposes.

The § 1239 attribution rules provide that if a person's personal or business relatives own stock, then he is deemed to own that stock. Thus, the applicability of § 1239 is limited since the attribution rules do not include stock owned by the taxpayer's parents, brothers, sisters, adult children, trusts of which he is the beneficiary, partnerships of which he is a member, or corporations which he controls. However, such parties are included in the attribution rules of § 267(c) and § 318.

152. § 267(b)(2).

153. Section 267(c) also gives constructive ownership of stock in the following situations: § 267(c)(1), stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, part-



preciable property, as does §1239, but also applies to non-depreciable property.<sup>154</sup>

### (3) Section 351

The "sale" by a businessman to his controlled corporation can also be prevented by application of §351. The Commissioner may rule that the sale subsequent to the §351 transaction was an integral part of the corporation's formation, thus within §351.<sup>155</sup> The taxpayer has the burden of proving that the requirements of §351 have not been met.<sup>156</sup>

### (4) Section 362

The Commissioner may also try to prevent the transaction from receiving the tax benefits of a "sale" by classifying the transaction as a §362 contribution to capital.<sup>157</sup> If the transaction is classified as a §362(a)(2) contribution to capital, then the corporation will take a §362 carryover basis, instead of a §1012 stepped-up cost basis.<sup>158</sup> The transferor-shareholder will receive dividend treatment to the extent that the payments received from the "sale" are not in excess of the corporation's earnings and profits.<sup>159</sup>

## 2. General Rule of Contribution to Capital

Beside §351 transactions and purchases (i.e., sales to the corporation), the corporation may also acquire property by arranging for contributions to capital.<sup>160</sup> Such Contributions may come from existing shareholders or from

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ners, or beneficiaries, § 267(c)(3), an individual owning (otherwise than by or for his family) any stock in a corporation shall be considered as owning the stock owned, directly or indirectly, by or for his partner.

154. The potency of § 267 can be seen in the following cases. In *Drake, Inc. v. Comm'r*, 145 F.2d 365 (10th Cir. 1944), the corporation's loss on the sale of a farm to a purchaser, who owned more than 50% in value of the corporation's stock, was held not to be deductible under § 267's predecessor. In *Comm'r v. Whitney*, 169 F.2d 562 (2d Cir. 1948), a partnership sold some of its assets to a corporation, the value of whose stock was more than 50% owned by the partners of the seller partnership. The court held the partnership's loss on the sale not to be deductible under § 267's predecessor.

155. *Labrot v. Burnet*, 57 F.2d 413 (D.C. Cir. 1932) the taxpayer transferred \$86,000 to the corporation in exchange for all of its stock. Several days later, the corporation "purchased" land from the taxpayer for \$80,000. Section 351's predecessor was applied; *Snowden v. McCabe*, 111 F.2d 743 (6th Cir. 1940). (Section 351's predecessor was applied to disallow a loss that the taxpayer was attempting to claim.)

156. For further discussion of this issue, see BITTKER & EUSTICE, ch. 3 at 52-56 (1971).

157. In *Lantz Co. v. United States*, 424 F.2d 1330 (9th Cir. 1970), notes, which were payable to the shareholders in 5 years, and which were incurred on the date of incorporation, were deemed to be capital contributions, thus they were not entitled to § 163 interest deductions. However, in *Rudolph Investment Corp.*, ¶ 72,129 P-H 1972 T.C. Mem. ¶ 72,129 the parent company owned 75% of the stock of the subsidiary company. The parent made loans evidenced by a one year note and three demand notes. The interest on the notes was accrued and all of the parties expected the notes to be repaid; therefore, the court held the notes to be debt, even though the subsidiary was initially inadequately capitalized.

158. The advantages of a § 1012 cost basis are discussed in the text accompanying note 111.

159. Section 316 provides that a dividend is any distribution of property made by a corporation to its shareholders to the extent of its earnings and profits.

