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William J. Rands

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William J. Rands†

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† Professor of Law, University of Cincinnati College of Law. B.A. Centenary College (1968), J.D. Tulane University (1973), member of Arkansas and Louisiana Bars.

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I. INTRODUCTION

The focus of this Article is the federal-tax treatment of incorporation and its centerpiece, section 351 of the Internal Revenue Code.1 Compared to much of the arcane language contained in Subchapter C of the Internal Revenue Code, the trip through the incorporation process is almost refreshing; although complex and detailed, the law is relatively coherent and sensible. It is, comparatively, an oasis of sanity. The Article begins by outlining the statutory regime for tax-free incorporations. It examines section 351’s theoretical and policy underpinnings. It studies

the system's requirements. It evaluates two of the more complex subsystems within the section 351 regime: liabilities and the "boot" rules.² It concludes with a discussion of two nettlesome problems associated with the incorporation process: the relationship of section 351 with other Subchapter C sections and midstream incorporation problems.

II. THE STATUTORY REGIME IN BRIEF

Section 351(a) of the Internal Revenue Code is the centerpiece of Subchapter C's subcode regulating the tax consequences for the incorporation process—it sets out the requirements for achieving a tax-free incorporation of a business.³ If its conditions are satisfied, no gain or loss is recognized by the parties contributing assets to the corporation in exchange for the transferee corporation's stock or securities.⁴ It also triggers a battery of other code sections⁵ that are part of the subcode that implements section 351's policy underpinnings.

Generally speaking, section 351 provides for the nonrecognition of gain or loss to a person or persons transferring property to a corporation solely in exchange for stock or securities of that corporation, if that person or persons are in control of the corporation immediately after the exchange.⁶ According to section 368(c) and its corresponding Treasury Regulations, a person or persons are in control of a corporation if they own at least 80% of the total combined voting power of the corporation and at least 80% of the total number of shares of each class of nonvoting stock.⁷ Section 357(a) states that the nonrecognition treatment accorded by section 351(a) is not disallowed merely because the property transferred is subject to a liability or the corporation assumes a liability of a transferor.⁸ If the corporation distributes cash or other property (boot) to a transferor in addition to shares or securities, the transferor then recognizes a realized gain but only to the extent of the money and fair market value of the boot.⁹ According to section 358, computing the basis of shares or securities received in a section 351 transaction starts with the basis the transferor had in the property he gave up,¹⁰ i.e., a substituted

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² See infra text accompanying notes 373-570.
³ I.R.C. § 351(a) (1986).
⁴ Id.
⁵ See id. §§ 357(a)(1), 357(c)(1)(A), 357(3), 358(a), 362(a)(1), 368(c), 1245(b)(3), 1250(d)(3).
⁶ Id. § 351(a).
⁸ I.R.C. § 357(a).
⁹ Id. § 351(b)(1).
¹⁰ Id. § 358(a)(1).
basis, but then requires four reductions and one addition. The reductions are for: (1) the fair market value of boot property distributed to the transferor;\(^1\) (2) the amount of money paid to the transferor;\(^2\) (3) the amount of the transferor's liabilities assumed by the corporation;\(^3\) and (4) the amount of liabilities encumbering the property transferred by the shareholder to the corporation.\(^4\) The addition is to increase the transferor's basis in his shares or securities by adding his recognized gain.\(^5\) The transferor takes a fair market value basis in the boot.\(^6\)

According to section 1032(a) of the Internal Revenue Code, no gain or loss is recognized to a corporation on the receipt of money or other property in exchange for its stock.\(^7\) Additionally, no gain or loss is recognized to a corporation on the receipt of money or other property in exchange for its own securities.\(^8\) If the transfer of property to the corporation in exchange for its stock or securities meets the requirements of section 351, section 362(a) requires the corporation to take a carryover basis in the property it received, i.e., it uses the transferor's basis as its basis in the property.\(^9\) The carryover basis is subject to one adjustment: The corporation increases its basis by the amount of any gain recognized to the transferor on the transfer.\(^10\)

11. Id. § 358(a)(1)(A)(i).
12. Id. § 358(a)(1)(A)(ii).
13. Id. §§ 358(a)(1)(A)(ii), 358(d)(1). If the transferee corporation assumes a liability of a transferor as part of a section 351 exchange, the liability is treated as money paid to the transferor for purposes of computing his basis in the stock or securities received in the exchange. Id. § 358(d)(1). Then he is required to decrease his basis in that stock or those securities by the amount of money paid to him, which, due to section 358(d)(1), includes his liability assumed by the corporation. Id. § 358(a)(1)(A)(ii).
14. Id. §§ 358(a)(1)(A)(ii), 358(d)(1). Liabilities encumbering transferred property are treated in the same manner as liabilities of the transferor that are assumed by the transferee corporation. See supra note 13 and accompanying text. Id.
15. Id. § 358(a)(1)(B)(i).
16. Id. § 358(a)(2).
17. Id. § 1032(a). Application of section 1032(a) does not depend on the tax treatment accorded the other party to the transaction, who, depending on the circumstances, can be taxed in a variety of manners. For example, he or she might be entitled to nonrecognition under section 351(a), be treated as a party to a fully taxable exchange under section 1001, or be treated as the recipient of taxable compensation under section 61.
18. In tax law the term "securities" usually refers to debt only, and not to stock. See Rands, The Closely-Held Corporation: Its Capital Structure and the Federal Tax Laws, 90 W. VA. L. REV. 1009, 1017 n.28 (1988). No code section is needed to accord nonrecognition to a corporation issuing its own debt to acquire property because the transaction is neither an exchange nor sale of property by the issuing corporation.
20. Id.
III. Theoretical and Policy Underpinnings

The theoretical underpinning for the nonrecognition rule of section 351 and its related sections is that the placement of assets in a corporation as part of the incorporation process is a change in the form and not in the substance of ownership. The same people own the same property, only now they have pieces of paper called stock certificates to evidence their ownership. Because they have not “cashed in” on their investment in the property, the exchange should not be taxable to them or to their controlled entity, the corporation. Inasmuch as they are in the same position after the transfer as they were before it, they are required to continue their pretransaction basis in their investment by using the basis they had in the transferred property as their basis in their shares or securities. Similarly, since the placement of the assets in the corporation is considered merely a change in form of ownership, no reason exists for changing the basis in the assets transferred to the corporation. The transferors’ basis in those assets is carried over to the corporation which takes that basis as its own. The substituted basis in the shares or securities and the carryover basis in the assets also serve to lock in any appreciation (or diminution) in the value of the assets that went untaxed (or not deducted) at the time of the section 351 transfer. Such appreciation or diminution will be recognized on a subsequent disposition of either the shares or securities or the transferred property.

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22. See sources cited supra note 21.

23. See I.R.C. § 358(a)(1) (1986). The substituted basis in the stock or securities is subject to the adjustments described in notes 10-16 and accompanying text. See also id. § 358(a)(1)(A), (B) (gain recognized added to basis: cash boot, fair market value of other boot property and liabilities transferred to corporation subtracted from basis).

24. Id. § 362(a)(1). The transferee corporation is entitled to increase the carryover basis by the amount of any gain recognized by the transferor. Id.

25. See, e.g., Hempt Bros., 490 F.2d at 1178-79 & nn.10-11; Barker v. United States, 200 F.2d 223, 228 (9th Cir. 1952); Consolidated Utility Co. v. Commissioner, 84 F.2d 548, 550 (5th Cir. 1936); T.W. Phillips Jr., Inc. v. Commissioner, 63 F.2d 101, 103 (3d Cir. 1933); Newman Saunders & Co. v. United States, 36 F.2d 1009, 1011-12 (Ct. Cl. 1929), cert. denied, 281 U.S. 760 (1930); Haas Bldg. Co. v. Commissioner, 22 B.T.A. 528, 534 (1931).

26. If the transferee corporation in a section 351 exchange is a dealer in the property transferred to it, naturally, it wants the highest basis possible in the property to minimize the amount of its recognized income on resale. If a cost basis would be higher than a carryover...
over basis also assures that the corporation will have the same depre-

27. Sometimes the stake in section 351 controversies is the depreciation deductions of the

28. The Code accords nonrecognition treatment to stock dividends, complete liquidations

29. For example, the merger of a small, privately held corporation into a publicly held
corporation may qualify as a tax-free reorganization, even though the shareholders in the
closely held corporation may exchange their illiquid stock for the marketable stock of the
publicly held corporation. See B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION

30. Any transferor of property is entitled to nonrecognition treatment under section 351(a)
if he is part of a group that transfers property and controls the corporation after the transfer.
S. LIND, S. SCHWARZ, D. LATHROPE & J. ROSENBERG, FUNDAMENTALS OF CORPORATE
TAXATION 58 (2d ed. 1987) [hereinafter LIND & SCHWARZ].

31. Id.
they have changed their positions, and this change in position is significant and could be taxed. But the section 351 nonrecognition system reflects the underlying basic policy that the United States tax law should not inhibit capital formation.32 People should be permitted to form corporations and transfer property to them without being taxed. Incorporation is not an appropriate time to impose a tax. To do so would inhibit something of crucial importance to the United States: the start-up of new businesses and the formation of capital.

IV. REQUIREMENTS OF SECTION 351

Section 351 and its related sections apply only to transfers of property to corporations that meet four basic requirements contained in section 351(a):33

1. there must be a transfer of property to the corporation;
2. the transferors must receive stock or securities of that corporation;
3. the shares or securities must be issued in exchange for the transferred property; and
4. immediately after the exchange, the transferors must be in control of the corporation, as control is defined in section 368(c).35

As simple as section 351(a) seems to be, it leaves innumerable interstices that Congress, the government and the courts have sought to fill with other Internal Revenue Code provisions, regulations, revenue rulings and court decisions.39 Fortunately, the government is often

34. Id.
35. Id. § 368(c).
36. Code sections other than section 351(a) are needed to deal with various other matters, including boot, liabilities, the transferor's basis in the stock or securities, services rendered in exchange for the shares or security and the tax treatment of the transferee corporation. See id. § 351(b) (treatment of recipient of boot); id. § 357 (impact of transferred liabilities on section 351 exchanges); id. § 358 (shareholder's and securityholder's basis in the stock, securities or boot received in a section 351 exchange); id. § 351(d) (services not treated as property in section 351 exchanges); id. § 362(a)(1) (transferee corporation's basis in assets received in section 351 exchange); id. § 1032(a) (nonrecognition treatment for transferee corporation issuing stock in section 351 exchange).
37. The regulations, for example, contain a rule that permits the Commissioner to disregard an exchange of property for stock or securities issued for property of relatively small value in comparison to the value of the stock and securities already owned by the property transferor, if the primary purpose of the transfer is to qualify exchanges of property with stock or securities by other persons transferring property. Treas. Reg. § 1.351-1(a)(1)(ii) (as amended in 1967). For operating rules considering the issuance of ruling letters about this regulation, see Rev. Proc. 77-37, 1977-2 C.B. 568.
38. For example, the Treasury has been active in issuing revenue rulings on what consti-
willing to issue advance rulings as to the applicability of section 351 to a proposed transaction. It has even prepared a detailed checklist that tax counsel can submit along with a request for a ruling.\textsuperscript{40}

\textbf{A. Transfer of Property to the Corporation}

For section 351 and its related sections to apply, there must be a transfer of property to the corporation.\textsuperscript{41} The term "property" includes real,\textsuperscript{42} personal,\textsuperscript{43} tangible\textsuperscript{44} and intangible\textsuperscript{45} property. It includes


39. The two most litigated section 351 areas are the definition of "stock" and "securities," see, e.g., Bradshaw v. United States, 683 F.2d 365 (Ct. Cl. 1982), and gauging the impact of the step transaction doctrine on the control requirement. Compare Culligan Water Conditioning of Tri-Cities, Inc. v. United States, 567 F.2d 867 (9th Cir. 1978) with S. Klein on the Square, Inc. v. Commissioner, 14 T.C. 786 (1950), aff'd, 188 F.2d 127 (2d Cir.), cert. denied, 342 U.S. 824 (1951).

40. See app. for Treasury's checklist set out in Rev. Proc. 83-59, 1983-2 C.B. 575 11. Revenue Procedure 86-3, 1986-1 C.B. 416 describes several section 351 issues for which the Internal Revenue Service will not issue advance rulings. The most important is the tax effect of an exchange when the transferor receives bonds, debentures or other debt and the term of the debt is either less than ten years or a determination as to whether the debt is properly classified as debt or equity is required in order to establish that the section 351 requirements are met. \textit{Id.} at 420. The Internal Revenue Service has also suspended the issuance of advance rulings for exchanges of widely held real estate or oil and gas interests in exchange for stock when the exchange is the result of solicitation by promoters, brokers or investment houses for the stock as issued in a form designed to render it readily tradeable. \textit{Id.} at 422. Also excluded from advanced rulings are exchanges of real property for a cooperative housing corporation for the stock of a commercial real estate corporation. \textit{Id.} at 421. Finally, the Internal Revenue Service will not rule on the applicability of section 351 to certain failed reverse triangular mergers. \textit{Id.} at 422.

Revenue Procedures 77-37, 1977-2 C.B. 568 sets out the rules for issuing a letter ruling for exchanges involving stock or securities issued for property of relatively small value in comparison to the value of stock and securities already owned by a property transferor. \textit{Id.}

41. I.R.C. § 351(a) (1986).


43. See, e.g., D'Angelo Assoc's. v. Commissioner, 70 T.C. 121 (1978) (transferred assets included dentist's equipment); Connolly Tool & Eng'g Co. v. Commissioner, 23 T.C.M. (CCH) 1222 (1964) (inventory).

44. The cases cited \textit{supra} notes 42 and 43 involved the transfer of tangible property.

cash, accounts receivable, choses in action, equitable interests in property, inventory, stock in trade, patents, technical know-how, leaseholds, trade names and trademarks, goodwill, and commerc-

§ 1.351-1(a)(2) (example (1)—property included manufacturing plant plus patent) (as amended in 1967).

46. See, e.g., Portland Oil Co. v. Commissioner, 109 F.2d 479 (1st Cir.), cert. denied, 310 U.S. 650 (1940); Halliburton v. Commissioner, 78 F.2d 265 (9th Cir. 1935); Holstein v. Commissioner, 23 T.C. 923 (1955); Rev. Rul. 69-19, 1969-1 C.B. 101. Someone who only pays cash for the stock does not need to rely on a special section to obtain nonrecognition treatment, because no gain or loss is ever recognized merely on the transfer of money. The significance of the treatment of money as property is that the contributor of cash can be included as a member of a group of transferors for purposes of determining whether the 80% control requirement is met. Kahn & Gann, Corporate Taxation and Taxation of Partnerships and Partners 559 (2d ed. 1984).

47. See, e.g., Hempy Bros., 490 F.2d at 1175; P.A. Birren, 116 F.2d at 719.

48. See, e.g., Roberts Co. v. Commissioner, 5 T.C. 1 (1945) (lawyer's assignment of claim to collect contingent fee); Ungar v. Commissioner, 22 T.C.M. (CCH) 766 (1963) (interest in contract right to buy property assigned to corporation). If the chose in action is based on services performed by the assignor, the Commissioner and courts sometimes are reluctant to classify that chose in action as property, thereby taking the exchange out of section 351. See, e.g., United States v. Frazell, 335 F.2d 487, cert. denied, 380 U.S. 961 (1965), on remand, 269 F. Supp. 885 (W.D. La. 1967).

49. See, e.g., Florida Mach. & Foundry Co. v. Fays, 168 F.2d 957 (5th Cir. 1948); Ocean Sands Holding Corp. v. Commissioner, 41 T.C.M. (CCH) 1 (1980), aff'd, 701 F.2d 167 (4th Cir. 1983), cert. denied, 454 U.S. 827 (1984); National Bellas Hess, Inc. v. Commissioner, 20 T.C. 636 (1953), aff'd, 220 F.2d 415 (8th Cir. 1955); Roberts, 5 T.C. at 1; Straubel v. Commissioner, 29 B.T.A. 516 (1933), aff'd, 76 F.2d 388 (3d Cir. 1935).

50. See, e.g., Connolly Tool, 23 T.C.M. (CCH) at 1222; see also B. Bittker & J. Eustice, supra note 29, ¶ 3.17.

51. See Connolly Tool, 23 T.C.M. (CCH) at 1224 ("property under contract or earmarked for customers"). Farmers have encountered problems when transferring growing crops to their controlled corporation, though less with the definition of property than with the assignment-of-income doctrine or with the clear reflection of income under sections 446 and 482. See, e.g., Rooney v. United States, 305 F.2d 681 (9th Cir. 1962); Weinberg v. Commissioner, 44 T.C. 233 (1965), aff'd in part and remanded in part, 386 F.2d 836 (9th Cir. 1967), cert. denied, 392 U.S. 929 (1968).


53. The area of technical know-how is controversial, because much of its value is often attributable to service performed either in the past or to be performed in the future by the transferor. See infra text accompanying notes 690-93. Nevertheless, it has sometimes been considered "property." See, e.g., E.I. Du Pont, 471 F.2d at 1211; Frazell, 335 F.2d at 490; Eli Lilly & Co. v. Commissioner, 84 T.C. 996 (1985); Rev. Rul. 71-564, 1971-2 C.B. 179; Rev. Rul. 64-56, 1964-1 C.B. 133, modifying Rev. Rul. 55-17, 1955-1 C.B. 388; Rev. Proc. 74-36, 1974-2 C.B. 491, amending Rev. Proc. 69-19, 1969-2 C.B. 301.


56. See R. & J. Furniture Co. v. Commissioner, 20 T.C. 857 (1953), rev'd on other grounds,
puter software.\textsuperscript{57} Stock or securities, however, are not to be considered as issued in return for "property" for purposes of section 351 if they are issued to pay for: (1) services rendered, or to be rendered, for the benefit of the corporation;\textsuperscript{58} (2) a debt of the transferee corporation not evidenced by a security;\textsuperscript{59} or (3) interest on a debt of the transferee corporation which interest accrued on or after the beginning of the transferor's holding period for the debt.\textsuperscript{60} Outside of these three exclusions, then, the term "property" includes virtually anything capable of being transferred as a matter of state law.

Of the three excluded items, the exclusion of services is the most important. Though the impact of the exclusion extends beyond what happens to the person performing the services,\textsuperscript{61} its purpose is simple enough—it assures that stock received in consideration for services rendered to the corporation is taxable to the recipient as compensation to

\textsuperscript{58} I.R.C. § 351(d)(1) (1986).
\textsuperscript{59} Id. § 351(d)(2). The Bankruptcy Tax Act of 1980 added section 351(d)(2) to the Code. Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, 94 Stat. 3406 (1980) (codified at 26 U.S.C. § 351(d)(2) (1988)). Its purpose is to allow creditors on open account to take an immediate bad-debt deduction for their claim against an insolvent corporate debtor, even though they take stock or securities of the corporate debtor. B. BrrIrker & J. Eustice, supra note 29, ¶ 3.02(2). Without section 351(d)(2), the open account creditor would probably be stuck with the general section 351(a) nonrecognition rule and thereby be pretermitted from taking its loss deduction. See Rev. Rul. 77-81, 1977-1 C.B. 97. Yet section 351(d)(2) could compel the transferor of an open-account debt with little or no basis, e.g., cash basis trade creditor, to recognize a gain on the exchange at that debt for the corporate debtor's stock, because section 351(d)(2) is not limited to insolvency situations. I.R.C. § 351(d)(2).

Section 351(e)(2) exempts from section 351 nonrecognition treatment issuance of stock or security to satisfy the indebtedness of a corporate debtor involved in a Chapter 11 (or similar) proceeding, whether or not the transferred debt is evidenced by a security. Id. § 351(e)(2).

Additionally, section 1276(d)(1)(C), added to the Code in 1986, taxes the accrued gain of a transferor of a market discount bond, despite section 351. See id. § 1276(d)(1)(C); see also B. BrrIrker & J. Eustice, supra note 29, ¶ 3.02(2).


\textsuperscript{61} For example, someone who furnishes only services in exchange for his stock is not counted among the "transferors of property" for purposes of determining whether persons who did transfer property own enough stock after their transfers to satisfy section 351's 80% control test. In one case, the tax court held that a 50% stockholder took his stock in return for services. James v. Commissioner, 53 T.C. 63 (1969). The result was that the whole transaction failed to qualify under section 351, because the other stockholder was the only transferor of property and he owned only 50% of the stock immediately after the exchange. Id. at 69; see also Columbia Oil & Gas Co. v. Commissioner, 41 B.T.A. 38 (1940), aff'd, 118 F.2d 459 (5th Cir. 1941).
the extent of the fair market value of the stock. Thus, the exclusion is a corollary to the general tax-law rule that compensation is to be treated as taxable income under section 61 of the Internal Revenue Code. Unfortunately, trying to ascertain whether the shares were issued for services or property is often difficult. For one thing, the private sector is unlikely to hoist a red flag to alert the government that the primary consideration provided by a shareholder for his stock was the performance of services and not the overvalued property that he listed on his tax return. Moreover, there are the gray areas of technical know-how, trade secrets, goodwill, customer lists and the like. Undoubtedly, such intangibles often carry a high value and hence are assignable in the business world. Much of their value, however, is often attributable to services performed in the past, or to be performed in the future, by the transferor. If someone conveys such an intangible in exchange for the shares or securities of a controlled corporation, has he transferred "property" or has he been compensated for services? Not an easy question!

A revenue ruling announced the government's acceptance of the proposition that technical know-how at least can constitute property that can be transferred, without recognition of gain or loss, in exchange for stock or securities under section 351. The revenue ruling held that the term "property" includes anything qualifying as "secret processes and formulas" within the meaning of section 861(a)(4) and 862(a)(4) of the Internal Revenue Code and any other secret information as to a device, process, or the like, in the general nature of a patentable invention, without regard to whether it is patentable in the patent-law sense.

Where the information transferred has been developed specifically...

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62. See, e.g., Frazell, 335 F.2d at 489; Mailloux v. Commissioner, 320 F.2d 60 (5th Cir. 1963); James v. Commissioner, 53 T.C. 63 (1969), aff'd, 118 F.2d 459 (5th Cir. 1971); Washburne v. Commissioner, 27 T.C.M. (CCH) 577 (1968).

63. In an interesting switch, in Hempt Bros., 490 F.2d at 1177, the taxpayer wanted section 351 not to apply to an assignment of accounts receivable to a controlled corporation. One of the taxpayer's arguments was "that income be taxed to him who earns it." Id. (citing Appellant's Brief at 32, Hempt Bros., Inc. v. United States, 490 F.2d 1172, cert. denied, 419 U.S. 826 (1974)). The court, however, determined that, first, accounts receivable constitute "property" that can be transferred tax-free under section 351. Id. at 1175. Second, it found that the assignment-of-income doctrine does not override section 351 nonrecognition treatment for the transfer of accounts receivable to the corporation. Id. at 1177-88.


66. Id.
cally for the transfeeree, however, the revenue ruling stated that the stock received in exchange for it must be treated as payment for services rendered. This result seems proper because the shares would then constitute payment for hired work and ought to be taxed like any other form of compensation. Where the transferor performs services that are merely ancillary and subsidiary to the property transfer, the revenue ruling would still allow nonrecognition treatment under section 351. For example, the transferor is allowed to demonstrate and explain the use of the property to promote the transaction.

While these guidelines from the revenue ruling are helpful in delineating how to deal with technical know-how developed in a manufacturing business, they do not offer much assistance in other contexts. For example, suppose that Anne operates a proprietorship in a service industry where client contacts are important and tangible assets are negligible. Over the years she has developed a regular clientele. If she incorporates her business with herself as sole shareholder, neither the government nor anyone else is likely to assert that any part of the process of incorporation should be taxable to Anne. Section 351 would seem to be intended to insulate exactly that type of a transaction from being deemed a taxable event. Suppose, however, that an out-of-town partnership in the same industry proposes that Anne join a consolidated business enterprise that is to include both the partnership and Anne’s proprietorship. Anne accepts the proposal, the consolidated enterprise incorporates, and Anne transfers her few tangible business assets plus a customer list to the corporation in exchange for a portion of its shares. The value of the shares exceeds the value of the tangible assets. The new corporation promptly hires Anne to manage its business in Anne’s city. Is the customer list “property” for purposes of section 351? Is it a disguise for an unwritten promise by Anne to perform services for the newly formed corporation? Is Anne transferring goodwill for her shares? Is goodwill “property” for purposes of section 351? Do the answers to these questions depend on whether anyone besides Anne can use the customer list? If no one else can, isn’t it true that the shares issued to Anne are for services to be rendered by her in the future? Even so, Anne is still transferring her own business assets to the corporation, though they may be negligible. Because she is transferring at least some property, can she be counted as a

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67. Id.
68. Id.
69. Id. at 134-35.
70. Certainly, goodwill sometimes can be “property” that can be transferred under section 351. See sources cited supra note 55.
"transferor of property" for purposes of the section 351 control test?\(^{71}\) If Anne's participation in the transaction involving the partnership is considered to be outside section 351, the tax treatment is contrary to the nonrecognition treatment that Anne would get if she incorporates with herself as sole shareholder. Is it logical to reach contradictory results in these two situations? Unfortunately, none of these questions are easy to answer. Clearly there are no pat generalizations. Tax counsel moves at his own peril if he or she does not seek a private ruling when encountering these types of situations.

B. Transferors' Receipt of Controlled Corporation's Stock or Securities

Section 351(a) requires the transferor of property to the controlled corporation to receive stock or securities in such corporation in exchange for his property.\(^ {72}\) To receive complete nonrecognition, he can receive nothing other than the controlled corporation's stock or securities. If the consideration paid to the transferor consists entirely of cash or a debt of the corporation not amounting to a security (or both), the transaction is a taxable sale not covered by section 351 at all with the transferor as the seller and the corporation as the buyer.\(^ {73}\) The seller usually recognizes his gain\(^ {74}\) (or loss if he can avoid falling under section 267).\(^ {75}\) Because it is merely buying something, the corporation recognizes neither a gain nor a loss and takes a cost basis in the purchased property.\(^ {76}\) If the cor-

\(^{71}\) If Anne transfers no property at all, she is not among the group of transferors of property who must "control" the corporation for section 351 to apply. If she transfers property and performs services for her stock, she is considered one of the transferors and all the stock she owns can be counted towards meeting the control test, provided the amount of stock received for the property is not relatively insubstantial compared to the amount of stock received for the services and she is not transferring property merely to accommodate others who want section 351 treatment but own too little stock to qualify for control without her. See Treas. Reg. § 1.351-1(a)(1)(ii) (as amended in 1967).

\(^{72}\) I.R.C. § 351(a) (1986).

\(^{73}\) See, e.g., Bradshaw v. United States, 683 F.2d 372 (Ct. Cl. 1982); Piedmont Corp. v. Commissioner, 388 F.2d. 886 (4th Cir. 1968); Burr Oaks Corp. v. Commissioner, 365 F.2d 24 (7th Cir. 1966); Aqualane Shores, Inc. v. Commissioner, 269 F.2d 116 (5th Cir. 1959); Laugerquist v. Commissioner, 53 T.C.M. (CCH) 530 (1987). Indeed, the sale/section 351 exchange or capital contribution controversy has been heavily litigated.

\(^{74}\) See, e.g., Bradshaw, 683 F.2d at 371-72.

\(^{75}\) Section 267(a)(1) prohibits a deduction for a loss on the sale or exchange of property between specified related parties. See I.R.C. § 267(a)(1) (1986). "Related parties" governed by this rule include individuals owning 50% or more of the controlled corporation. Id. at § 267(b)(2). Furthermore, section 267 can trap the unwary. For example, the transferor of loss property taking back only 79 percent of the stock might expect to recognize his loss because he lacks the 80 percent control required by section 351. Indeed, he is outside of section 351, but section 267 nevertheless prohibits a loss deduction for him because the loss was sustained in a transaction between related parties.

\(^{76}\) The stake in many of these cases is the transferee corporation's basis in the transferred
poration uses any other sort of property (excluding its own stock or securities) to pay for the acquired assets, the transaction is a taxable exchange. The corporation as well as the other party to the exchange recognize a gain or loss computed by using the fair market value of the property received as the amount realized and subtracting from it the adjusted basis in the property given up. Each party takes a cost basis in his new property.

According to section 351(a), nonrecognition treatment is accorded when property is transferred to the corporation solely in exchange for stock or securities in such corporation. The word “solely” is misleading. One might infer that if the corporation distributes anything other than its own shares or securities, the transaction will be outside section 351. However, this inference is incorrect; “solely” does not mean solely. If the transferors, in addition to the stock or securities permitted to be received under section 351(a), receive money or other property “to boot,” section 351 and its related sections still apply. However, under section 351(b)—the “boot” section—the recipient of the other property or money must recognize any realized gain to the extent of the money and the fair market value of any other property he received. In addition, the transferee corporation recognizes a gain or loss if it transfers recognition property other than cash or its own debt in exchange for the acquired assets.

The tax law adds a few wrinkles when the transferor of property receives both stock and debt in the exchange. If the debt is treated as a security, the transaction is nontaxable under section 351. If the debt is

77. It would be odd for a transferring corporation to use property other than its own debt, stock or cash to acquire assets. If for some reason it did, the exchange would be taxable under I.R.C. section 1001. One such possible exchange would be a corporate division that fails one of the statutory or common-law requirements for tax-free status.


79. See Philadelphia Park, 126 F. Supp. at 188. The amount realized is a party’s cost basis in a taxable exchange.

80. I.R.C. § 351(a).

81. I.R.C. § 351(b).

82. Id. §§ 351(b), 358(a)(2); see also Winterburn v. Commissioner, 27 T.C.M. (CCH) 910, 915 (1968).

83. Without a nonrecognition section to exempt the exchange from taxation, the corporation must recognize a gain or loss under the normal rule of section 1001. Id. § 1001.

84. Section 351 provides for nonrecognition treatment to the transferor when he received either “stock or securities.” I.R.C. § 351(a) (emphasis added); see also Rands, supra note 18, at 1084.
reclassified as stock, the transaction is also nontaxable.\textsuperscript{85} If the debt is honored as a debt not amounting to a security, it is treated as boot with the boot recipient recognizing any realized gain to the extent of the boot received.\textsuperscript{86} The boot recipient takes a fair market value basis in the boot,\textsuperscript{87} which ordinarily ought to be the face value of the debt. Since payments on retirement of debt are a nontaxable return of capital up to the holder’s basis in the debt and the holder’s basis in the non-security debt is probably face value, the debtholder is unlikely to have any additional taxable gain upon repayments of principal. Of course, interest payments will be ordinary income. The transferee corporation’s basis in the transferred property will be an exchanged (carryover) basis plus the gain recognized, if any, to the transferor on the account of the boot.

Neither the Internal Revenue Code nor the regulations define “stock” or “security.”\textsuperscript{88} Those two terms have generated substantial law review commentary,\textsuperscript{89} including some by this author,\textsuperscript{90} and innumerable

\begin{footnotesize}
\begin{enumerate}
\item See Rands, supra note 18, at 1083.
\item I.R.C. § 351(b); see, e.g., Wham Constr. Co. v. Commissioner, 600 F.2d 1052, 1054 (4th Cir. 1979); Turner v. Commissioner, 303 F.2d 94, 96 (4th Cir.), cert. denied, 371 U.S. 922 (1962), on remand, 23 T.C.M. (CCH) 952 (1964), aff’d, 343 F.2d 150 (4th Cir. 1965); see also Rev. Rul. 80-228, 1980-2 C.B. 115. See generally Rands, supra note 18, at 1084.
\item I.R.C. § 358(a)(2).
\item Section 385 of the Internal Revenue Code authorizes the Secretary of the Treasury to prescribe regulations to determine whether an interest in a corporation is to be treated as stock or debt. \textit{Id.} § 385(a). Section 385(b) sets forth five factors that “the regulation may include among other factors.” \textit{Id.} § 385(b). Section 385 was hailed by leading commentators as “perhaps the most important and potentially far-reaching corporate provision added by the Tax Reform Act of 1969.” B. Brittker & J. Eustice, supra note 29, ¶ 4.05. Its literature was replete with predictions as to the contents of the regulations. \textit{Id.} at 4-16 to 4-19; see also Recommendations as to Federal Tax Distinction between Corporate Stock and Indebtedness, N.Y. State Bar Assn. Tax Section Committee on Reorganization Problems, 25 TAX LAW. 57 (1971). In March, 1980, the Treasury issued a lengthy, detailed and controversial set of proposed regulations. 45 Fed. Reg. 18,957 (1980). These regulations promulgated in December, 1980, were to be effective for investments after April 30, 1981, but the Treasury twice extended their effective date in the face of criticism from the tax bar and the special interest groups. Extensive amendments were proposed in December, 1981, followed by still further extensions of the extension date. In July, 1983, all versions of the regulations were withdrawn, and it is likely that the entire project will be abandoned. See Lind & Schwarz, supra note 30, at 114.
\item See, e.g., Rands, supra note 18, at 1088-99.
\end{enumerate}
\end{footnotesize}
reported judicial opinions.91

Nevertheless it is possible to make some generalizations about the two terms. Stock generally refers to what is known in non-tax circles as "equity securities."92 It includes non-voting93 as well as voting94 and preferred95 as well as common.96 The section 351 regulations declare that the term "stock or securities" does not include rights or stock warrants.97

As it is used in tax law, the term "securities" is limited to what is known in non-tax circles as "debt securities."98 This limitation in definition is not found in the financial world where the term "securities" includes equity securities as well as debt securities.99 Unlike in the financial world, in tax law a debtor-creditor relationship must exist for an interest in a corporation to be counted as a "security."100 Additionally, in tax law the term "security" contemplates a corporate debt that amounts to an investment in the corporation—one that represents an integral part of the corporation's long-term financial planning.101 For
example, a debt owed by a corporation to a supplier on an open account is not a security while a twenty year promissory note constituting a significant portion of its capital structure is considered a security.102

Despite protestations to the contrary,103 once it has been decided that an instrument is bona fide debt and not equity, the term of the debt is clearly the single most important factor in determining whether a debt obligation amounts to a security.104 Debt instruments payable in full within five years usually are not considered securities,105 except under unusual circumstances.106 Such debts are too close to a cash equivalent to be considered an investment in the business, a sine qua non for securities status.

In contrast, a debt instrument maturing at ten years or more is likely to be considered a security,107 for then it is an integral part of the corporation's capital structure. Though some commentators have considered debts maturing within a five to ten year period to be of questionable status,108 debts within that time frame generally have been classified as securities.109 Debts calling for payments both before and after the five year dividing line have been classified both ways, with authorities looking at both the average term and the date of final payment.110

102. See Crofoot v. Commissioner, 4 T.C.M. (CCH) 97 (1945).
103. See, e.g., Bradshaw, 683 F.2d at 377; Sisto Fin. Corp., 139 F.2d at 255; Nye, 50 T.C. at 212; Camp Wolters, 22 T.C. at 751; see also Plumb, supra note 89, at 562.
104. See, e.g., Bradshaw, 683 F.2d at 377 n.28; Dennis, 473 F.2d at 283; Hertwig, 398 F.2d at 455; Campbell, 322 F.2d at 832-35; see also B. Bittker & J. Eustice, supra note 29, ¶ 3.04; Plumb, supra note 89, at 562-63; Rands, supra note 18, at 1089.
105. See Pinellas Ice & Storage Co., 287 U.S. at 468-69; Bradshaw, 683 F.2d at 377 n.28; Neville Coke & Chem. Co., 148 F.2d at 602; Nye, 50 T.C. at 212 n.9; B. Bittker & J. Eustice, supra note 29, ¶ 3.04; Plumb, supra note 89, at 562-63; Rands, supra note 18, at 1089.
106. See Campbell, 322 F.2d at 832-35; Plumb, supra note 89, at 563; Rands, supra note 18, at 1090.
107. Bradshaw, 683 F.2d at 377 n.28; see, e.g., Hertwig, 398 F.2d at 455 (12 1/2 years); Burnham v. Commissioner, 86 F.2d 776 (7th Cir. 1936)(10 years), cert. denied, 300 U.S. 683 (1937); Parkland Place Co. v. United States, 248 F. Supp. 974 (N.D. Tex. 1964)(10 years), aff'd, 354 F.2d 916 (5th Cir. 1966); Nye, 50 T.C. at 214 (10 year installments); see generally Kaufman, supra note 89, at 119; Plumb, supra note 89, at 563; Rands, supra note 18, at 1089.
108. Kaufman, supra note 89, at 120; Plumb, supra note 89, at 563; Rands, supra note 18, at 1089.
109. See, e.g., Helvering v. Watts, 296 U.S. 563 (1935) (one to seven year bonds were securities); Parkland Place, 354 F.2d at 918 (ten year promissory note was security); Campbell, 322 F.2d at 834-35 (five year promissory note held to be security); Commissioner v. Freund, 98 F.2d 201 (3d. Cir. 1938) (six year serial bonds deemed to be security); Burnham, 86 F.2d at 777 (ten year promissory classified as security); Camp Wolters, 22 T.C. at 753 (installment notes payable between five and nine years held to be security); see also Plumb, supra note 89, at 563-64; Rands, supra note 18, at 1089.
110. See Rev. Rul. 59-98, 1959-1 C.B. 76; Rev. Rul. 56-303, 1956-2 C.B. 193; see also Bradshaw, 683 F.2d at 377 n.28; Hertwig, 398 F.2d at 455; Nye, 50 T.C. at 213.
The rationale for the stock or securities requirement is subtler than that for some of the other requirements. After all, if the transferor controls the transferee corporation, what difference should the type of consideration he receives make? The transferor still owns the transferred property, because he owns the corporation, no matter what he received in exchange for the property. The rationale seems to be that at the heart of the "stock or securities" requirement is the desire to make certain that "sales" of properties are taxable to the seller. The tax law does not want someone who has "cashed out" on his property to avoid recognition of his gain. If the transferor is paid with cash or with property not amounting to an ownership interest in the corporation, he owns something he did not own before, cash or the other piece of property. The transferor is "cashed out" on that property—he has turned it into something different than the transferred property itself.

This rationale makes sense when all the transferor receives in exchange for his property is stock of his controlled corporation. At that point he is neither cashed in on a hypothetical gain nor closed out on a hypothetical loss. His position is essentially unchanged. Before the exchange he owned the piece of property. Afterwards he owns a corporation that owns the same piece of property. All that he got in the transaction is a piece of paper that says he owns the corporation that owns the piece of property that he transferred. The receipt of stock requirement serves the purpose of separating a change in form—something that should be nontaxable—from a sale, something that should be taxable.

On the other hand, this rationale falters considerably for the transferor in a section 351 exchange who takes securities rather than stock of the controlled corporation. Indeed, it is curious that section 351 even accords nonrecognition treatment for the recipient of securities. The transferor of the property is making himself a creditor of the corporation when before he was the outright owner of the property that he conveyed to the corporation. Other nonrecognition code sections in corporate tax law make the change from an equity to a debt position a taxable event. Whether or not it is, section 351 seems to leave no doubt that transfers of property to a controlled corporation in exchange for securities is tax free. There could be a deeper policy reason for allowing nonrecognition—perhaps the purpose is to accommodate the owners of a closely-held venture who, for non-tax reasons, often desire some shareholder-held debt in their capital structure as a hedge.

112. Id. § 351(a).
against bankruptcy.\textsuperscript{113} Again, the United States wants to encourage the formation of new business, and maybe this accommodation of the small business owner will promote that policy, notwithstanding the weakness of the change-of-form rationale, as applied to property-for-securities transactions.\textsuperscript{114}

Two companion revenue rulings help to explain the role of securities in section 351 exchanges.\textsuperscript{115} In the first of these rulings, pursuant to a plan, four individuals (\emph{A, B, C} and \emph{D}) each transferred property of equal value to a newly organized domestic corporation.\textsuperscript{116} \emph{A, B} and \emph{C} received all of the stock in exchange for their property. \emph{D} received securities but no stock of the corporation in exchange for his property.\textsuperscript{117} The government opined that \emph{A, B} and \emph{C} would not recognize a gain or loss, because they maintained a proprietary interest in the property transferred through stock ownership which put them in control of the corporation within the meaning of section 368(c). \emph{D}, on the other hand, was not covered by section 351, because he was not part of a group that "controls" the corporation according to section 368(c), which is one of the requirements for section 351 treatment.\textsuperscript{118} The ownership of securities in such a corporation, even though representing a bona fide indebtedness, provided him with no proprietary interest in the corporation, but rather, with an interest only as a creditor. \emph{D} failed to qualify under the continuity-of-interest principle and, accordingly, \emph{D} was required to recognize a gain or a loss.\textsuperscript{119}

When one bears in mind that section 351 unequivocally provides nonrecognition treatment for the exchange of property for securities, one might question the above revenue ruling which would tax \emph{D} when he exchanges his property for securities.\textsuperscript{120} The law is clear that a group of transferors is to be treated as a single unit for purposes of the section 351 control test, provided it acts pursuant to a plan.\textsuperscript{121} \emph{D} would seem to meet all of the section 351 criteria, even though he received securities only and no stock: (1) \emph{D} transferred property to the corporation; (2) \emph{D} received securities in such corporation; (3) the securities were in exchange for the property transferred; and (4) because \emph{D} and \emph{A, B} and \emph{C}

\begin{thebibliography}{121}
\bibitem{113} See generally Rands, \emph{supra} note 18.
\bibitem{114} See \emph{supra} notes 21-32 and accompanying text.
\bibitem{117} \emph{Id.}
\bibitem{118} I.R.C. \S\ 368(c).
\bibitem{120} \emph{Id.} at 116.
\bibitem{121} See I.R.C. \S\ 318 (constructive stock ownership rules).
\end{thebibliography}
acted as a group. D was part of the group that controlled the corporation immediately after the transfer. The primary source of authority cited by the government in the revenue ruling was a 1940 Supreme Court decision that declined to treat an exchange of all of the assets of one corporation for bonds of another corporation as a tax-free reorganization under the Revenue Act of 1928. In that case, neither the selling corporation nor its sole stockholder took any equity in the acquiring corporation. Hence, the whole transaction failed under the continuity-of-interest doctrine. The facts of the revenue ruling are distinguishable in that A, B and C did take stock in the controlled corporation and thus at least a major part of the transaction satisfied continuity-of-interest principles. More importantly, unlike the Revenue Act of 1928, the Internal Revenue Codes of 1954 and 1986 contain explicit rules in the reorganization sections that make a change in status from stockholder to securityholder a taxable event. Current section 351 has no corresponding provision, even though the reorganization sections show that Congress was aware of the issue when it enacted the Codes.