160. A contribution of capital consists of any payment of money or delivery of property to a corporation. These payments, if made by shareholders, may be in the nature of assessments or an additional price paid for the shares owned. If the payment is by a governmental

nonshareholders; but in either case, the corporation does not recognize gross income.<sup>161</sup> However, the contribution may really be disguised compensation for goods or services provided by the corporation, upon which it hopes to avoid ordinary income tax. The following factors indicate whether the contribution qualifies under §118 as an exclusion from gross income: (1) the corporation's requirements for additional capital to conduct its business; (2) the shareholder's expectation of return by means of an increase of his equity in the corporation; (3) the corporation's improvement of the corporate capital position (i.e., not a mere payment for goods or services); (4) the voluntariness and proration of the shareholder's contributions; and (5) the lump-sum form of contribution (i.e., not a payment of periodic dues or fees).<sup>162</sup>

#### a. Shareholder Contributions

Where shareholders make prorata contributions, such payments, assumptions of liabilities, forgiveness of debts,<sup>163</sup> or contributions of other property are in the nature of assessments, which represent an additional amount paid for their equity investment (stock).<sup>164</sup> Thus, the basis of the stock increased. The Service might regard such contributions as part of a single series of steps within §351, and thus apply §358<sup>165</sup> to determine the transferor's basis in the acquired property.<sup>166</sup> If §351 is applied, then the corporation's basis will be the transferor's basis plus the amount of gain recognized by the transferor, as provided by §362 (a).

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unit or a civic group, then it may be an inducement for the corporation to locate in a particular community or to expand its operating facilities. Treasury regulation § 25.2511-1(h)(1) (1973) (i.e., gift tax regulation) provides that a transfer of property by a party to a corporation generally represents a gift by the party to the shareholders. However, if the transferring party is a shareholder of the corporation, then there is no gift to the extent of his proportional interest in the corporation. Thus, if all of the shareholders made "gifts" to the corporation in proportion to their interest in the corporation, then there would be no gift tax. The regulation also provides that there may be an exception to the gift tax rule, if the transfer is to a charitable, public, political, or similar organization, under a theory of a gift to the organization as a single entity.

161. *Edwards v. Cuba R.R. Co.*, 268 U.S. 628 (1925) (Subsidy payments by the Cuban government for construction of a railroad did not constitute income.).

162. *United Grocers, Ltd. v. U.S.*, 186 F. Supp. 724, 731 (N.D. Cal. 1960), *aff'd*, 308 F.2d 634 (9th Cir. 1962) (Monthly membership payments to a wholesale grocery cooperative, which sold to both members and nonmembers but which distributed dividends only to members, were deemed payments for goods and services that were included in the cooperative's gross income. The payments were not capital contributions.).

163. *Treas. Reg. § 1.61-12(a)* (1968); *J.A. Maurer, Inc.*, 30 T.C. 1273 (1958) ("Loans" were made to the corporation by its stockholders under terms that no outside lender would have agreed upon. The shareholders eventually received partial repayment and "forgave" the balance due. The court held that the advances constituted contributions to capital and not indebtedness, the forgiveness of which would have resulted in taxable income to the corporation.); However, in *Hutton v. United States*, (31 Am. Fed. Tax. R. 2d) ¶ 73,425 (W.D. Tenn. Dec. 26, 1972), the shareholders made loans to their corporation. The loans were represented on the corporate records as promissory notes with a fixed maturity date. The loans were used for operating funds in the slack sales years, but the original capitalization was not thin. The court held that the money advanced by the stockholders constituted loans rather than contributions to capital.

164. *Treas. Reg. § 1.118-1* (1956).

165. For discussion of § 358, see text accompanying note 113.

166. Landis, *Contributions to Capital of Corporations*, 24 *TAX L. REV.* 241, 254 (1967).

## b. Nonshareholder Contributions

In the case of nonshareholder contributions to capital,<sup>167</sup> the corporation still gets nonrecognition treatment,<sup>168</sup> but §362 (c) requires that the basis for the contributed property be zero.<sup>169</sup> Thus, the ultimate tax consequence to the corporation is to defer, rather than eliminate, the tax liability arising from the benefit of the contribution.<sup>170</sup>

The contributions from nonshareholders usually come from one of two groups: (1) civic groups-municipalities,<sup>171</sup> or (2) future customers.<sup>172</sup> In both situations, the crucial question is whether the contribution is within §61<sup>173</sup> income for payment of goods or services or within the §118 safe harbor.<sup>174</sup>

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167. If the contribution is a disguised payment for goods or services, then § 118 is not applicable and the payment is § 61 ordinary income to the corporation.