In the other companion revenue ruling, four individuals (A, B, C and D again) already owned all of the outstanding stock of a domestic corporation, which had been operating for a number of years. Each

125. Id.
126. Id. For a discussion of the continuity-of-interest doctrine see infra notes 127-40 and accompanying text. See also B. Bittker & J. Eustice, supra note 29, ¶ 3.04.
130. Id. § 351. D did not retain a proprietary interest in the enterprise to which he transferred the property. See Rev. Rul. 73-472, 1973-2 C.B. 115. For cases supporting the government's position, see, e.g., LeTulle, 308 U.S. at 419-21; Pinellas Ice & Cold Storage Co., 287 U.S. at 468-70; West Side Fed. Sav. & Loan Ass'n, 494 F.2d 404 (6th Cir. 1974); Roebling v. Commissioner, 143 F.2d 810 (3d Cir.), cert. denied, 323 U.S. 773 (1944); Commissioner v. American Light & Traction Co., 125 F.2d 365 (7th Cir. 1942); Helvering v. New President Corp., 122 F.2d 92 (8th Cir. 1941). See generally Posin, Taxing Corporate Reorganizations: Purging Penelope's Web, 133 U. PA. L. REV. 1335, 1360 (1985); Turnier, Continuity of Interest—Its Application to Shareholders of the Acquiring Corporation, 64 CAL. L. REV. 902, 921 (1976).
131. See I.R.C. § 368(a)(1).
132. These comments are not intended to mean that the government's position is not fully untenable. The courts probably would accept it. After all, looking at D and at D standing alone, he fails the continuity-of-interest test. Perhaps the best way to put it is that the government's position is debatable, though not necessarily wrong.
transferred property to the corporation in exchange solely for securities of the corporation. The government held that no gain or loss was recognized to A, B, C or D, because each owned a proprietary interest in the transferee corporation immediately after the transfer as represented by their ownership of stock in the corporation. While it might be strange to accord nonrecognition treatment for this change from an equity to a debt interest, the language of section 351 strongly supports this revenue ruling. Section 351 clearly covers transfers of property to a controlled corporation in exchange for securities of the corporation. Unlike the reorganization sections, section 351 contains no special rules that make a taxable event the change from equity to debt. The continuity-of-interest principle is not violated, because A, B, C and D all own stock in the corporation after the transaction is completed.

C. Exchange of Property for Stock or Securities

For section 351 to apply, the transferee corporation must issue its shares of securities in exchange for the transferred property. Though not usually controversial, this exchange requirement can generate disputes when the transferor retains an interest in intangible property transferred to the corporation. The issue closely parallels those involving

134. Id.
135. Id. at 116.
137. Id.
139. Id. § 351.
142. B. Bittker & J. Eustice, supra note 29, ¶ 3.04, at 3-14. For decisions involving such controversy, see First Victoria Nat'l Bank v. United States, 620 F.2d 1096 (5th Cir. 1980); E.I. Du Pont de Nemours & Co. v. United States, 471 F.2d 1211 (Ct. Cl. 1973); Magnus v. Commissioner, 259 F.2d 893 (3d Cir. 1958); Hickman v. Commissioner, 29 T.C. 864 (1958); Claude Neon Lights, Inc. v. Commissioner, 35 B.T.A. 424 (1937); see also I.R.C. § 1235 (transfers of all substantial rights to a patent); id. § 1253 (transfers of franchises, trademarks and trade names). While a transfer of franchise rights and the like to a controlled corporation in exchange for its stock could, on its face, be considered to constitute a prohibited "retained interest" transfer under section 1253, that provision presumably ought not to be read to deny section 351 nonrecognition treatment to incorporation transfers of such property in the absence of a clear congressional intent to this effect. The stated purpose of section 1253 was to clarify the sale/license distinction in the case of a taxable transfer of franchises, not to prohibit the tax-free incorporation of such items. See generally Olson, Federal Income Taxation of Patent & Know-How Transfers, 28 St. Louis U. L. J. 537 (1984); Stiner, The Tax Consequences of Transferring Patent Rights in an Invention, 31 Pract. Law. 81 (1985).
the definition of "property" discussed above.\textsuperscript{143} The concern of the government is that the retention of a substantial interest in the intangible property might make the transfer itself no more than a granting of a license to use the property, payments for which ordinarily are taxable immediately as ordinary income.\textsuperscript{144} Moreover, shares or securities constitute capital assets to the transferor.\textsuperscript{145} In the halcyon days of preferential treatment for long-term capital gains, if a transferor waited six months before selling the stock, a transferor could have turned an ordinary income item (the license) into a long-term capital gain.\textsuperscript{146} Hence, the government has wanted section 351 not to apply and the shares or securities to be treated as royalties, i.e., taxable immediately to the transferor as ordinary income.\textsuperscript{147} Emphasizing the presence of the word "exchange" within the statutory language of section 351, the government has contended that the section 351 exchange requirement should be equated with the concept of "sale or exchange" under the capital gains provisions of the Internal Revenue Code.\textsuperscript{148} Importing the definition of the word "exchange" from the capital gains sections, the government would require an "unqualified right in perpetuity . . . of all substantial rights in the property" for section 351 to apply.\textsuperscript{149} The Court of Claims has rejected the government position.\textsuperscript{150} In \textit{E.I. Du Pont de Nemours & Co. v. United States},\textsuperscript{151} a parent corporation had granted its wholly-owned subsidiary a royalty-free, nonexclusive license to make, use and sell herbicides under patents belonging to the parent, which retained all other rights to the patents.\textsuperscript{152} In exchange for

\begin{footnotesize}
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\item The concern of the government is that the retention of a substantial interest in the intangible property might make the transfer itself no more than a granting of a license to use the property, payments for which ordinarily are taxable immediately as ordinary income.\textsuperscript{144}
\item Moreover, shares or securities constitute capital assets to the transferor.\textsuperscript{145}
\item In the halcyon days of preferential treatment for long-term capital gains, if a transferor waited six months before selling the stock, a transferor could have turned an ordinary income item (the license) into a long-term capital gain.\textsuperscript{146}
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\item Importing the definition of the word "exchange" from the capital gains sections, the government would require an "unqualified right in perpetuity . . . of all substantial rights in the property" for section 351 to apply.\textsuperscript{149}
\item The Court of Claims has rejected the government position.\textsuperscript{150}
\item A parent corporation had granted its wholly-owned subsidiary a royalty-free, nonexclusive license to make, use and sell herbicides under patents belonging to the parent, which retained all other rights to the patents.\textsuperscript{152}
\end{enumerate}
\end{footnotesize}
this grant and in lieu of royalties, the parent corporation received stock in the subsidiary.\textsuperscript{153} The government took the position, described above,\textsuperscript{154} that the transfer of the licenses for the shares did not amount to an exchange for purposes of section 351 because the transfer did not result in a complete divestiture of all of the parent’s interest in the patents.\textsuperscript{155} The Court of Claims found a “compelling reason” for not importing the capital gains exchange requirement into section 351—section 351 and the capital gains sections have directly opposing aims. The capital gains section stresses the completeness of disposition by the transferor, while section 351 emphasizes the transferor’s continuing dominion over the property through its requirement that the transferor control the transferee corporation.\textsuperscript{156} The court stated that if continuation of control is the essence of section 351, it would be “odd to hold” that retention of some of the economic rights in the transferred property by the transferor ought to be a taxable event.\textsuperscript{157} The transferor is then giving up less than he would if he transferred all his rights in the property for shares or securities, an exchange that undoubtedly would qualify under section 351.\textsuperscript{158}

The government position was not completely without merit. Section 351 uses the word “exchange”\textsuperscript{159} and that word has a definite meaning in the capital gains provisions of the Code.\textsuperscript{160} According to the drafting rule of parallelism, it is good draftsmanship to give the same meaning to the same word throughout one statute or document.\textsuperscript{161} Thus, it would make sense that “exchange” means the same thing in different sections of the Internal Revenue Code.

Nevertheless, the Court of Claims position in \textit{Du Pont} seems superior.\textsuperscript{162} It is improbable that Congress was thinking about the drafting

\textsuperscript{153} Id.
\textsuperscript{154} See supra notes 141-49 and accompanying text.
\textsuperscript{155} \textit{E.I. Du Pont}, 471 F.2d at 1213-15.
\textsuperscript{156} \textit{Id.} at 1217-18.
\textsuperscript{157} \textit{Id.} at 1218-19.
\textsuperscript{158} \textit{Id.} at 1219.
\textsuperscript{159} I.R.C. § 351(a).
\textsuperscript{160} Sections 1222, 1231 and 1235, for example, all use the term “exchange.” See I.R.C. §§ 1222, 1231, 1235. For a discussion of the meaning of the term “exchange” in a capital gains case, see \textit{E.I. Du Pont}, 471 F.2d at 1217-18.
\textsuperscript{161} The drafting rule described as parallelism is the fundamental concept of consistency in drafting statutes, that words and expressions recurring through the statute be given the same meaning. R. Dickerson, \textit{The Fundamentals of Legal Drafting} 11-12 (1965). When words are used in a consistent and repetitious manner in statutes, the legislative intent may be inferred that these words were intended to have the same meaning. A. Russell, \textit{Legislative Drafting and Forms} 13 (4th ed. 1938).
\textsuperscript{162} \textit{E.I. Du Pont}, 471 F.2d at 1214.
rule of parallelism when it used the word "exchange" in these two dispa-
rate sections of the Code, sections that have contrasting objectives. More
importantly, in Du Pont the patents had not yet earned any income for
the parent at the time of the transfer.\textsuperscript{165} No outsider had paid anything
to use them.\textsuperscript{164} The parent still owned all rights to the patents, although
a few of those rights had been dropped down to the subsidiary in ex-
change for shares of the subsidiary.\textsuperscript{165} Plainly the same taxpayer owned
the same assets, although part of it had been placed inside another corpo-
rate shell: There had yet to be a true cashing in on the patents. True, the
parent had exchanged an ordinary income item (a nonexclusive license)
for a capital asset (stock), but that sort of change is common in section
351 exchanges. Moreover, this change can hardly be said to be a tax
shelter. The transferred items retain their ordinary income status in the
hands of the transferee corporation,\textsuperscript{166} and the transferor's holding pe-
riod begins on the date of the exchange.\textsuperscript{167} Assuming a regime favoring
long-term capital gains, any sale of shares within six months of the ex-
change would entitle the transferor to short-term capital gain (or loss)
only.\textsuperscript{168} Furthermore, the retention of some of the attributes of owner-
ship attached to a particular item of property by the transferor does not
preclude the transferred rights from constituting "property" for purposes
of section 351. The right to \textit{use} property is "property" within the mean-
ing of the section.\textsuperscript{169} If accepted, the government's position would un-
dercut tax-free treatment for what is indeed an exchange of property for
shares of securities, a transaction that meets the literal requirements
of section 351. The government's importation of the definition of "ex-
change" from such an inapposite part of the Code as the capital gains
provisions, which have an objective diametrically opposed to that of sec-
section 351, hardly justifies removing a transaction that facially meets the
section 351 requirements from the coverage of that section.

Is the taxpayer "safe" in assuming that the retention of some of the
attributes of ownership in intangible property will not disqualify a trans-
fer of several of the other attributes from tax-free treatment under section

\begin{itemize}
\item \textsuperscript{163} \textit{Id.} at 1212.
\item \textsuperscript{164} \textit{Id.}
\item \textsuperscript{165} \textit{Id.} at 1219.
\item \textsuperscript{166} I.R.C. \textsection 1221(1). The license on the patent would be used to produce stock in trade or
inventory, types of property expressly excluded from the term "capital asset." \textit{Id.}
\item \textsuperscript{167} \textit{Id.} \textsection 1223(1).
\item \textsuperscript{168} \textit{Id.} \textsections 1222(1), (2).
\item \textsuperscript{169} See, e.g., R. & J. Furniture Co. v. Commissioner, 20 T.C. 857, 865 (1953), \textit{rev'd on other
grounds}, 221 F.2d 795 (6th Cir. 1955) (leasehold interest was held to be property for a
section 351 purpose).
\end{itemize}
351? The answer to that question would have to be "no." While the government has suffered losses in the courtroom, it has not budged from its position that the transferor must give up substantially all rights in the property for perpetuity. Unless tax counsel is willing to march down to the courthouse, perhaps he or she should either seek an advance ruling from the government or transfer all rights connected with the intangible property to the corporation in the section 351 transfer.

D. Control of the Transferee Corporation

1. Rationale

Section 351(a) of the Internal Revenue Code provides for the non-recognition of gain or loss to a person or persons transferring property to a corporation solely in exchange for stock or securities of that corporation, but only if that person or persons are in control of the corporation immediately after the exchange. According to section 368(c) and the regulations, that person or persons are in control of the corporation if they own at least 80% of the total combined voting power of the corporation and at least 80% in number of the shares of all nonvoting classes.


of stock.\textsuperscript{172} The purpose of the control requirement is to enforce the continuity-of-interest principle that underlies the nonrecognition treatment accorded by section 351.\textsuperscript{173} If the transferors of the property own 80\% or more of the transferee corporation, they have preserved their proprietary interest in the transferred property by virtue of their stock ownership and ought not to be taxed for what amounts to a change in form but not in substance of their ownership.\textsuperscript{174} Inversely, a transfer of property to a corporation not controlled by the transferors is more than a change in the form of ownership because the transferors are giving up their dominion over the transferred property. The transaction is no longer an internal rearrangement of the transferor's own assets accompanied by no sacrifice of control.\textsuperscript{175} Instead, third parties—the other shareholders in the corporate transferee—acquire a substantial, albeit indirect, interest in the transferred property. Hence, the exchange is like a sale and ought to be taxable to the transferors.\textsuperscript{176}

2. 80\% requirement

Though it is by no means exclusive, 80\% stock ownership is a common watershed in measuring a controlling stock interest in corporate tax law.\textsuperscript{177} In a sense it is arbitrary; it could just as well be 70\% or 75\% or any other arbitrarily chosen percentage. It is more the product of line-drawing, however, than capricious behavior by Congress. For example, let us look at a person, Anne, who is the sole owner of a piece of property. If she transfers that property to a corporation for 100\% of its shares, she has not given up any rights in that property. As sole shareholder, she picks out whomever she wants to run the corporate affairs. Thus, she retains control over the use of the property. Any income generated by the property inures solely to her benefit; she can either take it out of corporate solution through dividends or salaries, or she can leave it in the corporation to build up the book value of her shares. If she

\textsuperscript{172} I.R.C. \S 368(c); Treas. Reg. \S 1.368-2(c) (as amended in 1986).
\textsuperscript{173} Six Seam Co. v. United States, 524 F.2d 347, 355 (6th Cir. 1975); E.I. Du Pont de Nemours & Co. v. United States, 471 F.2d 1211, 1214-16 (Ct. Cl. 1973); Portland Oil Co. v. Commissioner, 109 F.2d 479, 488 (1st Cir.), \textit{cert. denied}, 310 U.S. 650 (1940).
\textsuperscript{174} See Heverly v. Commissioner, 621 F.2d 1227, 1243 (3d Cir. 1980); \textit{E.I. Du Pont}, 471 F.2d at 1214-18; Heberlein Patent Corp. v. United States, 105 F.2d 965, 968 (2d Cir. 1939).
\textsuperscript{175} See \textit{Six Seam Co.}, 524 F.2d at 355; \textit{E.I. Du Pont}, 471 F.2d at 1214.
\textsuperscript{176} See, e.g., I.R.C. \S\S 318(a)(2)(C), (3)(C) (1986) (50\% or more in value ownership test to trigger the section 318 constructive stock ownership rules).
\textsuperscript{177} See, e.g., I.R.C. \S 332(b)(1) (liquidation of subsidiary); \textit{id.} \S 338(d)(3) (stock purchases treated as asset acquisitions); \textit{id.} \S 355(a)(1)(D)(ii) (corporate divisions); \textit{id.} \S 368(a)(1)(B) ("B" reorganizations); \textit{id.} \S 368(a)(1)(C) ("C" reorganizations); \textit{id.} \S 1239(c)(1)(A) (sales of depreciable property between 80\% shareholder and his corporation).
wants to cash in on the property, she can sell her shares. If she wants to reconvert the property to her personal use, she can make the corporation distribute the property to her (either as a dividend or a liquidating distribution).

If Anne takes less than 100% of the shares of the corporate transferee, however, she suffers a dilution in her rights in the transferred property. Whereas before the transfer she owned 100% of the ownership rights attributable to the transferred item, she now must share those rights with the other shareholders of the corporate transferee. If she takes anything more than 50% of the shares (even one share more than 50%), she probably is not giving up the power to control how the property is used. State law normally vests the majority shareholder with the power to elect the full board of directors and, hence, the power to determine corporate policy.\textsuperscript{178}

Assuming that the transferor does have voting control over the corporation, however, would not ownership of anything more than 50% of the shares be a more logical measuring stick of control than the 80% now in the statute?\textsuperscript{179} Probably not, because a reduction from 100% to approximately 50% in the economic rights attributable to the transferred property is significant. For example, if Anne takes 51% of the shares, only 51% of the income generated by the property inures to her benefit. Of course, there should be a \textit{quid pro quo} for this percentage reduction—presumably the 49% shareholders are contributing something of value to the corporation. But the reduction in interest from 100% to 51% is too large to consider the transaction a mere change in the form of ownership. Anne is accepting a 49% reduction in her economic rights to her property in exchange for a 51% interest in the property transferred by the 49% shareholders. The change in Anne's interest is too great not to be considered a taxable exchange or sale. Of course, if Anne owns exactly

\textsuperscript{178} See F. O'NEAL \& R. THOMPSON, \textit{supra} note 92, §§ 3.12, 3.16, 4.02. A statement of the Georgia Supreme Court is typical: "The majority stockholders, or the majority of the directors . . . have the right to determine the business policy of the corporation." Regenstein v. J. Regenstein Co., 213 Ga. 157, 159, 97 S.E.2d 693, 695 (1957); \textit{see also} Merill v. Davis, 359 Mo. 1191, 225 S.W.2d 763 (1950); McQuade v. Stoneham, 263 N.Y. 323, 334, 189 N.E. 234, 238 (1934); Hand v. Dexter, 41 Ga. 454, 461 (1871). Of course, state law also permits majority shareholders to cede part of the decision-making power to the minority shareholders, a concession that minority shareholders often insist upon as a prerequisite to their investment. F. O'NEAL \& R. THOMPSON, \textit{supra} note 92, at § 4.02-.03.

\textsuperscript{179} The Internal Revenue Code does contain several control tests set at 50% of stock ownership. \textit{See}, e.g., I.R.C. § 312(j)(2) (allocation of earnings and profits within affiliated group of foreign investment companies); \textit{id.} § 318(a)(2)(C) (constructive stock ownership rules); \textit{id.} § 318(a)(3)(C) (same); \textit{id.} § 542(a)(2) (stock ownership requirement for personal holding companies).
80% of the shares of the corporation (and thereby satisfies the control test for purposes of section 351), her economic interest in the transferred property is diminished, too, but only from 100% to 80%, which is not such a substantial reduction.

Essentially then, the 80% line represents a compromise between requiring 100% stock ownership in the corporate transferee, a requirement that would allow for no dilution whatsoever in the transferors' interest in the transferred property, and allowing a mere majority stock interest in the corporate transferee to suffice, a rule that would allow a substantial dilution in the economic rights attributable to property ownership.

3. Numbers, not value

The Internal Revenue Code has a variety of control tests that are deceptively similar, and one needs to use care to differentiate among them. For example, some tests require 50% stock ownership only. Other tests are measured by the value and not the number of shares held. Other 80% tests exclude nonvoting, nonparticipating preferred shares. The 80% test used for purposes of section 351 is contained in section 368(c) and is also used in reorganizations. It is measured by the number and not the value of shares held by the transferors of property. Moreover, except for transfers involving corporations that are part of an affiliated group filing consolidated tax returns, none of the statutory attribution of constructive ownership rules, elsewhere applicable in corporate taxation, apply to the control test of section 368(c).

Tribunals have also rendered divergent decisions regarding control. Several old cases have attributed shares held by trustees or estate repre-
sentatives to the beneficial owners, but the persuasiveness of these cases as precedent has been questioned. A recent Tax Court opinion rejected a taxpayer's argument that, for purposes of measuring control, shares held in a fiduciary capacity for the benefit of others should be aggregated with shares held by the same person but not in any fiduciary capacity and instead in their own name and own right. Deciding correctly on this issue, the Tax Court expressly refused to determine that the shares held by a trustee should be attributed to the trust beneficiaries.

4. Stock entitled to vote

For corporations with more than one class of stock, the statutory language is not a model of clarity. Section 368(c) provides: "[T]he term 'control' means the ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation." With respect to the voting stock requirement, the section has been interpreted to require the transferors to own shares entitling them to at least 80% of the votes in the corporation. If the corporation has more than one class of voting stock, the transferors are not required to own 80% of each class of voting stock so long as they own shares entitling them to 80% or more of the voting power. For example, suppose that X Corp has two classes of voting stock—class A and class B. Class A entitles its holders to 90% of the votes in the corporation. Class B entitles its holders to 10% of the votes. Anne transfers assets to X Corp in exchange for class A shares. Immediately after the transfer, she owns all of the class A shares, but none of the class B shares. Because she owns stock possessing at least 80% of the total combined power in the corporation (90% in her case), she meets the voting stock requirement, even though she owns none of the class B shares. Where

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189. See, e.g., Kamborian v. Commissioner, 56 T.C. 847, 865 (1971), aff'd, 469 F.2d 219 (1st Cir. 1972); see also Rothman, supra note 148, at A-14.

190. Kamborian, 56 T.C. at 865.

191. Id. at 865-67.


194. Id.
each class of stock elects a specified number of directors, a weighing formula is used.\textsuperscript{195} For example, suppose that X Corp has two classes of voting stock—class A and class B. Each elects ten and five directors, respectively. If Anne receives 90% of class A and 60% of class B, she meets the 80% control requirement since she is deemed to control nine of the class A directors and three of the class B directors, and therefore, twelve of fifteen or 80% of all.

Unfortunately, neither the Code, the regulations nor the cases define the term “entitled to vote.” The results are some gray areas of interpretation. For example, many states’ corporation codes entitle shareholders to vote on specified matters irrespective of whether the shares are given voting power by the charter.\textsuperscript{196} The holders of shares designated as non-voting by the charter are likely to have a statutorily guaranteed right to vote on charter amendments,\textsuperscript{197} consolidations,\textsuperscript{198} mergers,\textsuperscript{199} distrib-


\textsuperscript{199} See, e.g., CAL. CORP. CODE § 1101 (West Supp. 1988); DEL. CODE ANN. tit. 8, §§ 242, 251(c), 262 (1983); Ohio Rev. Code Ann., §§ 1701.16, 1701.78-85 (Anderson Supp. 1987). See generally Barton, supra note 198; Small, supra note 198; see also F. O'NEAL & R. THOMPSON, supra note 92, § 3.20.
tions in partial liquidation, sale of all corporate assets, dissolution and perhaps other matters. Moreover, such holders may have the right to vote by class if a proposed action adversely affects the relative position of the shares in that class. It is generally thought that these shares, which entitle holders to vote only upon extraordinary transactions, should not be considered "stock entitled to vote" for purposes of section 368(c). Otherwise, there would be no shares that would be considered as nonvoting stock, and the distinction between voting stock and nonvoting stock in section 368(c) would be meaningless.

A similar problem exists with respect to other classes of stock that are nonvoting except upon the occurrence of a designated contingency. For example, it is common for corporate charters to grant preferred shareholders the right to vote for directors only after dividends have been in arrears for a stipulated number of dividend periods. If the contingency has occurred and the holders of such stock are indeed voting, such classes of stock obviously are "entitled to vote" and ought to be considered voting stock for purposes of section 368(c). It is generally thought that such shares are not voting stock, unless the designated contingency, which triggers the right to vote, has occurred.

The government could clarify these two uncertain areas by adopting for section 351 transfers rules developed in analogous areas of corporate tax law. One revenue ruling holds that the term "voting stock," in the context of the consolidated return rules, means stock entitled to elect directors. The regulations for the disproportionate redemption sub-

203. F. O'Neal & R. Thompson, supra note 92, § 3.20.
208. Rev. Rul. 69-126, 1969-1 C.B. 218. Section 1504(a)(2)(A), the section explained in this
section of section 302 declare that stock that does not grant voting rights “until the happening of an event . . . is not voting stock until the happening of the specific event.” Though the revenue ruling and the regulation both are interpreting a different statutory term (“voting stock” instead of section 368(c)’s “stock entitled to vote”), their rationale seems suitable for section 368(c) purposes and should reinforce two of the recommendations made above: (1) stock that votes only on extraordinary matters would not be considered “stock entitled to vote”; and (2) stock with contingent voting rights should be considered “stock entitled to vote” only after the contingency occurs and the holders are voting for directors.

A more difficult question involves classes of nonvoting stock or securities that are convertible into voting stock. Unlike the preferred shareholder who has voting rights only upon the occurrence of events beyond his control, for example, arrearages in dividends, the holder of a convertible issue has the power to become a voting shareholder at any time. Perhaps such issues should be considered voting stock, because the holders have within their discretion the power to vote, even if they have yet to exercise it. However, prevailing authority, though taken from other areas of corporate tax law, is to the contrary. Convertible securities are not even considered stock, much less voting stock. Moreover, the Supreme Court has deemed warrants, devices resembling a conversion feature, not to be “voting stock” for purposes of B reorganizations. The section 351 regulations are in accord; stock warrants and stock rights are not to be considered “stock or securities” for section 351 purposes. Furthermore, some authority holds that the ownership of voting stock constitutes control, even when the shares are subject to shareholder voting agreements that result in someone else doing the vot-
ing instead of the actual holder.\textsuperscript{214}

5. All other classes of stock

Section 368(c) requires the transferors to own, in addition to voting stock, "at least 80% of the total number of shares of all other classes of stock of the corporation."\textsuperscript{215} A 1959 revenue ruling interpreted this poorly worded language to require ownership of at least 80% of the total number of shares of each class of nonvoting stock.\textsuperscript{216} The revenue ruling's interpretation reflects what the statutory language probably was intended to say, and everyone seems quite content with it.

6. Groups of transferors

Section 351 clearly covers transfers of property made by more than one person.\textsuperscript{217} When the transfers are made by a group of persons, the control requirement is measured by the stock owned by the group as a whole.\textsuperscript{218} In other words, the members' shares are aggregated to see whether they own 80% or more of the stock entitled to vote and 80% of each class of nonvoting stock. For example, suppose that Anne, Bob, Charles and Dorothy have agreed to form a new corporation, X Corp with each of the four persons to transfer property to X Corp in exchange for 25% of X Corp's stock. If the stock interests were not allowed to be aggregated, none of the four people would satisfy the 80% stock ownership test of section 368(c). When they are treated as a group and their shares are aggregated, they own 100% of the stock of X Corp and thereby satisfy the 80% stock ownership requirement.

The regulations declare that the phrase "immediately after the exchange" does not require simultaneous exchanges by the members of a group, but generally anticipates the situation where the rights of the part-

\textsuperscript{214} See National Bellas Hess, Inc. v. Commissioner, 20 T.C. 636 (1953), aff'd, 220 F.2d 415 (8th Cir. 1955); Federal Grain Corp. v. Commissioner, 18 B.T.A. 242 (1929).

\textsuperscript{215} I.R.C. § 368(c)(1).


\textsuperscript{217} I.R.C. § 351(a). Section 351 provides for nonrecognition treatment when property is transferred to a corporation by "one or more persons." \textit{Id}.

ties have been previously defined by agreement and the execution of the agreement proceeds expeditiously. Moreover, if the exchanges do not occur on approximately the same date and if the taxpayers want an advance ruling on the applicability of section 351 to their proposed transaction, they need to describe their “plan” and to give a “full explanation.” The cases show a far greater liberality, expecting no more than a generalized understanding between the parties that the members of the group will transfer property to the corporation. Indeed, in the case of transfers to close corporations, only the most ingenious among us are likely to believe that two or more transfers that take place within a relatively short time period are not part of an integrated transaction.

When the corporation has multiple classes of stock, there is no requirement that each member of the group receive some of each class of stock. The transfers are not disqualified for nonrecognition treatment under section 351 because, for example, some members of the group get only common stock and other members of the group get only preferred stock. The regulations also make it clear that section 351 does not require each member of the group to receive an interest in the corporation that is proportionate to his interest in the transferred property. Where the interest in the corporation is disproportionate to the transferors’ previous interest in the property transferred, the government will scrutinize the transaction to discover its true nature. The regulations offer the example of a father and son who organize a corporation with 100 shares of common stock. The father transfers property worth $8,000 in exchange for 20 shares of stock and the son transfers property worth $2,000 in exchange for 80 shares of stock. No gain or loss is recognized


For a full discussion of pre-1954 law, see generally Rothman, supra note 148, at A-10, A-12.

under section 351, but, if the facts reflect a gift, i.e., donative intent on the part of the father, the government will restructure the transaction according to its true nature—as if the father and son received shares in direct proportion to the value of the property being transferred to the corporation, 80 shares for the father and 20 shares for the son, and the father then made a gift of 60 shares to the son.\textsuperscript{224}

7. Stock owned prior to the exchange

The control test is measured by the percentage of stock owned by the transferor immediately after the transfer.\textsuperscript{225} The stock owned by the transferor at this point includes previously own stock as well as stock received in exchange for the transferred property. Therefore, if the transferor owns any stock in the transferee corporation at the time of the transfer, he aggregates this old stock with any new stock he receives in the exchange to measure his percentage of control for section 351 purposes. For example, suppose that Anne, the holder of 40 of X Corp's 60 issued and outstanding shares, transfers property to X Corp in exchange for an additional 40 X Corp shares. In measuring Anne's control immediately after the transaction, Anne aggregates her original 40 shares with her 40 new shares. She thus owns 80% of X Corp's 100 issued and outstanding shares, making her an 80% shareholder and thereby satisfying the section 368(c) control test.

Section 351 also applies to the transferor who had control prior to the transfer. For example, suppose that in the preceding hypothetical Anne originally had owned 48 of X Corp's 60 issued and outstanding shares. Her percentage of stock ownership prior to the transfer would have been exactly 80%. If she transfers property in exchange for an additional 40 shares, she aggregates her original 48 shares with her 40 new shares to determine her percentage of control. In this example, she still owns 80% of the stock, satisfying the control test.

\textsuperscript{224} Treas. Reg. § 1.351-1(b)(2) (example (1)). In the example in the text, since both the father and the son transferred property to the corporation and, together, owned 100% of the stock immediately after the transaction, it is easy to see that the requirements of section 351 are met. In other situations, however, a restructuring of the transaction can have an impact on whether or not the transaction meets the section 351 requirements. For example, in the example in the text, suppose that the son had transferred no property to the corporation. Should the exchange between father and the corporation fall outside section 351, since a non-transferor of property ended up with 80% of the stock? Or should the transaction be regarded as the issuance of 100% of the stock to father followed by a gift of 80% of the stock to the son? Arguably, the exchange of the father's assets for 100% of the stock satisfies the control test, because the father controlled the corporation "immediately after the exchange." Moreover, he was under no legal compunction to pass on the stock to his son. For conflicting answers, compare Wilgard Realty Co. v. Commissioner, 127 F.2d 514 (2d Cir.), cert. denied, 317 U.S. 655 (1942) with D'Angelo Assoc. v. Commissioner, 70 T.C. 121 (1978).

\textsuperscript{225} I.R.C. §§ 368(c), 351(a).
shares. She thus owns 88 of X Corp's 100 issued and outstanding shares, making her an 88% shareholder and thereby satisfying the section 368(c) control test. The newly issued shares need not push the transferor past the 80% stock ownership mark for section 351 to apply.

8. Issuing stock or securities for services and the control requirement

It is a common practice in the business world for a corporation to issue its shares or securities (especially its shares) for services rendered or to be rendered to the corporation. If there is no more to the transaction, it falls completely outside of section 351. Section 351(d)(1) states clearly that stock (or securities) shall not be considered as issued in return for "property" for purposes of section 351, if it is issued to pay for services rendered, or to be rendered, for the benefit of the corporation. In some instances, however, issuing of shares or securities as payment for services is merely one part of a larger transaction that includes transfers of property to the corporation in exchange for its shares or securities. The purpose of this section is to discuss the impact that issuing of shares in payment for services has upon these larger transactions.

The person who receives his or her stock or securities solely in exchange for services rendered for the corporation cannot be counted as part of the group that is required to own 80% or more of the transferee corporation's stock for the whole transaction to qualify under section 351. For his shares to be counted towards meeting the 80% control test, he would have had to have transferred some property to the corporation. Accordingly, the people who did transfer property must themselves own 80% or more of the shares. They cannot include the shares of the person only performing services to meet the 80% control test, even if that person's role in the transaction was an integral part of a defined, preconceived plan. The following examples better illustrate this rule.

Example 1. Anne and Bob transfer property to a newly formed corporation in exchange for 78% of its stock. Charles receives the other 22% of the stock for marketing services performed for the corporation. No part of the transaction qualifies under section 351, because, immediately after the transaction, the transferors of property, Anne and Bob, own only 78% of stock and hence do not have the "control," i.e., 80% stock ownership, required by section 351 and section 368(c). The 22% of the shares owned by Charles cannot be aggregated with the shares owned by Anne and Bob since Charles is not a transferor of property and is

226. Id. § 351(d)(1).
227. LIND & SCHWARZ, supra note 30, at 66; B. BITTKER & J. BRISTICE, supra note 29, ¶ 3.02; see also Treas. Reg. § 1.351-1 (as amended in 1967).
outside the coverage of section 351.\textsuperscript{228}

\textit{Example 2.} Anne and Bob transfer property to a newly formed corporation in exchange for 85\% of its stock. Charles receives the other 15\% of the stock for marketing services performed for the corporation. The part of the transaction involving Anne and Bob meets the section 351 requirements, because, immediately after the transaction, the transferors of property, Anne and Bob, own more than 80\% of the stock of the transferee corporation and hence meet the "control" requirement of sections 351 and 368(c).\textsuperscript{229} The part of the transaction involving Charles is outside section 351 because Charles is not a transferor of property.

The person who transfers property \textit{and} performs services in exchange for stock or securities of the transferee corporation is counted as part of the group that is required to own 80\% or more of the transferee corporation's stock.\textsuperscript{230} His shares are included because he is a transferor of property. In fact \textit{none of his shares} are excluded, even though it would be easy enough to allocate between shares issued for the services and shares issued for the transferred property and thus to exclude the shares issued for the services. In other words, \textit{all} the shares owned by this person immediately after the transaction are counted in measuring the 80\% control test just as if he had only transferred property and had not performed services.\textsuperscript{231} The fact that stock issued to a particular transferor is partly for services does not result in denial of section 351 treatment so long as that transferor did indeed transfer some property and he is part of a group of transferors that satisfy the 80\% control test.\textsuperscript{232} The following example illustrates this rule.

\textit{Example 3.} Anne and Bob formed a new corporation called X Corp. Anne transferred property worth \$60,000 in exchange for 600 X Corp shares worth \$60,000. Bob performed marketing services worth \$4,000 for X Corp. He also transferred property worth \$36,000 to X Corp. In exchange for the services and the transferred property, X Corp issued 40 shares worth \$40,000 to Bob. Each of the described transactions was pursuant to a definitive agreement between Anne and Bob. Since immediately after the transaction, the transferors of property—

\begin{footnotes}
\textsuperscript{228} See, e.g., Treas. Reg. § 1.351-1(a)(2) (example (2)); see also B. BITTKER & J. EUSTICE, \textit{supra} note 29, ¶ 3.02, at 3-7.

\textsuperscript{229} I.R.C. §§ 351, 368(c).

\textsuperscript{230} See Treas. Reg. § 1.351-1(a)(2) (example (3)); see also LIND \& SCHWARZ, \textit{supra} note 30, at 66; B. BITTKER \& J. EUSTICE, \textit{supra} note 29, ¶ 3.02 at 3-6; Rothman, \textit{supra} note 148, at A-51.

\textsuperscript{231} See Treas. Reg. § 1.351-1(a)(2) (example (3)); see also B. BITTKER \& J. EUSTICE, \textit{supra} note 29, ¶ 3.02, at 3-6; Rothman, \textit{supra} note 148, at A-51.

\textsuperscript{232} See I.R.C. § 368(c).
\end{footnotes}
Anne and Bob—owned 80% or more of the outstanding stock of X Corp, 100% in their case, no gain or loss is recognized upon the exchanges of property for stock. While the payment for services does generate other income tax consequences for Bob who must treat stock received for the services as taxable compensation, e.g., Bob realized $4,000 of ordinary income, all of the stock owned by Bob after the transaction is counted in measuring the stock owned by the transferors for purposes of the 80% control test.

The regulations contain a two-pronged exception to this rule.\(^{233}\) The exception is designed to impede the use of a nominal property transfer to boot-strap a non-qualifying transaction to one covered by section 351. According to the regulations, stock or securities issued for property of relatively small value, (1) as compared to the value of stock and securities already owned by the transferor\(^{234}\) or (2) as compared to the value of stock or securities to be received for services performed by the transferor, is not to be treated as having been issued in return for property if the primary purpose of the transfer is to qualify the transaction under section 351.\(^{235}\) For purposes of advance letter rulings, the Internal Revenue Service does not consider transferred property to be of "relatively small value," if its fair market value equals or exceeds 10% of the fair market value of the stock or securities already owned or to be received for services by such person.\(^{236}\) The following three examples illustrate these rules.

**Example 4.** X Corp has 900 shares of issued and outstanding stock, all of which is owned by Anne and is worth $90,000. Anne and Bob have agreed in principle that Bob will transfer an asset worth $10,000 and with a basis of $3,000 in his hands to X Corp in exchange for 100 X Corp shares which are worth $10,000. Because Bob would own less than 80% of the X Corp shares (100 of 1000 shares or 10%), the exchange would not be covered by section 351 and Bob would be compelled to recognize a taxable gain of $7,000 ($10,000 stock received minus $3,000 basis). To prevent recognition of Bob's gain, Bob has suggested that Anne transfer an asset worth $100 to the corporation for one X Corp share worth $100. Bob still would transfer his asset for 100 X Corp shares. If the transaction is completed as suggested by Bob, Anne and Bob both will have

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234. Id.
transferred property solely in exchange for stock or securities of X Corp, the transferee corporation, and together they will own 100% of the X Corp stock. Thus, they literally would meet all of section 351's requirements for nonrecognition treatment. The only share of X Corp stock issued to Anne, however, would be of relatively small value when compared to the value of the stock already owned by her (0.11% or 100/90,000), and the primary purpose of Anne's transfer would be to qualify Bob's exchange for nonrecognition treatment under section 351. The regulations would require the share issued to Anne to be considered as not having been issued in return for property, i.e., being outside the coverage of section 351. The result is that Bob would be the only transferor of property and would own an insufficient percentage of stock (9.99% or 100/1001) to meet the control test. Hence, he would have a taxable gain of $7,000. Curiously, the transfer by Anne would seem to be a taxable event also, since her transfer is deemed to be outside section 351.