168. Treas. Reg. § 1.118-1 (1956).

169. Section 362(c) provides that the property, other than money, which is contributed by nonshareholders, shall have a basis of zero. If money is contributed by nonshareholders, then the property acquired with such money shall have a zero basis. If there is an excess of money contributed over the cost of the property acquired by such money within twelve months from the date of contribution, then the amount of such excess shall be applied to the reduction of the basis of any other property held by the corporation. Treasury regulation § 1.362-2 (1955) provides for the order in which the other property is to have its basis reduced.

170. The amount of deferred tax is essentially an interest free government loan, which is paid back over the life of the property (i.e., reduced depreciation deductions) and upon sale of the property (i.e., sale at a lower basis, resulting in higher gain realized or lower loss realized). However, if the corporation is not profitable, then the "interest free loan" will never be paid back because there is no taxable income.

171. A civil group-municipality will realize that its locale has undesirable traits, which cause lower rates of return to be earned in comparison to other possible sites. In *Brown Shoe Co. v. Comm'r*, 339 U.S. 583 (1950), the company received transfers of cash and property from community groups as an inducement to locate or expand its operations in the community. The United States Supreme Court held the property received to be a § 118 capital contribution, since it was made without any direct service being performed by the company. The court reasoned that the only expectation of the contributors was that of an advantage to the community as a whole. In *United States v. Chicago, B & Q R.R.*, 412 U.S. 401 (1973), the railroad received governmental contributions for the construction of improvements; however, the railroad had to bear the cost of maintenance and replacement of such improvements. The court held that the improvements did not qualify as capital contributions under § 362(a)(2)'s predecessor because they were neither bargained for nor intended to substantially increase the railroad's income. The court held that the improvements had a zero basis, which is consistent with § 362(c). The court avoided the technical classification of "contribution to capital" because of the applicability of the 1939 Code to the 1930 governmental contributions. The court applied § 362(c) theory because it governs transactions after June 22, 1954, and the tax year in question was 1955.

172. In *Teleservice Co. v. Comm'r*, 254 F.2d 105 (3rd Cir.), *cert. denied*, 357 U.S. 919 (1958), future customers' contributions, which were made in payment of the cost of constructing television facilities to be used by the customers upon payment of further fees, were held not to be gifts or § 118 capital contributions. Rather, the court held such "contributions" to be part of the price of the service, thus the corporation incurred § 61 income.

173. *Cf. Detroit Edison Co. v. Comm'r*, 319 U.S. 98 (1943) (The company expanded its services by constructing additional facilities. The company was induced to expand only after the potential customers contributed part of the cost of the expansion. The court did not regard the payments as donations or contributions, but it deducted the amount of the payments from the basis of the new facilities. If the project had been so risky that it would not have been undertaken without customer financing of the capital investment, then the safe harbor of § 118 would have been applicable. Note, *Taxation of Nonshareholder Contributions to Corporate Capital*, 82 HARV. L. REV. 619, 642 (1969).

174. The businessman should be wary of entering into the civic group-municipality contribution situation since such fosters inefficient operations. The operation is inefficient because the corporation would have started its operations in another location, which was economically more favorable than the locale of the contributing community. The contribution offsets the

### B. Contingent Stock Agreements

If there are several transferors, they may disagree as to the value of the transferred assets in relation to their income producing ability. The disagreement may result in a dispute as to how much stock each transferor is entitled. The transferors may enter into a contingent stock agreement, which would provide a right to receive additional stock contingent upon the amount of income produced by the disputed asset.<sup>175</sup> The Service has instituted a policy of favorable rulings on contingent stock agreements,<sup>176</sup> which may satisfy the §351 stock or securities requirement.