Example 5. Anne is an expert in a high technology industry. Bob owns equipment that could be used to start up a business in that industry. He has a basis of $4,000 in the equipment; it is worth $50,000. Anne and Bob have agreed in principle that they will incorporate a new business in that industry and that each of them will take 50% of the stock of the newly created corporation. Each 50% stock interest will be worth $50,000. They both understand that the primary consideration provided by Anne for her shares is services to be rendered for the corporation. Unless Anne transfers property to the corporation in exchange for part of her shares, Bob's transfer of the equipment to the corporation for stock will fall outside the coverage of section 351 for failure to meet the 80% control test. To help Bob attain nonrecognition treatment, Anne is willing to transfer an asset owned by her and worth $100 as partial consideration for her stock. Because Anne and Bob would then both be transferors of property, the transferors of property would own 100% of the X Corp stock immediately after the exchange. According to the regulations, however, the stock issued to Anne would not be considered as having been issued in return for property because it would be of relatively small value when compared to the value of the stock to be received for her services (2% or $100/$50,000) and the primary purpose of her transfer would be to qualify Bob's transfer for nonrecognition treatment under section 351.237 The result would be that Bob would be the only transferor of property and would own an insufficient percentage of stock (50%) to meet the control test. Hence, he would have a taxable gain of

$46,000 ($50,000 stock received minus $4,000 basis in the equipment). The transfer of property by Anne would seem to be a taxable event also, since her transfer is deemed to be outside section 351. Regardless of the applicability of section 351, Anne must treat the stock received in exchange for services as compensation, i.e., ordinary income to the extent of its fair market value.

Example 6. X Corp has 500 shares of issued and outstanding stock, all of which are owned by Anne and are worth $50,000. Anne and Bob have agreed in principle that Bob will transfer property worth $40,000 with a basis of $6,000 in his hands to X Corp in exchange for 400 X Corp shares worth $40,000. However, because Bob would own less than 80% of the X Corp shares, the exchange would not be covered by section 351 (400 of 900 shares or 44.4%), and Bob would be compelled to recognize a taxable gain of $34,000 ($40,000 minus $6,000). To prevent recognition of the gain by Bob, Anne has agreed to transfer property worth $10,000 to X Corp in exchange for an additional 100 X Corp shares. The Internal Revenue Service would not consider the property transferred by Anne to be of "relatively small value" within the meaning of the regulations, because its fair market value ($10,000) exceeds 10% of the fair market value of the stock already owned by Anne (10% x $50,000 = $5,000). Thus, for purposes of issuing an advance ruling, the Internal Revenue Service would consider Anne to be a transferor of property. The transferors of property, Anne and Bob, then would own 100% of the X Corp stock immediately after the exchange, thereby meeting the 80% control test, and the whole transaction would be accorded nonrecognition treatment under section 351.

9. "Immediately after the exchange"

Section 351 requires the transferors of property to be in control of the corporation "immediately after the exchange." Thus, the focus of the statutory language is a point in time. One might infer that momentary control, even followed by a prompt and predetermined loss of control, should satisfy section 351. On occasion, however, courts have recognized that this interpretation undercuts the continuity-of-interest principle that constitutes the basic supposition for the nonrecognition

238. I.R.C. § 351(a).
239. See, e.g., Stanton v. United States, 512 F.2d 13 (3d Cir. 1975); Portland Oil Co. v. Commissioner, 109 F.2d 479 (1st Cir.), cert. denied, 310 U.S. 650 (1940); see also B. BETTKER & J. EUSTICE, supra note 29, ¶ 3.09 at 3-31; LIND & SCHWARZ, supra note 30, at 62.
treatment accorded by section 351.\textsuperscript{240} The same people own the same property, only now they have pieces of paper called stock certificates to evidence their ownership.\textsuperscript{241} Despite some early cases to the contrary,\textsuperscript{242} it seems to be settled that momentary control is insufficient under at least some circumstances.\textsuperscript{243} However, it is unsettled just what those “some circumstances” happen to be.

The key in this genre of cases usually is the step transaction doctrine.\textsuperscript{244} That doctrine applies where a series of transactions, independent in form, are so dependent in substance as to require the tax consequences to be measured by viewing the overall transaction from beginning to end without according any independent significance to the steps in between.\textsuperscript{245} The doctrine sometimes is invoked to try to take a series of transactions outside of section 351\textsuperscript{246} and sometimes to try to put a series of transactions inside section 351.\textsuperscript{247} At times it is the private sector that invokes it\textsuperscript{248} and at other times it is the government.\textsuperscript{249} The courts have preferred three tests—end result,\textsuperscript{251} interdependence\textsuperscript{252}

\textsuperscript{240} See, e.g., Le Tulle v. Scofield, 308 U.S. 415, 309 U.S. 694 (1940); Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462 (1933).

\textsuperscript{241} See Portland Oil, 109 F.2d at 488.

\textsuperscript{242} See id. at 489; B. Bittker & J. Eustice, supra note 29, ¶ 3.09, at 3-31; Lind & Schwartz, supra note 30, at 56.


\textsuperscript{244} See generally Chirelstein & Lopata, supra note 171; Mintz & Plumb, supra note 171; Rothman, supra note 148, at A-17. For a further discussion of the “step-transaction doctrine,” see D. Kahn, Basic Corporate Taxation § 10.25, at 407-10 (3d ed. 1981).

\textsuperscript{245} Rothman, supra note 148, at A-17.

\textsuperscript{246} See, e.g., Intermountain Lumber, 65 T.C. at 1033; Baker Commodities, Inc. v. Commissioner, 48 T.C. 374 (1967), aff’d, 415 F.2d 519 (9th Cir. 1969); American Bantam Car Co. v. Commissioner, 11 T.C. 397 (1948), aff’d, 177 F.2d 513 (3d Cir. 1949), cert. denied, 339 U.S. 920 (1950); Independent Oil Co. v. Commissioner, 6 T.C. 194 (1946); W & K Holding Corp. v. Commissioner, 38 B.T.A. 830 (1938); Omaha Coca-Cola Bottling Co. v. Commissioner, 26 B.T.A. 1123 (1932).

\textsuperscript{247} See, e.g., Edlund Co. v. United States, 288 F.2d 17 (2d Cir. 1961); Scientific Instrument Co. v. Commissioner, 17 T.C. 1253 (1952), aff’d per curiam, 202 F.2d 155 (6th Cir. 1953).

\textsuperscript{248} See, e.g., Priv. Ltr. Rul. 8,727,005 (Mar. 18, 1987).


\textsuperscript{250} The three tests are: (1) end result, (2) interdependence, and (3) binding commitment.
and binding commitment\textsuperscript{253}—for deciding when to use the step transaction doctrine. All three tests have been applied to section 351 transactions at one time or another.\textsuperscript{254} In addition to the tests, time is an important factor.\textsuperscript{255} The closer in time the series of transactions are, the more likely the step transaction doctrine applies.\textsuperscript{256} Additionally, the parties must have intended an integrated transaction for the step transaction doctrine to apply,\textsuperscript{257} although the parties’ conduct may be more probative of their intent than their testimony.

A 1978 Ninth Circuit opinion, \textit{Culligan Water Conditioning v. United States}\textsuperscript{258} illustrates the most commonly encountered problem—at the exact point in time of the exchange the transferors owned 80\% or more of the shares, but soon thereafter they relinquished their control by selling a stock interest of 20\% or more to an outsider.\textsuperscript{259} In \textit{Culligan}, a proprietor named Kramis incorporated a company called Kennewick on October 4, 1964. The evidence was unclear as to the exact date that he transferred the proprietorship assets in exchange for the Kennewick stock.\textsuperscript{260} The court found only that the exchange occurred sometime between October 1, 1964, and mid-April, 1965.\textsuperscript{261} In January, 1965, Kramis began negotiating for the sale of the Kennewick business with an

\begin{footnotes}
\footnote{251. See, e.g., Ericsson Screw Mach. Prods. Co. v. Commissioner, 14 T.C. 757 (1950); see also Chirelstein & Lopata, \textit{supra} note 171, at 970.}
\footnote{252. See, e.g., South Bay Corp. v. Commissioner, 345 F.2d 698 (2d Cir. 1965); American Wire Fabrics Corp. v. Commissioner, 16 T.C. 607 (1951); \textit{American Bantam Car}, 11 T.C. at 405; see also Chirelstein & Lopata, \textit{supra} note 171, at 970; Rothman, \textit{supra} note 148, at A-18.}
\footnote{253. See, e.g., Hazelton Corp., 89 F.2d at 513; Bassick v. Commissioner, 85 F.2d 8 (2d Cir.), \textit{cert. denied}, 299 U.S. 592 (1936); \textit{Manhattan Bldg.}, 27 T.C. at 1032; S. Klein on the Square, Inc. v. Commissioner, 14 T.C. 786, \textit{aff’d}, 188 F.2d 127 (2d Cir.), \textit{cert. denied}, 342 U.S. 824 (1951); \textit{American Bantam Car}, 11 T.C. at 406; see also Chirelstein & Lopata, \textit{supra} note 171, at 971.}
\footnote{254. See Chirelstein & Lopata, \textit{supra} note 171, at 971; Rothman, \textit{supra} note 148, at A-17 to A-19.}
\footnote{255. The courts traditionally consider as relevant the length of time that elapses between the two transactions. See \textit{Rothman}, \textit{supra} note 148, at A-18; Mintz & Plumb, \textit{supra} note 171, at 249.}
\footnote{256. See, e.g., \textit{Love v. Commissioner}, 113 F.2d 236 (3d Cir. 1940); see also Mintz & Plumb, \textit{supra} note 171, at 249.}
\footnote{257. See, e.g., \textit{Ericsson Screw Mach. Prods.}, 14 T.C. at 763; see also Minnesota Tea Co. v. Helvering, 302 U.S. 609, 613 (1938); \textit{Thurber v. Commissioner}, 84 F.2d 815 (1st Cir. 1936); \textit{Vest v. Commissioner}, 57 T.C. 128 (1971), \textit{aff’d}, 481 F.2d 238 (5th Cir.), \textit{cert. denied}, 414 U.S. 1092 (1973); \textit{Kind v. Commissioner}, 54 T.C. 600 (1970); Rothman, \textit{supra} note 148, at A-18.}
\footnote{258. 567 F.2d 867 (9th Cir. 1978).}
\footnote{259. \textit{Id.} at 868.}
\footnote{260. \textit{Id.} at 870.}
\footnote{261. \textit{Id.}.}
\end{footnotes}
outsider who subsequently formed his own corporation, "Tri-Cities," to acquire Kennewick. On April 4, 1965, Kramis, by then the sole shareholder of Kennewick, sold all of his Kennewick stock to Tri-Cities. In June, 1965, Tri-Cities liquidated Kennewick. Tri-Cities did not want section 351 to apply to Kramis' prior transfer of assets to Kennewick for the Kennewick shares. It insisted that Kramis had a plan to part with control at the time he formed Kennewick and transferred assets to it. Furthermore, Tri-Cities claimed that this first part of the transaction was merely the first step of an integrated transaction that resulted in a sale of those assets rather than a transfer to a controlled corporation. To the chagrin of Tri-Cities, it could not prove that at the time the assets were transferred to Kennewick there existed an obligation or plan for Kramis to part with control of Kennewick. The evidence about a preconceived plan, which the court felt was a sine qua non for applying the step transaction doctrine, was too "murky" for that doctrine to apply. Section 351 (and its related sections) covered Kramis' transfer of his proprietorship assets to Kennewick, even though Kramis sold his Kennewick stock to Tri-Cities within a relatively short time period (seven months at most and probably even less).

Culligan demonstrates how difficult it can be to pin down exactly what has happened inside close corporations, which are notoriously unkempt in their record-keeping. If a court is determined to deem a preconceived plan or a binding commitment as a prerequisite for applying the step-transaction doctrine, it is likely to become frustrated when presented with an amorphous set of facts that do not tend to prove anything. The more unsettled the facts, the more unlikely a court will be able to find that plan or commitment. The "murky" records are most likely to work against the taxpayers who want the step-transaction doctrine to apply. The Ninth Circuit, for instance, placed the burden on the taxpayers to prove the existence of the plan or commitment.

262. Id.
263. Id.
264. Id.
265. Tri-Cities wanted Kennewick, its wholly-owned subsidiary, to have the highest possible basis in its assets. That basis would have been higher if the acquisition of the assets by Kennewick was treated as a purchase so it could take a "cost" basis rather than a section 351 exchange with a carry-over basis.
266. Culligan, 567 F.2d at 870.
267. Id.
268. Id.
269. Id.
270. See D'Angelo Assocs., 70 T.C. at 133.
271. Culligan, 567 F.2d at 870.
amorphous record problem is less likely to impede the government when it invokes the step-transaction doctrine. Most courts are cognizant of the degree of informality with which these closely held business enterprises operate. They are aware that the parties in the private sector may make oral as well as written plans and can intentionally obfuscate their own plans when it is to their advantage in court.

Revenue Ruling 79-70 provides an intriguing, though questionable, interpretation of the impact of the step-transaction doctrine on the section 351 control requirement. The situation addressed in the revenue ruling is the following: X transferred property to a newly organized corporation, Newco, in exchange for all of Newco's stock. Pursuant to a prearranged binding agreement, X sold 40% of its Newco stock to Y, and Y purchased securities for cash from Newco. Because the sale of the Newco stock by X to Y was an integral part of the incorporation and pursuant to prearranged binding agreement, the control requirement was determined after that sale. The Internal Revenue Service reaffirmed its long-standing position that the section 351 control requirement is not satisfied where, pursuant to a binding agreement entered into prior to the transfer of property to the corporation, a transferor loses control of the corporation by sale of stock received in the transfer to a third party who does not transfer property to the corporation. After the sale was complete, X owned 60% of the Newco stock and Y owned 40%. Since Y was not a transferor of property to Newco with respect to Newco stock, Y's 40% ownership of the Newco stock could not be counted in determining whether the transferors of property met the control requirement.

If Y had not paid cash for Newco securities, the rationale in Revenue Ruling 79-70 would be unassailable. X would have been the only transferor of property, and he would have owned only 60% of the Newco stock after completion of the transaction. The revenue ruling would be in complete accord with case law. But Y did transfer property (cash) to Newco. He did end up owning stock and securities in Newco. If the step transaction is to be used, it is hard to see why section 351 should not cover the transaction. Two persons, X and Y, formed a new corporation (Newco). Each transferred property to the corporation. Together they owned 100% of the Newco stock as a result of the transaction. Y

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272. See, e.g., id.; Intermountain Lumber, 65 T.C. at 1033.
273. See, e.g., Culligan, 567 F.2d at 869; Wilgard Realty, 127 F.2d at 516; D'Angelo Assocs., 70 T.C. at 135-36.
275. Id. at 145.
276. Id.
277. Id.
received Newco securities, but that should not disqualify him from being treated as part of the control group, because he also received stock. X received cash, but he, too, received stock. The cash payment to X had exactly the same economic effect for him as a cash payment made to him by Newco, i.e., a boot distribution, which would be allowable under section 351. True, Y and not Newco paid the cash to X, but the party actually making the disbursement seems insignificant, as the step-transaction doctrine requires the tax consequences to be measured by viewing the overall transaction without according independent significance to any particular step. The transaction should be stepped together as follows: Y pays cash to Newco for securities and 40% of the Newco stock, and X transfers property to Newco in exchange for 60% of Newco's stock and cash. That is the substance of the transaction, and it fits neatly within section 351(b).

A second problem involves a sale of shares by one transferor of property to another transferor of property. The Internal Revenue Service offered its opinion in Revenue Ruling 79-194. Z and "a group of investors," pursuant to a binding agreement, transferred property to Newco in exchange for all of Newco's stock. Z received 80% of the Newco stock. The investors took the other 20%. Pursuant to the agreement, Z sold 31% of the Newco stock to the investors, thereby lowering Z's stock ownership to 49% and raising the investors' interest to 51%. Because Z's sale of 31% of the Newco stock to the investors was an integral part of the incorporation and pursuant to a binding agreement, the control requirement of section 351(a) was determined after the sale. According to the ruling, the fact that there was a shift in the ownership of stock among the transferors after the exchanges with Newco did not affect the applicability of section 351, because the persons transferring property to Newco in exchange for Newco stock owned 100% of the Newco stock immediately after the exchange.

Revenue Ruling 79-194 implied that the result would have differed had Z sold the 31% of the Newco stock to pre-existing shareholders who

278. Id. at 144.
279. Id.
280. Id.
281. See I.R.C. § 351(b).
283. The cash can be treated as "boot" pursuant to section 351(b), thus not denying nonrecognition treatment to Y under section 351. See I.R.C. § 351(b).
285. Id. at 146.
did not transfer property to Newco as part of the same transaction. These other shareholders then could not be counted as transferors of property and could not be included as part of the control group. Z would then own only 49% of the stock immediately after the transaction, and the transaction would fall outside section 351 for failure of the transferors to meet the 80% control test.

A third issue involves the interplay between outstanding options to purchase the transferee corporation's stock and the "immediately after the exchange" language of section 351. For example, suppose that Anne transfers property to X Corp in exchange for X Corp stock. Immediately after the exchange Anne owns 100% of X Corp's issued and outstanding shares. At the time of the exchange, however, Bob has an option to purchase 30% of the X Corp stock. He promptly exercises his option and takes the 30%. Does the purchase of the shares by Bob result in Anne not having control "immediately after the exchange" as required by section 351? Should the answer depend on whether Bob purchased the shares from Anne or from X Corp? The cases are insufficient in number to provide definitive answers to these issues. Moreover, they are contradictory.

For example, in Harder v. Commissioner, a sole proprietor transferred his business assets to a newly formed corporation in exchange for all the transferee corporation's stock on January 2nd. Simultaneously the proprietor granted an option to purchase part or all of his stock to three other people. The option was exercisable "from time to time on or after July 3." The Tax Court concluded that the proprietor's transfer of property in exchange for stock qualified as a tax-free exchange under section 351's predecessor. Distinguishing another case where

286. Id.
287. Id.
289. See, e.g., Barker v. United States, 200 F.2d 223 (9th Cir. 1952); Commissioner v. First Nat'l Bank of Altoona, 104 F.2d 865 (3d Cir. 1939), cert. dismissed, 309 U.S. 691 (1940); Penn-Dixie Steel Corp. v. Commissioner, 69 T.C. 837 (1978); Harder v. Commissioner, 17 T.C.M. (CCH) 494 (1958); National Bellas Hess, Inc. v. Commissioner, 20 T.C. 636 (1953), aff'd, 220 F.2d 415 (8th Cir. 1955); Federal Grain Corp. v. Commissioner, 18 B.T.A. 242 (1929).
290. Compare National Bellas Hess, 20 T.C. at 637 (transferor acquired the requisite control for the transfer to be granted nonrecognition status under section 351) with Barker, 200 F.2d at 232 (transferors held to have relinquished their unrestricted control over their stock).
291. 17 T.C.M. (CCH) 494 (1958).
292. Id. at 494.
293. Id.
294. Id. at 497, 499.
295. Id. at 499.
the outsider was clearly obligated to purchase the transferor's stock simultaneously with or immediately after the transfer, the court emphasized that the three optionees "were under no obligation whatever to buy any of the corporation's stock" from the proprietor. What happened on or after July 3 thus had "no bearing" on the case. The proprietor had control immediately after the January 2 exchange and that was what counted.

A 1952 Ninth Circuit opinion, Barker v. United States, took a contrary stance. Two groups of investors transferred their stock in a California corporation to a newly formed Delaware corporation. Group 1 received all of the common stock of the Delaware corporation in the exchange. Group 2 received all of the preferred stock of the Delaware corporation (divided into two classes—first and second preferred) in the exchange. Group 2 promptly sold approximately 50% of the first preferred to an investment banker and furthermore gave the investment banker an option to acquire the remaining first preferred. The investment banker promptly exercised the option to acquire the remaining first preferred shares from Group 2. Both the sale and option were pursuant to a prearranged contract. The Ninth Circuit concluded that the transferors of property, Group 1 and Group 2, failed to satisfy the 80% control requirement. The court might have based its conclusion solely on the prearranged sale of the first preferred stock to the investment banker, but it did not. It said that by granting the option, Group 2 had relinquished its power to dispose of the shares as it otherwise might have wished. Such a restriction upon its freedom of action deprived it of unrestricted control of the stock. Since the restriction affected more than 20% of the first preferred stock, the transaction was held not to qualify as a tax-free exchange for failure of the transferors of property to meet the 80% control test.

296. Id. citing May Broadcasting Co. v. United States, 200 F.2d 852 (8th Cir. 1953).
297. Harder, 17 T.C.M. (CCH) at 499.
298. Id.
299. Id.
300. 200 F.2d 223 (9th Cir. 1952).
301. Id. at 226-27.
302. Id. at 226.
303. Id. at 226-27.
304. Id. at 227.
305. Id.
306. Id. at 226-27.
307. Id. at 229.
308. Id.
309. Id.
What should the law be? Let us review a series of transactions:

(1) If the option is granted in favor of someone who is also a transferor of property, the existence of the option probably ought not to result in disqualifying the transfer from section 351 treatment. Whether or not the option is exercised, the end result is that transferors of property own 80% or more of the stock of the corporate transferee (assuming that the initial transferors satisfy the control test). Query: What if the optionor (a) is himself a transferor and has transferred what amounts to a large percentage of the corporate assets in exchange for his shares, e.g., 50%, (b) held a large block of stock in the transferee corporation, e.g., 50%, and (c) is divested of all of his stock by a prompt exercise of the option? Doesn’t the transaction closely resemble a sale of the optionor’s interest in this property, a transaction not within the purview of section 351 non-recognition treatment? Shouldn’t the continuity-of-interest principle be dredged up to take the transaction outside section 351?

(2) If the corporation grants the option and the optionee is not a transferor (at least not prior to the exercise of the option), then the optionee transfers property (usually cash) to the corporation in exchange for his stock. If his participation is part of an overall plan to provide the corporation with assets in exchange for its stock or securities, it seems then that he ought to be counted as being a transferor of property for stock, and his shares ought to be counted in measuring the 80% control test.

310. Bradshaw v. United States, 683 F.2d 365 (Ct. Cl. 1982); Piedmont Corp. v. Commissioner, 388 F.2d 886 (4th Cir. 1968) (held to be sale); Harbour Properties, Inc. v. Commissioner, 32 T.C.M. (CCH) 580 (1973) (held not to be a sale); see also Six Seam Co. v. United States, 524 F.2d 347 (6th Cir. 1975); Labrot v. Burnet, 57 F.2d 413 (D.C. Cir. 1932); B. Bittker & J. Eustice, supra note 29, ¶ 3.04.


312. As the language of section 351 explicitly recognizes, there is sometimes more than one transferor of property. Usually such cases are pursuant to a plan, and therefore, the transaction qualifies as tax-free under section 351 if the transferors as a group pursuant to this plan satisfy the 80% control test immediately after the exchange. See B. Bittker & J. Eustice, supra note 29, ¶ 3.08; Rothman, supra note 148, at A-7 to A-13. For decisions interpreting this, see Vogel Fertilizer Co. v. United States, 634 F.2d 497 (Ct. Cl. 1980), aff’d, 455 U.S. 16 (1982); Portland Oil Co. v. Commissioner, 109 F.2d 479 (1st Cir.), cert. denied, 310 U.S. 650 (1940); Kamborian v. Commissioner, 56 T.C. 847 (1971), aff’d, 469 F.2d 219 (1st Cir. 1972); Miller Bros. Elec., Inc. v. Commissioner, 49 T.C. 446 (1968); Stevens Pass, Inc. v. Commissioner, 48 T.C. 532 (1967); Baker Commodities, Inc. v. Commissioner, 48 T.C. 374 (1967), aff’d, 415 F.2d 519 (9th Cir. 1969); Hartford-Empire Co. v. Commissioner, 43 B.T.A. 113 (1940), aff’d, 137 F.2d 540 (2d Cir.), cert. denied, 320 U.S. 787 (1943); Royal Marches v. Commissioner, 32 B.T.A. 76 (1935).
In some instances the original transferors might own an insufficient percentage of stock to qualify for section 351, unless the optionee exercises the option and the shares so acquired are aggregated with the other shares. Including the optionee in the transferor group, therefore, would be necessary for any part of the transaction to be covered by section 351. Of course, the taxpayers might not want section 351 to apply.\textsuperscript{313} In other instances the initial transferors might own 80% or more of the shares before the option is exercised, but less than 80% afterward. If the initial transfer and the option are not stepped together, the initial transfer would still be covered by section 351, because the transferor would own 80% or more of the stock immediately after the exchange. If the initial transfer and the option are stepped together, but the optionee is not counted as part of the transferor group (an unreasonable interpretation), no part of the transaction would be covered by section 351 (assuming that the optionee does not receive 80% or more of the stock in exchange for property-in-kind, in which case his exchange would be covered by section 351). The suggested rule would "save" the latter transaction from being disqualified, too, because the optionee would be treated as part of the transferor group and hence the transferors would own more than 80% of the stock. The optionee should be considered as part of the control group only if he promptly exercises the option. If the optionee waits a long time, at some point he must be considered outside the transferor group.\textsuperscript{314}

Almost assuredly somebody would object to the proposed rule, because including the optionee in the control group is conditioned on the exercise of the option and courts often refuse to step together a series of transactions when the latter transactions in the series are not nearly certain to occur at the time the first in the series does occur.\textsuperscript{315} But the proposed rule is supported by the IRS's stance on best-efforts underwriting,\textsuperscript{316} an analogous situation. In a best-efforts underwriting, the movement of property from the public investors to the corporation is direct and uninterrupted.\textsuperscript{317} The IRS has posited that the public investors should be deemed to be transferors for section 351 purposes, provided that the sale of stock to the public takes place in a short period of time and the rights of the parties are clearly defined in the offering.\textsuperscript{318}

\textsuperscript{313} See, e.g., Bradshaw, 683 F.2d at 373; Piedmont, 388 F.2d at 889; see also Lind & Schwarz, supra note 30, at 91.
\textsuperscript{314} See Mintz & Plumb, supra note 171, at 258.
\textsuperscript{315} See, e.g., National Bellas Hess, 20 T.C. at 647; American Bantam, 11 T.C. at 406.
\textsuperscript{317} See Rothman, supra note 148, at A-23.
incorporation and the subsequent public offering are elements in a single transaction.\textsuperscript{319} The same can be said of an option granted as part of a larger transaction to provide a corporation with assets in exchange for its stock or securities.

(3) If: (a) the optionor but not the optionee is a transferor of property to the corporation (the situation in both \textit{Hardy}\textsuperscript{320} and \textit{Barker}\textsuperscript{321}) and (b) the option results in the transferors owning less than 80% of the shares, perhaps it would be wise to take a pragmatic approach. If the option is exercised shortly after the transfer, the transferors could be deemed not to have control “immediately after the exchange.”\textsuperscript{322} If the option is not exercised promptly, the transferors could be deemed to have control “immediately after the exchange.”\textsuperscript{323} This simple approach would avoid several of the difficult step-transaction doctrine inquiries, including whether the initial transfers and the option were “mutually interdependent.”\textsuperscript{324} The most difficult question under this approach would be determining what is “prompt,” an interpretative problem that inheres in the statutory language (“immediately after the exchange”)\textsuperscript{325} and that seemingly could be eliminated only by congressional enactment of a bright line rule (\textit{e.g.}, “for 60 days after the exchange”).

A fourth issue involves the transferor of property who quickly turns over the newly issued stock to a \textit{related} taxpayer. There are numerous permutations in the transaction raising this particular issue. For example, if the transferor is also a corporation, it might distribute the newly received shares to its own shareholders\textsuperscript{326} or to another related entity.\textsuperscript{327} If the transferor is a natural person, he or she might make a gift of the

\textsuperscript{319}. \textit{Id.}
\textsuperscript{320}. See supra notes 291-99 and accompanying text for a discussion of \textit{Harder}.
\textsuperscript{321}. See supra notes 300-09 and accompanying text for a discussion of \textit{Barker}.
\textsuperscript{322}. I.R.C. § 351(a).
\textsuperscript{323}. \textit{Id.}
\textsuperscript{324}. Perhaps the single most important factor in determining the applicability of the step-transaction doctrine is whether the transactions are so interdependent that none of the transactions would have been effected without the others also being consummated. The courts have held that when the latter transactions are the \textit{sine qua non} for the former, the individual transactions are treated as one unified transaction. \textit{See, e.g.}, South Bay Co. v. Commissioner, 345 F.2d 698 (2d Cir. 1965); American Wire Fabrics Corp. v. Commissioner, 16 T.C. 607 (1951); \textit{American Bantam}, 11 T.C. at 406; \textit{see also} Rothman, supra note 148, at A-18.
\textsuperscript{325}. I.R.C. § 351(a). \textit{See, e.g.}, \textit{Baker Commodities}, 48 T.C. at 402; Overland Corp. v. Commissioner, 42 T.C. 26 (1964); \textit{see also} Mintz & Plumb, supra note 171, at 253; Rothman, \textit{supra} note 148, at A-17.
\textsuperscript{326}. Section 351(c) governs this possibility. \textit{See} I.R.C. § 351(c); \textit{see also} B. BITTWER & J. EUSTICE, \textit{supra} note 29, ¶ 3.09 at 3-31 n.92, 3-35.
\textsuperscript{327}. \textit{See} Rev. Rul. 68-298, 1968-1 C.B. 139 (corporation transferred property to newly formed subsidiary in exchange for all of its stock and distributed 25% thereof in redemption of one of its shareholder’s stock).
Section 351(c) resolves one of the problems. It states that in determining control, a distribution of the newly received stock by a “corporate transferor” (a transferor that itself is a corporation) to its own shareholders is not to be taken into account. In other words, the shares issued to the corporate transferor are counted in measuring the 80% control test, even though they are promptly distributed to the transferor's shareholders. The distribution to the shareholders is outside the section 351 transaction, however, and must be accounted for by other Subchapter C sections. For example, it might be treated as a section 355 spin-off distribution, a section 302 redemption or a section 301 distribution.

If a partnership transfers its assets for all of the stock of a newly formed corporation and then distributes the stock to its partners, such distribution does not violate the section 368(c) control requirement either.

The IRS has been prolific in issuing revenue rulings concerning section 351 transactions followed by a quick disposition of the newly issued shares by a corporate transferor to a related entity. Generally it posits that these later transactions do not disqualify the initial transfer from section 351 nonrecognition treatment. The seminal ruling, Revenue Ruling 77-449, involved successive transfers of the same assets, first, from a corporation to its wholly-owned first-tier subsidiary in exchange for additional shares of the first-tier subsidiary’s stock and, second, from that first-tier subsidiary to its wholly-owned, second-tier subsidiary in exchange for additional shares of that second-tier subsidiary’s stock.

The parent retained the shares of the first-tier subsidiary. The first-tier subsidiary retained the shares of the second-tier subsidiary. The second-

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329. I.R.C. § 351(c).
330. A spin-off distribution is a distribution by one corporation of the stock of a subsidiary (either an existing subsidiary or a newly created one). A distribution can qualify under section 355 whether or not it is pro rata with respect to the distributing corporation's shareholders. Id. § 355; see also B. BITTKER & J. EUSTICE, supra note 29, ¶ 13.03.
331. I.R.C. § 302 (such redemption is treated as a distribution as a general rule).
332. Id. § 301.
333. See Miller Bros., 49 T.C. at 449-50.
The transaction effected what is known in tax parlance as a "double drop-down." The Internal Revenue Service chose to view both exchanges as independent transactions rather than to invoke the step-transaction doctrine, even though both exchanges were part of an integrated and pre-planned transaction. Since each of the transfers satisfied the requirements of section 351, no gain or loss was recognized by either the parent or the first-tier subsidiary.

A 1983 revenue ruling extended the analysis of Revenue Ruling 77-449 to double drop-downs to 80% owned (as opposed to wholly-owned) subsidiaries. Another 1983 ruling extended the analysis of Revenue Ruling 77-449 to the transfer of assets by a corporation to its wholly-owned first-tier subsidiary which in turn transferred the assets to a partnership in which the first-tier subsidiary and a second-tier subsidiary were partners. The Internal Revenue Service again viewed the two transfers separately. Because the transfer from the parent to the first-tier subsidiary satisfied the requirements of section 351 and the contribution by the first-tier subsidiary to the partnership satisfied the requirements of section 721, no gain or loss was recognized by either the parent corporation or the first-tier subsidiary.

The double drop-down revenue rulings make sense. Each of the double drop-downs was to an entity controlled by the corporation originally owning the transferred assets. It never relinquished control of the transferred assets, because it had control of the ultimate transferee of the assets. The transactions resulted in a change in the form of ownership and ought not to result in a recognized gain or loss.

In Revenue Ruling 84-111, the Internal Revenue Service also eschewed the step-transaction doctrine in describing the tax consequences applicable to three alternative methods for structuring the incorporation of a partnership. In "situation one" the partnership transferred all of its assets to a newly formed corporation in exchange for all of the corporation's stock and an assumption of the partnership liabilities. The partnership then terminated by distributing the newly issued stock to its partners. In "situation two" the partnership distributed all of its as-

337. Id.
338. Id.
339. Id.
342. Id.
344. Id.
sets and liabilities to its partners, and the partners then transferred all
the partnership assets to a newly formed corporation in exchange for all of
the corporation's stock and an assumption of the partnership liabilities.\(^{345}\) In "situation three" the partners transferred their partnership in-
terests to the newly formed corporation in exchange for all of the
corporation's stock.\(^{346}\) In each situation the steps were parts of a plan to
incorporate the partnership for valid business reasons.\(^{347}\) Revoking a
1970 revenue ruling, which had held that the federal income tax conse-
quences of the three situations should be the same without regard to
which of the three transactions was entered into,\(^{348}\) Revenue Ruling 84-
111 elected to accord independent significance to each step in the de-
scribed situations with the result that, depending on the format chosen
for the transaction, the basis and holding periods of the various assets
received by the corporation and of the stock received by the former part-
ners could vary.\(^{349}\) The revenue ruling stated that the government
wanted to enable taxpayers to avoid certain potential pitfalls raised by
the 1970 revenue ruling, e.g., collapsible corporation status under section
341,\(^{350}\) and to facilitate flexibility with respect to the basis and holding
periods of the assets and stock received in the exchange.\(^{351}\)

In some instances a person transfers property to a newly formed
corporation in exchange for all of its shares and then gives a portion of
those shares to a family member,\(^{352}\) usually either a spouse\(^ {353}\) or a
child.\(^{354}\) If the transferor gives away more than 20% of the stock, he has
managed to reduce his own percentage of stock ownership below the
80% level. Indeed, he may have intended to push down his percentage
of stock ownership below the 80% mark so that his transfer to the corpo-
ration avoids section 351 treatment.\(^{355}\) The leading case is a Second Cir-
cuit opinion, *Wilgard Realty Co. v. Commissioner*,\(^{356}\) a case in which the
transferor gave away approximately 75% of the shares on the same day

\(^{345}\) *Id.*

\(^{346}\) *Id.*

\(^{347}\) *Id.*


\(^{350}\) I.R.C. § 341.


\(^{352}\) See, e.g., *Stanton*, 512 F.2d at 14; *Fahs v. Florida Mach. & Foundry Co.*, 168 F.2d 957
(5th Cir. 1948); *Wilgard Realty*, 127 F.2d at 515-16; *D'Angelo Assoc.*, 70 T.C. at 132; Majon-
nier & Sons, Inc. v. Commissioner, 12 T.C. 837 (1949), *non acq.*, 1949-2 C.B. 4; see also B.

\(^{353}\) See *Stanton*, 512 F.2d at 14.

\(^{354}\) See *Fahs*, 168 F.2d at 958.

\(^{355}\) See B. Bittker & J. Eustice, *supra* note 29, ¶ 3.09, at 3-34.

\(^{356}\) 127 F.2d 514 (2d Cir.), *cert. denied*, 317 U.S. 655 (1942).
that he received them.\textsuperscript{357} The court held that, despite the gift, the transferor satisfied the control test, because he had the power to keep the stock or give it away.\textsuperscript{358} The court was not impressed with the argument that he had made up his mind to give away most of the stock before the transfer. The court thought that it was "immaterial" how soon thereafter he elected to dispose of his stock by gift or otherwise and whether or not such disposition was pursuant to a preconceived plan.\textsuperscript{359} Wilgard still is good law: A gift to a family member made after the transfer does not disqualify the transaction from section 351 treatment.\textsuperscript{360}

After Wilgard, taxpayers who wanted to avoid nonrecognition treatment made the corporation issue more than 20\% of its stock directly to the donees.\textsuperscript{361} Since the donees would not transfer any property to the corporation, the transfers presumably would not fall under section 351 because the transferors failed to own 80\% of the stock of the transferee corporation.\textsuperscript{362} This method of avoiding section 351 was recognized for almost thirty years,\textsuperscript{363} but a 1978 Tax Court opinion, \textit{D'Angelo Associates v. Commissioner},\textsuperscript{364} has raised doubts about the viability of this device.

In \textit{D'Angelo}, a dentist incorporated his dental practice, transferring cash and assets to the corporation.\textsuperscript{365} To avoid section 351, he made the corporation issue its shares directly to his children instead of to himself.\textsuperscript{366} The court, however, viewed the transaction as a transfer of assets by the dentist to the corporation in exchange for its shares followed by a gift of the controlling stock to the children.\textsuperscript{367} The determinative factor, the court felt, was the absolute right of the transferor to designate who was to receive the newly issued stock.\textsuperscript{368} The power to designate the recipient of the stock, not the precise moment that the power was exercised, was controlling. The court concluded that the possession of this power in the transferor was the essential element for control under section 351 and that, therefore, the transaction satisfied the section 351 con-

\textsuperscript{357} \textit{Id.} at 515-16 (total shares = 200; shares given as gift = 156; therefore: percent of shares given as gift = 156/200 x 100 = 78\%).
\textsuperscript{358} \textit{Id.} at 516.
\textsuperscript{359} \textit{Id.}
\textsuperscript{360} See, e.g., \textit{Stanton}, 512 F.2d at 18; \textit{D'Angelo Assoc.}, 70 T.C. at 132; see also Rothman, \textit{supra} note 148, at A-24.
\textsuperscript{361} See D. \textsc{Kahn}, \textit{supra} note 244, § 8.12, at 298 n.4; see also \textit{Fahs}, 168 F.2d at 959.
\textsuperscript{362} See \textit{Fahs}, 168 F.2d at 958.
\textsuperscript{363} Thirty years passed between 1948, the year of the \textit{Fahs} decision, 168 F.2d 957 (5th Cir. 1948), and 1978, when \textit{D'Angelo Assoc. v. Commissioner}, 70 T.C. 121 (1978), was decided.
\textsuperscript{364} 70 T.C. 121 (1978).
\textsuperscript{365} \textit{Id.} at 123-24.
\textsuperscript{366} \textit{Id.} at 128.
\textsuperscript{367} \textit{Id.} at 131.
\textsuperscript{368} \textit{Id.} at 132.
Commentators have suggested that courts should distinguish, or in a de facto manner already have distinguished, between commercially and intra-family motivated losses of control for purposes of section 351 disqualification. A commercially motivated loss of control results in disqualification, while an intra-family loss of control does not result in disqualification. Perhaps another distinction is as helpful—the loss of control resulting from a transfer of stock to a nonrelated party is more likely to result in disqualifying the full transaction from section 351 treatment than a loss of control resulting from a transfer of stock to a related party. The IRS certainly has propounded revenue rulings that bolster the latter conclusion.

V. LIABILITIES

Sections 357(a), 358(d)(1) and 362(a)(1) are the primary sections of the Code that deal with the impact of liabilities on section 351 exchanges. According to section 357(a), the transfer of property to a corporation under section 351 does not result in recognition of a gain or loss to the transferor, even though: (1) the transferred property is subject to a liability; or (2) the corporate transferee assumes a liability of the transferor. Section 358(d)(1) requires the transferor to reduce his basis in his newly received stock or securities by the sum of any liabilities encumbering the transferred property plus any of his liabilities assumed by the transferee corporation. Section 362(a)(1) requires the corporate transferee to take a carryover basis in the transferred assets, which basis is likely to include any liabilities encumbering the assets (if any), because the transferor probably included those liabilities in calculating his own basis in those assets.

369. Id. at 131-33.
370. See B. Bittker & J. Eustice, supra note 29, ¶ 3.09, at 3-34.
371. Id.
374. Id. § 357(a).
375. Id. § 358(d)(1). More specifically, section 358(d)(1) states that the liability is to be treated as money distributed to the transferor as part of the exchange. Id. Section 358(a)(1)(A) provides that the transferor is to take the substituted basis decreased by, among other things, the amount of any money distributed to the transferor. Id. § 358(a)(1)(a)(ii). In other words, the liability is treated as money distributed to the transferor and this distributed money results in a decrease in the transferor's basis in his stock. Id.; see also id. § 358(d)(1).
376. Id. § 362(a)(1). The cost of property, and therefore its basis under section 1012 of the code, includes payments with borrowed funds as well as the amount of obligations given or assumed by the purchaser as part of the price period. See 7 Fed. Taxes (P-H), ¶ 31161, 31164 (1989). It includes the amount of any mortgage encumbering the property at the time of the
Section 357(a) is the successor to section 112(k) of the 1939 Code, which was the congressional response to nullify the United States Supreme Court case of United States v. Hendler. In Hendler, the Court characterized the assumption of liabilities in an otherwise tax-free reorganization as the distribution of boot to the transferor. Hence, the transferor's realized gain was recognized to the extent of assumption. The Internal Revenue Code likewise could treat the amount of the liabilities as boot, tax it according to the boot rules, and allow the unencumbered portion of the transaction to pass tax-free. But in enacting section 357(a), (and its predecessor, section 112(k) of the 1939 Code), Congress decided not to do this. Instead, like its predecessor, section 357(a) accords total nonrecognition to the transaction, despite the transfer of liabilities.