### C. Tax Consequences of Elections

The transferee corporation, which has been newly created, must or may make elections concerning; (1) §441 taxable period (i.e., calendar year or fiscal year); (2) §446 method of accounting; (3) §471 inventory method; (4) §166 bad debt write off method; (5) §167 depreciation and amortization methods; (6) §1244 losses on small business investment company stock;<sup>177</sup> (7) §1372 Subchapter Selection by shareholders; and (8) §1501 privilege to file a consolidated return. An analysis of the potential future earnings of the corporations, via *pro forma* income statements, will permit the corporation and its shareholders to make elections, which will result in payment of a minimum amount of tax.

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economic inefficiencies that the corporation incurs in the community; but the value of the contribution may eventually decrease below the amount necessary to offset the inefficiency costs. The corporation may find itself locked into its inefficient locale due to the extraordinary expenses involved in dismantling and relocating its plant. These economic factors should be given serious consideration by the businessman in the planning stages. In situation where future customers finance risky operations by contributions, the businessman is able to take a large risk at a reduced cost. Such a gamble may be well worth the effort involved.

175. James C. Hamrick, 43 T.C. 21 (1964) (The court held that a contingent right to receive additional shares for transferred patent rights qualified as "stock" for purposes of § 351. The contingent payments were double the original number of shares issued.)

176. Rev. Proc. 67-13, 1967-1 Cum. Bull. 590, permits classification of contingent stock as "stock" for § 368 reorganizations, if the following conditions are met: (1) all of the contingent stock must be issued within 5 years of the date of transfer; (2) there must be a valid business reason (e.g., difficulty in determining value of an asset) for not issuing all of the stock immediately; (3) the maximum number of shares which may be issued is stated; (4) at least 50% of the maximum number of shares of each class of stock, which may be issued, are issued in the initial distribution; (5) the agreement evidencing the right to receive stock in the future is not negotiable or readily marketable; and (6) such right gives rise to receipt only of additional stock of the acquiring corporation or a corporation in control thereof. It seems probable that the same reasoning would be applied in a § 351 transaction.

177. Section 1244 permits an individual, who has incurred a loss from the sale or exchange of § 1244 stock, to take an ordinary loss instead of a capital loss. The maximum amount, which may be treated as an ordinary loss in any taxable year, is \$25,000 per individual. Section 1244(c) provides that § 1244 stock is common stock in a domestic corporation if: (A) such corporation adopted a plan after June 30, 1958, to offer such stock for a period (ending not later than 2 years after the date such plan was adopted) specified in the plan, (B) at the time of the plan's adoption, the corporation was a small business corporation (which is defined in § 1244(c)(2) by placing limits on the aggregate amount for which the stock may be offered), (C) at the adoption of the plan, no portion of a prior offering was outstanding, (D) the stock was issued for money or other property, and (E) such corporation, in the 5 most recent taxable years prior to the loss (or if the corporation has not been in existence for 5 years, then for the taxable years or portion of a taxable year during which the corporation has been in existence) derived more than 50% of its aggregate gross receipts from sources other than royalties, rents, dividends, interest, annuities, and sales or exchanges in stocks or securities.

#### D. Tax Consequences of Incorporating a Partnership Under §351

If a partnership incorporates, then there are three methods of qualifying under §351:

(1) the partnership could transfer its properties to the corporation in exchange for its stock;<sup>178</sup>

(2) the partnership may liquidate, distribute the assets in kind to the partners, and then the partners might transfer the assets to the corporation in a §351 exchange;<sup>179</sup> or

(3) the partners may transfer their partnership interests to the corporation in a §351 exchange, which could be followed by a liquidation of the partnership and a distribution of its assets to the corporation.<sup>180</sup>

#### E. Section 482 Allocation of Income

If the incorporators try to deal independently with the new corporation (e.g., by leasing or licensing), then the Commissioner may impose §482, allocation of income and deductions among taxpayers, or constructive dividend theory in order to properly allocate income.<sup>181</sup>

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178. The partnership may either continue in existence, holding the stock as partnership property, or liquidate, distributing the stock in a complete liquidation. Section 1371(a)(2) provides that if the partnership stays in existence as a shareholder of the corporation, then there can be no Subchapter S election.