Section 357(a) nonrecognition treatment is sound. As noted in the congressional reports for section 357(a)'s predecessor, it is not customary in the typical transaction changing the form or entity of a business to liquidate the liabilities of the business; such liabilities are almost invariably assumed by the corporation that continues the business. If assuming liabilities would result in the recognition of a gain, then the purpose of the reorganization sections, as well as section 351, which is to postpone the recognition of gain, would largely be nullified.

Moreover, the shareholder in such cases has not really cashed in on purchase, whether the buyer takes subject to the mortgage or becomes personally liable for it. See Crane v. Commissioner, 331 U.S. 1, 14 (1947).

378. See generally Greiner, Behling, & Moffett, Assumption of Liabilities and the Improper Purpose—A Re-Examination of Section 357(b), 32 Tax Law. 111, 112 (1978).
380. 303 U.S. 564 (1938).
381. Id. at 566.
382. Id. at 566-67.
385. I.R.C. § 357(a). Sections 357(b) and 357(c) contain statutory exceptions to the nonrecognition rule of section 357(a). See infra notes 407-504 and accompanying text for a description of these exceptions. Section 113(a)(6) of the 1939 Code contained the rule now contained in section 357(b). See I.R.C. § 113(a)(6) (1939), amended by I.R.C. § 357(b) (1986). See generally Surrey, Assumption of Indebtedness in Tax-Free Exchanges, 50 Yale L. J. 1 (1940).
387. Id.
his investment because of the transferred liability. For instance, take the case of the transferor of encumbered property. Before the transfer he owned property subject to a liability; now he owns stock in a corporation that owns the same property subject to the same liability. There is no real change in the shareholder's net worth, because the value of the stock is diminished by the amount of the liability. He has exactly the same "equity" in his stock that he had previously in the transferred asset. For example, suppose that Anne bought a piece of property for $100. She paid $15 in cash and granted a mortgage of $85 to cover the balance of the purchase price. According to settled tax law, her basis in the property included the $85 mortgage as well as the $15 cash payment, i.e., the basis was $100. She later transferred the property for 100% of the stock of a newly formed corporation, X Corp. At the time of the transfer the property had appreciated in value to $120, and Anne had paid $15 on the mortgage, reducing the unpaid balance to $70. Immediately prior to the transfer, $50 of her net worth was traceable to her ownership of the property, i.e., her equity in the property ($120 fair market value minus $70 unpaid mortgage = $50 equity). Immediately after the transfer, $50 of her net worth was traceable to her ownership of the shares, i.e., the book value of her shares, which should have matched X Corp's equity in the transferred property ($120 fair market value assets minus $70 liabilities = $50 book value). Obviously, Anne has yet to cash in on her property. Whether or not she has placed the property in corporate solution, the asset is worth $50 to her.

According to section 357(a), the liability encumbering the transferred property does not prevent the usual nonrecognition rule of section 351(a) from applying to Anne. Hence, Anne doesn't recognize a gain on the transfer. According to section 358(a) and (d), Anne's basis in X Corp is $30: A substituted basis minus the liability encumbering the transferred property ($100 Anne's basis in transferred property minus $70 liability encumbering transferred property = $30). As determined under section 362(a), X Corp's basis in the property is the same as the

389. I.R.C. §§ 351(a), 357(a).
390. Id. §§ 358(a), (d).
391. Id. Section 358(a)(1) also requires the shareholder to decrease her basis in her newly received shares by the amount of money and the fair market value of any other property received by her in the exchange. Id. § 358(a)(1). She increases her basis by any gain she recognized on the exchange. Id. § 358(a)(1)(B).
basis that Anne had in the property,\textsuperscript{392} i.e., a carryover basis of $100.

The reduction in basis required by section 358(d)(l) is the primary mechanism for preventing the transferor of encumbered property from excluding the liability from his amount realized upon a later disposition of his stock.\textsuperscript{393} Such an exclusion would distort the actual gain that he realized on the sale of his stock, because the tax law permits him to count the liability as part of his basis in the transferred property,\textsuperscript{394} and he takes that basis in the transferred property as his basis in his shares.\textsuperscript{395} To illustrate, suppose that in the hypothetical above, Anne had sold her X Corp stock to Bob for $50 (the book value of her stock). Without the basis reduction required by section 358(d)(l), Anne’s basis in her stock would have been $100, i.e., a substituted basis.\textsuperscript{396} Not only would she have avoided recognizing a gain caused by the appreciation in value of the property on the sale of the stock to Bob, she even would have recognized a loss of $50 ($50 amount realized minus $100 basis in stock = $50 loss).\textsuperscript{397} Section 358(d)(l) required Anne to reduce her basis in her stock from $100 to $30 (\$100 substituted basis minus \$70 liability = \$30 basis in X Corp stock); however, she recognizes a $20 gain on the sale of the X Corp stock to Bob (\$50 amount realized minus \$30 basis in stock = \$20 gain).\textsuperscript{399} The property appreciated in value by $20 while she owned it, and thus, she is properly being taxed on that $20 upon sale of her stock. She also would have recognized a $20 gain if instead of transferring it to X Corp she had sold it, subject to the $70 mortgage, directly to Bob. According to \textit{Crane v. Commissioner},\textsuperscript{400} Anne’s amount realized would include the $70 mortgage as well as the $50 cash payment and thus would have been $120.\textsuperscript{401} Since she had a basis of $100 (which included the original amount of the mortgage),\textsuperscript{402} she would have recognized a gain of $20.\textsuperscript{403} The system works out so that Anne recognizes a $20 gain when she cashes in on her investment in the property, whether

\textsuperscript{392} Id. \S 362(a)(1). If the transferor recognized a gain on the exchange, the transferee corporation increases its basis in the transferred property by the amount of the recognized gain by the transferor. \textit{Id.}

\textsuperscript{393} Id. \S 358(d)(1).

\textsuperscript{394} See supra notes 376 and 389 and accompanying text.

\textsuperscript{395} See I.R.C. \S 358(a)(l).

\textsuperscript{396} Id. \Ss 358(a)(1), (d)(1).

\textsuperscript{397} See id. \S 1001(a).

\textsuperscript{398} Id. \S 358(d)(1).

\textsuperscript{399} Id. \S 1001(a), (c).

\textsuperscript{400} 331 U.S. 1 (1947).

\textsuperscript{401} See id. 331 U.S. at 12.

\textsuperscript{402} See supra notes 376, 388 and 394 and accompanying text.

\textsuperscript{403} See I.R.C. \Ss 1001(a), (c).
she does so through a direct sale of property or through sale of the stock of a corporation owning the property.

The encumbrance or the assumption of liability has no impact on the basis that the transferee corporation takes in the transferred assets. According to section 362(a)(1), which is silent about liabilities, the corporation takes the basis that the transferor had as its basis in the property.\textsuperscript{404} This rule makes sense. Because the section 351 transfer is considered to be merely a change in the form of ownership,\textsuperscript{405} the transferee corporation should be standing in the same shoes as the transferor with respect to the transferred property. That means that it should have the same basis in the property that the transferor had. To the extent the transferor included the liabilities in calculating his own basis in the transferred assets, the corporation does the same, but it does so because it takes a carryover basis\textsuperscript{406} and not because the transferred property is encumbered or it assumes a liability.

Section 357(b) contains one of the statutory exceptions to the general nonrecognition rule of section 357(a).\textsuperscript{407} Section 357(b) denies the nonrecognition treatment accorded by section 357(a) to the transferor where it appears that the principal purpose of the transferor with respect to the transfer of the liability was to avoid federal income tax on the exchange,\textsuperscript{408} or, if not for such purpose, at least was not a bona fide business purpose.\textsuperscript{409} If the government argues that section 357(b)(1) applies, section 357(b)(2) requires the transferor to prove the absence of the forbidden purpose by a "clear preponderance of the evidence."\textsuperscript{410} Using a bit of hyperbole, the regulations declare that the absence of a tax avoidance purpose or the presence of a bona fide business purpose must be "unmistakable!"\textsuperscript{411} If the government prevails with respect to the purpose, section 357(b) dictates that the liability must be treated as money distributed to transferors as part of the exchange.\textsuperscript{412} In other words, it is

\footnotesize
\begin{enumerate}
\item \textit{Id.} § 362(a)(1). If the transferor recognizes a gain on the exchange, the transferee corporation increases its basis in the transferred property by the amount of the gain recognized to the transferor. \textit{Id.}
\item \textit{Id.} § 362(a)(1).
\item \textit{Id.} §§ 357(a), (b). The other statutory exception is contained in section 357(c) of the Code. \textit{Id.} § 357(c).
\item \textit{Id.} § 357(b)(1)(A).
\item \textit{Id.} § 357(b)(1)(B).
\item \textit{Id.} § 357(b)(2); see also Greiner, Behling, & Moffett, \textit{supra} note 378, at 114-15.
\item Treas. Reg. § 1.357-1(c) (1961).
\item I.R.C. § 357(b)(1).
\end{enumerate}
to be considered boot, and is to be taxed according to the boot rules of section 351(b). According to section 351(b), a transferor in a section 351 exchange must recognize his or her realized gain if he or she has received, in addition to stock or securities permitted to be received under section 351(a), other property or money, but only to the extent of the amount of money received plus the fair market value of such other property received. If the transferred liability is governed by section 357(b), it is to be considered as money received by the transferor on the exchange for purposes of section 351.

Section 357(b) is deceivingly subtle. It is the transfer of the liability to the corporation, not the origin of the liability or the use of the proceeds derived from it, that must be tainted with the improper purpose for section 357(b) to apply. Neither the liability itself nor the use of the proceeds need have a business purpose. Thus, theoretically, the transferred liability might be a loan that had absolutely nothing to do with the business world at the time of its creation. The transferor might have used the loan proceeds for purely personal reasons, e.g., to finance the college education of his children; and yet, the transferor would not run afoul of section 357(b) if he can show that the purpose of transferring the liability to the corporation was not to avoid the boot rules and that he had a business purpose for transferring the debt to the corporation. Of course, it may be improbable that anyone, much less the government, is going to believe the transferor's protestations that he had a legitimate purpose.

413. See Greiner, Behling & Moffett, supra note 378, at 114. See also I.R.C. § 357(b)(1). The regulations declare that in such cases the total amount of the liabilities and not merely a particular liability with respect to which the tax avoidance or nonbusiness purpose existed shall be treated as money received by the transferor upon the exchange. Treas. Reg. § 1.357-1(c)(1961).

414. Id. If the transferor had an improper purpose in transferring the liability, section 357(b) requires the "total amount of the liability" transferred to be treated as money received by the transferor on the exchange. Id.; see also Greiner, Behling & Moffett, supra note 378, at 114.

415. See Greiner, Behling & Moffett, supra note 378, at 114. See also I.R.C. § 357(b)(1). The regulations declare that in such cases the total amount of the liabilities and not merely a particular liability with respect to which the tax avoidance or nonbusiness purpose existed shall be treated as money received by the transferor upon the exchange. Treas. Reg. § 1.357-1(c)(1961).


417. See I.R.C. § 357(b)(1); see also Thatcher, 61 T.C. at 35; ISC Indus., Inc., 30 T.C.M. at 1218; Estate of Stoll, 38 T.C. at 246-47; Greiner, Behling & Moffett, supra note 378, at 117, 122.

418. See ISC Indus., Inc., 30 T.C.M. at 1218-19; see also Greiner, Behling & Moffett, supra note 378, at 123-24; Lavya, supra note 417, at A-19.

419. See ISC Indus., Inc., 30 T.C.M. at 1218-19; see also Greiner, Behling & Moffett, supra note 378, at 123-24; Lavya, supra note 417, at A-17 to A-20.
business purpose for the transfer of the liability in such a case.\textsuperscript{421} Moreover, section 357(b) saddles him with the difficult burden of proving his proper purpose by a clear preponderance of the evidence.\textsuperscript{422} Still, according to the statute, the key is the transferor’s principal purpose in transferring the liability, not the origin of the liability or the use of the proceeds derived from it.\textsuperscript{423} One of the tainted purposes under section 357(b) is the avoidance of federal income tax on the section 351 exchange.\textsuperscript{424} As section 351 exchanges produce gain to the transferor only when he receives boot (cash or property other than the transferee’s stock or securities),\textsuperscript{425} this part of section 357(b) is aimed at transfers of liabilities that in effect are substitutions for the distribution of boot to the transferors. Without section 357(b) an owner with some equity in his property could take out a mortgage on it, stick the loan proceeds in his back pocket, and transfer the property tax-free under sections 351 and 357 in exchange for stock of his controlled corporation, which then takes over the burden of paying off the loan.\textsuperscript{426} No part of the transaction would result in taxable income for the transferor. The granting of a mortgage is not taxable.\textsuperscript{427} The transfer of the property and the assumption of the mortgage would be protected by sections 351(a) and 357(a).\textsuperscript{428} The problem is that, except for the order of the steps, the transaction is exactly the same as a transfer of unencumbered property to a controlled corporation followed by the granting of a mortgage by the corporation and a distribution of the loan proceeds by the corporation to the transferor. The distribution of the loan proceeds to the transferor in this second transaction clearly would be considered a distribution of boot, and would be taxed to the transferor under section 351(b).\textsuperscript{429} No matter

\textsuperscript{421} See, e.g., Drybrough, 376 F.2d at 358; Thompson v. Campbell, 353 F.2d 787, 788 (5th Cir. 1965); Campbell v. Wheeler, 342 F.2d 837, 840 (5th Cir. 1965); Harrison v. Commissioner, 41 T.C.M. (CCH) 1384 (1981); Wolf v. Commissioner, 43 T.C. 652 (1965), aff’d, 357 F.2d 483 (9th Cir. 1966).

\textsuperscript{422} I.R.C. § 357(b)(2); see also Greiner, Behling & Moffett, supra note 378, at 125.

\textsuperscript{423} See I.R.C. § 357(b)(1).

\textsuperscript{424} Id. § 357(b)(1)(A).

\textsuperscript{425} Id. § 351(a), (b).

\textsuperscript{426} See Lavva, supra note 417, at A-16; see also Thompson, 353 F.2d at 789; Bittker & J. Eustice, supra note 29, at ¶ 3.06, 3-22.

\textsuperscript{427} The granting of a mortgage is neither a sale nor an exchange of the property. Therefore the mortgage is not taxable. Moreover, if the mortgage does not have cash equivalent value, it is not taxable in the year of receipt. See Olster v. Commissioner, 79 T.C. 456, 469 n.14 (1982), aff’d, 751 F.2d 1168 (11th Cir. 1985).

\textsuperscript{428} I.R.C. §§ 351(a), 357(a).

\textsuperscript{429} See id. § 351(b). The proposition in the text assumes that each of the three steps is part of an integrated transaction that will be linked together through the step transaction doctrine. If the distribution of the loan proceeds by the corporation to the transferor is consid-
which of the two structures is chosen for the transaction, however, the transferor starts out with property and ends up with stock of a controlled corporation and cash in exchange for his property. The corporation ends up with new property and, ultimately, less cash. Section 357(b) makes the transfer of the mortgage result in boot income, too, unless the transferor can show that the transfer of the mortgage was not to avoid the boot income he would have been required to report had the corporation taken out the mortgage and distributed the loan proceeds to him after the transfer.\footnote{30}

Even if the purpose of transferring the liability was not to avoid federal income tax on the section 351 exchange, section 357(b) applies when the transferor cannot prove a bona fide business purpose for the transfer of the liability.\footnote{31} This rule is aimed at the transfer of personal liabilities that are unconnected with the corporation's business.\footnote{32} For example, if the transferee corporation assumes the payment of a loan that was used to furnish a college education for the transferor's child, the transferor will be hard pressed to prove a business purpose for the assumption of the loan by the corporation.\footnote{33} In one case, the court concluded that the assumption of the obligation to pay the personal taxes of the transferor served no business purpose.\footnote{34} The transferred liability, therefore, constituted boot to the transferor.\footnote{35} The courts and the government look askance at the transfer of a liability when the transferor retains the proceeds of the loan for personal use, rather than using them in the business, or retains encumbered assets while transferring the liability.\footnote{36}

Section 357(c)(1)\footnote{37} contains the other statutory exception to the general nonrecognition rule of section 357(a).\footnote{38} Unlike section 357(b) which provides a subjective test of motive,\footnote{39} section 357(c)(1) applies a
strictly objective test.\(^4\) Section 357(c)(1) requires the transferor in a section 351 exchange to recognize a gain to the extent that the sum of the transferred liabilities exceeds the total of the adjusted basis of the property transferred to the corporation as part of the exchange.\(^4\) For example, if in a section 351 exchange Anne transfers property subject to a $40 mortgage, with an adjusted basis in her hands of $15, she must recognize a gain of $25, the excess of the transferred liability over her adjusted basis in the transferred property.\(^4\)

The reasons for section 357(c) and its workings can be seen through another illustration.\(^4\) Suppose that Anne owns property that is worth $320 and is subject to a mortgage of $250 and in which she has an adjusted basis of $90. Her equity in the property is thus $70 ($320 fair market value minus $250 mortgage = $70 equity). If she sells the property to Bob for $320 ($70 cash and an assumption of the $250 mortgage),

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\(^4\) The hypothetical is based on the facts of Easson, 294 F.2d at 654.
she would recognize a gain of $230 ($320 amount realized minus $90 adjusted basis = $230 recognized gain). If section 357(c) did not exist and she transferred her property to a newly formed corporation in exchange for all of its shares, sections 351(a) and 357(a) would accord her nonrecognition treatment on the exchange, and her basis in her newly received shares, as computed under section 358(a) and 358(d), would be $90 substituted basis minus $250 transferred liability, equalling a negative basis of $160. If the tax law had been willing to require Anne to take a negative basis in her stock, the system could have worked properly without section 357(c).

Presumably Bob would be willing to buy Anne's shares at book value, which would be the same as the corporation's equity in the transferred property, i.e., $70 ($320 fair market value property minus $250 mortgage = $70 equity in property or book value of Anne's shares). When Anne sells her shares to Bob for $70, she would recognize a gain of $230 ($70 amount realized minus a negative adjusted basis of $160 in Anne's shares = $230 recognized gain), the same gain Anne would recognize if she did not incorporate and instead sold the property directly to Bob. The negative basis concept, however, disquieted the tax bar (including the judiciary), which had difficulty conceptualizing a basis below zero. Hence, in the mind of some, Anne's basis would have to be left at exactly zero. If Anne has a zero basis in her stock, her recognized gain on the sale of her shares to Bob for $70 would

444. See I.R.C. § 357(c)(1); see also Crane, 331 U.S. at 14.
445. See I.R.C. §§ 351(a), 357(a).
446. See id. §§ 358(a), (d).
447. For substantial commentary on the problems associated with a negative basis, see Crane, 331 U.S. at 9-10; Easson, 294 F.2d at 657-58; Cooper, Negative Basis, 75 Harv. L. Rev. 1352 (1962); Greenlee & Kramer, The Mortgagor with a "Negative Basis," 27 Taxes 887 (1949); Johnson, "Negative Basis" Problems in Oil and Gas Transactions, Third Ann. Inst. on Oil and Gas Transactions (1952); Kahn & Oesterle, A Definition of "Liabilities" in Internal Revenue Code Sections 357 and 358(d), 73 Mich. L. Rev. 461, 471 n.51 (1975); Lurie, Taxing Transfers of Mortgage Property, 39 Cornell L. Q. 611, 630 (1954); Comment, Section 357(c) and the Cash Basis Taxpayer, 115 U. Pa. L. Rev. 1154 (1967); see also B. BITTKER & J. EUSTICE, supra note 29, ¶ 3.06, at 3-25; Lavya, supra note 417, at A-22.
448. See I.R.C. § 1001(a), (b). For a discussion of computation of negative basis, see generally Cooper, supra note 447.
449. See supra notes 443-44 and accompanying text.
450. See Lavya, supra note 417, at A-22-23; see also Easson, 294 F.2d at 657-58 (tax court was not willing to accept the negative basis thesis); First Nat'l Indus., Inc. v. Commissioner, 26 T.C.M. (CCH) 608 (1967), aff'd, 404 F.2d 1182 (6th Cir. 1968), cert. denied., 394 U.S. 1014 (1969).