If the partnership distributes the stock to its partners, then the benefits of § 1244 are not available. Treasury regulations § 1.1244a-1(b)(2) and § 1.1244a-1(c) example 2 provide that in order to claim a deduction under § 1244, the individual or the partnership, which sustained the loss, must continuously hold the stock from the date of issuance. Thus, if the § 1244 stock is distributed (i.e., breaking the continuous holding requirement) by the partnership to its partners, who subsequently sell the stock for a loss, then the § 1244 ordinary loss treatment is not available. Also, upon distribution, the partners will take a § 732(a) substituted basis in the stock. However, § 732(a)(2) provides that basis shall not exceed the adjusted basis of the partner's interest in the partnership, reduced by any money distributed in the same transaction.

179. The partners would be subject to recognition of gain under § 731(a)(1), provided that money was received in excess of the partner's basis for the partnership interest. Section 731(a)(2) provides that the partner can recognize loss if cash, unrealized receivables, inventory, and/or depreciation recapture property are the only items received in the distribution. The loss would be recognized to the extent that the adjusted basis of the partner's interest in the partnership exceeds the sum of the above-mentioned items.

The excess amount would be subject to recognition of ordinary gain or loss under § 751, to the extent that it consisted of unrealized accounts receivable, inventory, or depreciated recapture property. (see § 1245(a)(3) and § 1250(c)). The partners would take a substituted basis, via § 732(a), in the distributed assets. Upon the subsequent § 351 transaction (i.e., the partners transfer the partnership assets to the corporation in exchange for its stock), the partners-shareholders would take a substituted basis, via § 358, in the stock. The partners-shareholders would have an opportunity for § 1244 treatment because they would have continuously held the stock.

However, if the partnership transfers the § 751 assets to the corporation in a § 351 transaction and subsequently distributes the stock in liquidation of the partnership, then § 731 and § 751 would be avoided because the partners would not receive any cash, unrealized receivables, inventory, or depreciated recapture property. The partners would not be entitled to § 1244 treatment upon sale of the stock at a loss because they did not continuously hold the stock. Also, the partners would take a § 732(a) substituted basis in the stock.

180. The partners-shareholders would take a § 358 substituted basis in the stock received, and they would have an opportunity for § 1244 treatment because they would have continuously held the stock. The corporation, however, would be subject to § 731 gain or loss on distribution and to § 751 gain or loss on receipt of unrealized receivables and inventory items.

181. For example, if a corporation leased a building from its controlling (see Treasury reg-

### F. *Losses on Sale or Worthlessness*

The individual taxpayer also faces important tax problems when there is a loss on the sale of stock or the worthlessness of debt. Whether the loss is capital or ordinary depends upon the following factors: (1) capital asset status; (2) existence of sale or exchange (actual or constructive); (3) form of the investment (stock, security or nonsecured claim); (4) relationship of the loss to the taxpayer's business; (5) taxpayer's holding period of the property; (6) individual or corporate taxpayer; and (7) taxpayer's control relationship to the corporation.<sup>182</sup>

If the individual taxpayer's loss is evidenced by a corporate security, then a §165 (g)(1) capital loss may be taken whether the loss is due from sale,<sup>183</sup> retirement<sup>184</sup> or worthlessness.<sup>185</sup> This is provided that the §265 (c)(2) requirement, that the transaction be entered into for profit, and the §267 provision denying deduction for losses between related persons, are satisfied. If the individual's loss on debt is not evidenced by a security, such as bond, debenture, or note, then the transaction is governed by §166 (bad debts), rather than a §165 (g)(1) (worthless securities). Section 166(a) provides an ordinary loss deduction for worthless debts, but § 166(d) carves out an exception by requiring short term capital loss treatment for nonbusiness debts. Thus, in the case of the small businessman and the closely held corporation, the imprecision of §166 (d)(2) in defining non-business debts can easily snare him when he makes loans during the corporation's initial stages.<sup>186</sup> In order to get §165 (g) (1) ordinary loss treat-

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ulation § 1.482-1(a)(3) (1968)) shareholder for \$1000 per month, while the fair rental value of the building was only \$400 per month, then the commissioner would deny the corporation a \$600 deduction per month, since that amount is the excess over the fair rental value. The shareholders are trying to bail out of the corporation the excess amount of income, thus seeking to escape the corporate tax. If the shareholders kept the entire \$1000 per month, then \$400 would be rental income and \$600 would be constructive dividend income to the shareholder. However, if the terms of the arrangement are fair, then the corporation is entitled to a § 162(a)(3) deduction for the full amount of the rent. This would be a proper avoidance of the double tax on corporate earnings, which are distributed to the shareholder-lessor in the form of rent. The shareholder-lessor would have ordinary income for the rent received.

182. BITTKER & EUSTICE, ch. 4 at 33 (1971).

183. § 1221; § 1222.

184. § 1221; § 1232.

185. § 1221; § 165(g)(1).

186. In *Whipple v. Comm'r*, 373 U.S. 193 (1963), the court classified the shareholder's "loans" to his controlled corporation as a nonbusiness debt or an investment in the corporation, thus requiring capital loss treatment rather than ordinary loss as a § 166 business bad debt. However, later cases have denied ordinary loss bad debt treatment and provided for capital losses. In *Millsap v. Comm'r*, 387 F.2d 420 (8th Cir. 1968), the controlling shareholder, who was not in the business of lending money or promoting corporations for quick resale, made a loan to the corporation. The loan became worthless, and the court held that the loan was a nonbusiness bad debt, which was entitled to capital treatment. In *Albert J. Bernard*, P-H 1973 T.C. Mem. ¶ 73,069 (Mar. 26, 1973), the taxpayer purchased stock in a corporation of which he was a shareholder, director, and president. The court held that the taxpayer failed to prove that he was in the business of promoting, organizing, financing, and managing corporations. Thus, the loss on the worthlessness was deemed a § 165(g) capital loss. The taxpayer will qualify for ordinary loss deductions only if the loan arises in: (1) a moneylending business; (2) a business of organizing, promoting, financing, and selling corporate enterprises; (3) protection or advancement of the taxpayer's business of working as the debtor's employee; or (4) a commercial business relationship with the debtor, rather than an investment relationship. (see BITTKER & EUSTICE, ch. 4 at 36-37 (1971).)

ment, the business motive for the loan must be "dominant and primary."<sup>187</sup> If the corporation borrows funds from the bank and the shareholders become guarantors for such loans, then the *Whipple* motive test is still applicable to determine if the shareholder is entitled to §165 (g) (1) ordinary loss treatment or capital loss treatment.<sup>188</sup> However, the businessman may be able to take an ordinary loss deduction for a loss on small business stock, under §1244.<sup>189</sup>

## V. CONCLUSION

The attorney for the businessman, by his awareness of the advantages and snares of the prior mentioned Code sections and situations, should be able to help his client maintain financial prosperity.

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187. Treasury regulation § 1.166-5(b)(2) (1959) provides that if the debt is proximately related to the taxpayer's trade or business at the time the debt becomes worthless, then the loss shall be treated as an ordinary loss in trade or business under § 165(c)(1). *United States v. Generes*, 405 U.S. 93, 103 (1972) (The shareholder made loans to the corporation for the purpose of permitting it to purchase machinery and equipment. The court held that the loss on the loan was not a business bad debt because the dominant motivation for the loan had no proximate relation to the shareholder's trade or business. The shareholder was limited to a § 166(d) capital loss.); *Robert E. Imel*, 61 T.C. No. 34 (Nov. 29, 1973) (The taxpayer was a bank officer, who made a loan to a person to whom the bank had refused to extend a loan. The taxpayer argued that (1) such loans were in connection with his business as a bank officer, and (2) that he was in the business of lending money. The court found that the taxpayer would not have lost his job for failure to make such a loan, rather his dominant motive was to secure new business for the bank so as to protect his investment. The court found that the worthless loan resulted in a § 166(d) nonbusiness bad debt subject to capital loss treatment.).

188. The Commissioner may impose § 165(f) capital loss treatment if the loss is due to a commitment which was essentially a capital investment.

189. See text accompanying note 177.