For a discussion of this issue prior to enactment of section 357(c), see Crane, 331 U.S. at 6-11 (1947); Parker v. Delaney, 186 F.2d 455, 459-60 (1st Cir. 1950) (Magruder, J., concurring) (computed gain on repossession of mortgaged property using negative basis), cert. denied, 341 U.S. 926 (1951).
be only $70 ($70 amount realized minus zero basis in shares = $70 recognized gain).\textsuperscript{452} The $70 gain would be $160 less than the $230 gain that she would recognize if she did not incorporate and instead sold the property directly to Bob.\textsuperscript{453}

In economic terms, of course, the sale of the property directly to Bob and the sale of the stock after incorporation are identical transactions. In both situations Anne receives cash in an amount equal to her equity in the property ($70) and is relieved of the obligation to pay the mortgage ($250). In the case of the incorporation, Anne is receiving stock, equal in value to her equity in her property, and is being relieved of a liability. If she has a zero basis when she sells her stock, she will be taxed only on the book value of her stock (the $70 paid by Bob).\textsuperscript{454} Congress could have remedied the problem by making Anne take a negative basis in her stock at the time of the section 351 exchange,\textsuperscript{455} which would have resulted in Anne recognizing a gain, as computed above, of $230.\textsuperscript{456} Instead Congress elected to tax the excess of the liability over the adjusted basis at the time of the section 351 transfer, declaring that “such excess shall be considered as a gain from the sale or exchange” of the transferred asset.\textsuperscript{457} Thus, under section 357(c) as currently constituted, Anne must recognize a gain on the excess of the transferred liability over her adjusted basis, which, when computed, results in recognized gain of $160 at the time of the section 351 transfer ($250 transferred liability minus $90 adjusted basis in Anne’s shares = $160 recognized gain).\textsuperscript{458} Anne then plugs the recognized gain and the assumed liability into the regular section 358 formula to compute her basis in her newly received stock.\textsuperscript{459} According to section 358(d) the liability is counted as cash distributed by the corporation to Anne as part of the section 351 exchange.\textsuperscript{460} The computation results in Anne taking a zero basis in her stock ($90 substituted basis minus zero dollars fair market value property-in-kind distributed to Anne minus $250 cash distributed to Anne [the mortgage] plus $160 gain recognized by Anne = zero dollars Anne’s basis in her stock).\textsuperscript{461} When Anne sells her stock to Bob for $70, she

\textsuperscript{452} See I.R.C. §§ 1001(a)-(c).

\textsuperscript{453} See supra text accompanying notes 443-44.

\textsuperscript{454} See supra text accompanying notes 443-44.

\textsuperscript{455} See Kahn & Oesterle, supra note 447, at 447; see also Easson, 294 F.2d at 658; Parker, 186 F.2d at 459 (Magruder, J., concurring); Cooper, supra note 447, at 1359.

\textsuperscript{456} See supra text accompanying notes 447-48.

\textsuperscript{457} See i.R.C. § 302(c)(1). See generally Kahn & Oesterle, supra note 447, at 471.

\textsuperscript{458} See i.R.C. § 357(c)(1).

\textsuperscript{459} See id. §§ 358(a), (d).

\textsuperscript{460} Id. § 358(d).

\textsuperscript{461} See id. §§ 358(a), (d).
recognizes a $70 gain,462 because her adjusted basis in her stock is zero. When Anne adds the $70 recognized gain on the sale of her stock to the $160 section 357(c)(1) recognized gain, she has a total recognized gain of $230 for the two transactions. That matches the amount of recognized gain that she would have had, if she had not incorporated and instead had sold the property directly to Bob for $230.463 It also matches the gain that she would have recognized, had she been required to take a negative basis in her stock.464

Neither section 357(b)465 nor section 357(c)(1)466 attempts to classify the type of gain recognized on account of their applicability. While section 357(b)467 is silent, section 357(c)(1) expressly leaves the classification of the gain to the other general definitional sections of the Internal Revenue Code, declaring that the recognized gain shall be treated as gain from the sale or exchange of a capital asset or a noncapital asset, "as the case may be."468 The determination of whether a recognized capital gain is long-term or short-term is made by referring to the holding period of the transferor in the transferred assets.469 If a transferor conveys more than one piece of property and those pieces, if sold by him, would produce more than one type of gain for him, e.g., a long-term capital gain and a short-term capital gain, he must prorate the gain recognized on account of section 357(c)(1) between those different types of gain according to the fair market values of the transferred items.470 A possible result of this proration rule is that in one transaction a transferor could recognize a gain that is divided into ordinary income, short-term capital gain and long-term capital gain.471 For example, suppose that Anne recognized a gain of $30 on account of section 357(c)(1). Based on their fair market value at the time of the transfer, noncapital assets constituted one-half of the assets that Anne transferred to the corporation, capital assets held for less than six months constituted one-third of the assets and capital assets held for more than six months constituted one-sixth of the assets. Of Anne's $30 recognized gain, $15 is ordinary income, $10 is a short-term capital gain and $5 is a long-term capital gain. Moreover, a

462. See id. §§ 1001(a)-(c).
463. See supra notes 443-44 and accompanying text.
464. See supra notes 447-48 and accompanying text.
465. See I.R.C. § 357(b)(1); Greiner, Behling & Moffett, supra note 378, at 127.
466. See I.R.C. § 357(c)(1); Treas. Reg. § 1.357-2(a) (1980); Greiner, Behling & Moffett, supra note 378, at 127.
467. See I.R.C. § 357(b)(1); Greiner, Behling & Moffett, supra note 378, at 127.
468. See I.R.C. § 357(c)(1); see also Treas. Reg. § 1.357-2(a) (1980).
470. Id.
471. Id.
revenue ruling has applied section 1239 to turn a capital gain recognized on account of section 357(c)(1) into ordinary income.\footnote{472} Similarly, the Tax Court has applied section 1245 recapture rules to section 357(c)(1) gain.\footnote{473} It is likely that other recapture rules, e.g., section 1250, also apply.\footnote{474}

Section 357(c)(2) requires section 357(b) to be applied over section 357(c)(1) in those situations when the transfer falls under both sections 357(b) and 357(c)(1).\footnote{475} The predominance of section 357(b) over 357(c)(1) more often than not is to the government's advantage, because section 357(b) is likely to produce a bigger recognized gain than would section 357(c)(1). Though the transferred liability produces recognized gain under section 357(b) only to the extent that the transferor has a realized gain,\footnote{476} the realized gain often covers the full amount of the transferred liability. When it does, the recognized gain produced by section 357(b) (the full amount of the transferred liability) obviously is greater than the gain that could be produced by section 357(c)(1), which taxes only the excess of the transferred liability over the adjusted basis of the transferred assets.\footnote{477} Because the subjective motive of the transferor
is a factor under section 357(b), it is virtually impossible to predict in advance whether a court will find for the taxpayer or the government when section 357(b) is at issue. Consequently, the government will launch a two-pronged attack against the transferor of the liabilities. When it looks like section 357(c)(1) applies, it is possible that section 357(b) applies also. In an attempt to treat the entire amount of the transferred liabilities as boot, the government will argue that section 357(b) applies. If the government loses on the section 357(b) issue, it next will invoke section 357(c)(1) to tax the excess of transferred liabilities over the adjusted basis of the transferred assets.

According to section 357(c)(3), a transferred liability is not counted as a liability in applying the general rule of section 357(c)(1) if the transferor would have been entitled to a deduction had he discharged the liability himself. Section 358(d)(2) contains a corresponding exclusion for determining the basis of the transferor in the stock or securities received in the exchange: the liabilities excluded under section 357(c)(3) are not used to reduce the transferor’s basis in the stock or securities he receives in the section 351 transfer.

Section 357(c)(3) codified the rule of Focht v. Commissioner, a case in which the Tax Court overruled the harsh stance it had taken in Raich v. Commissioner. In Raich, a cash method taxpayer incorporated his sole proprietorship, transferring both trade accounts receivable and trade accounts payable in exchange for all of the stock of a newly formed corporation. The transferred receivables nearly doubled his transferred payables. The other transferred assets were negligible. The Commissioner successfully claimed that the payables were liabilities

the gain of $160 that Anne would be required to recognize under section 357(c)(1), if that section were applicable.

478. Id. § 357(b)(1).


480. See Greiner, Behling & Moffett, supra note 378, at 128-29.

481. Id. at 128.


484. Id. § 357(c)(3).


486. 46 T.C. 604 (1966).

487. Id. at 605.
within the meaning of section 357(c) and that the receivables had a zero basis in the hands of the transferor.\textsuperscript{488} Thus, the sum of the transferred liabilities (mostly the payables) exceeded the basis of the transferred assets (mostly the receivables which had a zero basis).\textsuperscript{489} The Tax Court applied section 357(c) literally, holding that the proprietor had to treat the excess of the transferred liabilities over the adjusted basis of the assets as a recognized gain.\textsuperscript{490}

The \textit{Raich} decision drew "reams" of adverse criticism, leading eventually to its overruling by both \textit{Focht} and section 357(c)(3).\textsuperscript{491} Its problem was its failure to abide by a primary supposition of the tax system: For income to be stated clearly, revenues and expenses should be matched. By counting the revenues but not the expenses, the \textit{Raich} court distorted the income position of the proprietor.\textsuperscript{492} The result was a taxable gain for something that was not in fact an economic gain.\textsuperscript{493} The proprietor had not cashed in on his business; he had merely changed its form from a proprietorship to a corporation. Moreover, the transfer of the deductible obligation of a cash method taxpayer should not result in a recognized gain to him because that taxpayer would have been entitled to an additional benefit (a deduction) if he had paid the obligation; it would be inequitable to simultaneously treat the transferred liability as income to that taxpayer and to deny him the tax benefit for satisfaction of that debt.\textsuperscript{494}

Despite its origin as a balm for the cash method taxpayer who transfers both trade accounts receivable and trade accounts payable,\textsuperscript{495} the exclusion of section 357(c)(3) is by no means limited to transferred trade accounts payable or to cash method taxpayers. It also applies to other

\textsuperscript{488} \textit{Id.} at 610.
\textsuperscript{489} \textit{Id.} at 610-11.
\textsuperscript{490} \textit{Id.} at 611.
\textsuperscript{491} \textit{Focht}, 68 T.C. at 227-29 (citing Thatcher v. Commissioner, 533 F.2d 1114 (9th Cir. 1976) rev'd 61 T.C. 28 (1973); Bongiovanni v. Commissioner, 470 F.2d 921 (2d Cir. 1972)); see also I.R.C. § 357(c)(3).
\textsuperscript{492} \textit{Raich}, 46 T.C. at 608-10.
\textsuperscript{494} See Kahn & Oesterle, \textit{supra} note 447, at 462-66.
deductible expenses (such as accrued interest, taxes, rental or salaries)\textsuperscript{496} and to accrual method taxpayers. Section 357(c)(3) does not apply to a liability that results in the creation of, or an increase in, the basis in any property.\textsuperscript{497} The section's legislative history offers the example of a cash method taxpayer who purchases small tools on credit and, prior to paying for the tools, transfers them along with the related obligation to pay for them to a new corporation in a section 351 exchange.\textsuperscript{498} While the transferor would have been entitled to a deduction if he had paid off the obligation, pending payment, he has a basis in the tools equal to the amount of the unpaid obligation.\textsuperscript{499} According to section 357(c)(3)(B),\textsuperscript{500} that obligation does not constitute a liability for purposes of section 357(c)(1).\textsuperscript{501} More generally, the liabilities excludable under section 357(c)(3) are to be excluded from section 357(c) and 358(d) only because the definition of "liability" contained in section 357(c)(3) is not intended to affect the definition of the term "liabilities" for any other provision of the Internal Revenue Code, including section 357(a) and 357(b).\textsuperscript{502} Finally, 357(c)(3) also excludes liabilities from the general coverage of section 357(c)(1) if a payment to discharge the liability would be described in section 736(a) of the Internal Revenue Code.\textsuperscript{503} Section 736(a) governs payments made to a retiring partner, or to a deceased partner's successor in interest, in liquidation of the partner's active interest in the partnership.\textsuperscript{504}

A final issue is who, if anybody, is entitled to a deduction for the liabilities. It once was feared that the right to a deduction would be lost to both the transferor and the transferee if the transferee corporation assumed and paid the payables.\textsuperscript{505} Hence, tax counsel traditionally advised cash method clients incorporating their businesses to retain trade ac-

\textsuperscript{496} I.R.C. § 357(c)(3); see Kahn & Oesterle, supra note 447, at 473; Lavya, supra note 417, at A-28.
\textsuperscript{497} See I.R.C. § 357(c)(3)(B).
\textsuperscript{498} S. REP. No. 1263, 95th Cong., 2d Sess., reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 6761, 6948 n.7.
\textsuperscript{499} Id.
\textsuperscript{500} I.R.C. § 357(c)(3)(B).
\textsuperscript{501} Id. § 357(c)(1).
\textsuperscript{503} See I.R.C. §§ 357(c)(3), 736(a). For further explanation, see generally Lavya, supra note 417, at A-27.
\textsuperscript{504} I.R.C. § 736(a).
counts payable and pay them outside of the corporation.\textsuperscript{506} It was believed that the transferee corporation was not entitled to the deduction for those payables, either at the time of their assumption or at the time of their subsequent payment, because the assumption of the liabilities was regarded as part of the purchase price it paid to acquire the transferor’s assets.\textsuperscript{507} Moreover, the corporation could not even increase its basis for accepting the transferred liabilities in the transferred assets, except to the extent that those liabilities caused the transferor to recognize gain under sections 357(b) or 357(c).\textsuperscript{508} The cash method transferor was not entitled to deduct the payables either, because it was the corporation, not he, who paid the expense.\textsuperscript{509} Eventually, however, the IRS altered its private ruling policy so that a corporation could deduct cash basis payables assumed in a section 351 transaction if: (1) the transferor also contributed zero basis accounts receivable; and (2) the corporation agreed in the closing agreement entered into prior to the transfer to report the income on collection of the receivables.\textsuperscript{510} Then, in a 1978 Technical Advice Memorandum,\textsuperscript{511} the IRS suggested that a closing agreement was no longer necessary as long as a completed transaction met the criteria to which the government would look if an advance ruling was sought with respect to the transaction.\textsuperscript{512} Additionally, a 1980 revenue ruling mentioned that a transferee corporation under the cash receipts and disbursements method of accounting is allowed deductions under section 162 for the payments it makes to satisfy the assumed trade accounts payable when such payments are made.\textsuperscript{513} While authority is lacking as to what should happen when the corporate transferee is an accrual method taxpayer, it seems probable that the transferee corporation also would be allowed to deduct the payables, although the timing of the deduction could become an is-

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\textsuperscript{506} See id. at 495; see also Z. Cavitch, Tax Planning for Corporations and Shareholders § 4.03[2][d][i], at 4-36 (1974).

\textsuperscript{507} See Keller, supra note 505, at 496, 506, 511; see also W.P. Haden Co. v. Commissioner, 165 F.2d 588 (5th Cir. 1948); Holdcroft Transp. Co. v. Commissioner, 153 F.2d 323 (8th Cir. 1946); Rodney, Inc. v. Commissioner, 145 F.2d 692 (2d Cir. 1944); M. Buten & Sons, Inc. v. Commissioner, 31 T.C.M. (CCH) 178 (1972); Leavitt v. Commissioner, 31 T.C.M. (CCH) 453 (1972).

\textsuperscript{508} See Keller, supra note 505, at 506 n.112; see also I.R.C. §§ 357(b), (c), 362(a).

\textsuperscript{509} See Keller, supra note 505, at 496, 505, 512-13; see also Doggett v. Commissioner, 275 F.2d 823, 827 (4th Cir.), cert. denied, 364 U.S. 824 (1960); Citizens Nat’l Trust & Sav. Bank v. Welch, 119 F.2d 717, 719 (9th Cir. 1941); Kniffen v. Commissioner, 39 T.C. 553, 565-67 (1962).

\textsuperscript{510} See Keller, supra note 505, at 506; Worthy, IRS Chief Counsel Outlines What Lies Ahead for Professional Corporations, 32 J. Tax’n 88, 90 (1970).

\textsuperscript{511} Priv. Ltr. Rul. 78-30-010 (Apr. 14, 1978); see Keller, supra note 505, at 507.

\textsuperscript{512} See Keller, supra note 505, at 506-07.

Thus, it now seems clear that the corporation is entitled to a deduction for payment of the transferred trade accounts payable.

While most pitfalls that impeded the transfers of payables to the corporation have now been eliminated, incorporators might perceive a change as an opportunity to save taxes by retaining all or a part of either or both the receivables or payables. For example, if the transferor has losses and the corporation has income, the parties might be tempted to make the transferor retain the receivables and have the corporation assume the payables. Section VIII discusses these devices and their likelihood of success. Suffice it to say at this point, however, that the government is well-armed with the statutory anti-tax avoidance rules contained in sections 357(b), 446(b) and 482 to combat schemes that distort the proper reporting of income and deductions. The government, of course, has at its disposal the usual panoply of nonstatutory weapons (for example, the assignment of income doctrine) to combat purely tax-motivated schemes.

514. The most sensible solution is to let the transferee corporation deduct the payables when paid and include the receivables in income when collected, even though ordinarily it is an accrual-method taxpayer. This process is what would happen if the cash-method transferor had not placed the payables and receivables in the corporation in the first place.

515. See Keller, supra note 505, at 536-37.

516. See infra notes 583-713 and accompanying text. See generally Keller, supra note 505, at 526-38.

517. I.R.C. §§ 357(b), 446(b), 482.


520. For some of these nonstatutory doctrines, see, Stewart v. Commissioner, 714 F.2d 977 (9th Cir. 1983) (section 482 not applicable, but used "substance over form" doctrine and "court holding" doctrine enunciated in Commissioner v. Court Holding Co., 324 U.S. 331 (1945)). The other doctrines include the tax-benefit rule, the business-purpose doctrine and the step-transaction doctrine. See generally Schwarz, supra note 30.
VI. THE "BOOT" RULES

If, in addition to stock or securities of the controlled corporation, the transferor receives cash or other property "to boot," section 351(b)(1) requires him to recognize his realized gain (if any), but only to the extent of that cash plus the fair market value of that other property.\textsuperscript{521} According to section 351(b)(2), the transferor is not allowed to recognize a realized loss on account of the receipt of cash or other property.\textsuperscript{522} This recognition property, the cash and other property, is known vernacularly as "boot." Boot includes stock of other corporations\textsuperscript{523} as well as debt of the transferee corporation not amounting to a security.\textsuperscript{524} Other nonrecognition code sections have similar rules that require a recognition of gain to the extent of the boot received by the taxpayer.\textsuperscript{525} In effect these rules require the taxpayer to recognize a gain on the lesser of the gain realized or the boot.\textsuperscript{526}

Section 351(b)(1),\textsuperscript{527} like the other boot rules, tries to ease the friction between two tenets of tax law: (1) when a taxpayer sells or exchanges his property, he has "cashed in" on it and ought to recognize his gain for federal income tax purposes;\textsuperscript{528} and (2) mere changes in form of ownership should not result in a taxable gain or loss.\textsuperscript{529} As mentioned

\begin{itemize}
\item \textsuperscript{521} I.R.C. § 351(b)(1)(A)-(B) (1986).
\item \textsuperscript{522} Id. § 351(b)(2).
\item \textsuperscript{523} See Kahn, supra note 244, at 310. Section 351(a) provides nonrecognition treatment only for transfers of property to controlled corporations in an exchange corporation. I.R.C. § 351(a).
\item \textsuperscript{524} See, e.g., Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462 (1933); Turner v. Commissioner, 303 F.2d 94 (4th Cir.), cert. denied, 371 U.S. 922 (1962), on remand, 23 T.C.M. (CCH) 952 (1964), aff'd, 343 F.2d 150 (4th Cir. 1965); Pacific Pub. Serv. Co. v. Commissioner, 154 F.2d 713 (9th Cir. 1946); Neville Coke & Chem. Co. v. Commissioner, 148 F.2d 599 (3d Cir.), cert. denied, 326 U.S. 726 (1945); Cortland Specialty Co. v. Commissioner, 60 F.2d 937 (2d Cir. 1932), cert. denied, 288 U.S. 599 (1933); Sisto Fin. Corp. v. Commissioner, 47 B.T.A. 425 (1942), rev'd and remanded on other grounds, 139 F.2d 253 (2d Cir. 1943). For a fuller discussion on the distinctions between a debt amounting to a security and a debt not amounting to a security, see supra notes 72-140 and accompanying text.
\item \textsuperscript{525} See, e.g., I.R.C. § 1031(a) (like-kind exchanges), § 356(a)(1) (boot received in reorganizations and in section 355 transactions), § 1031(b).
\item \textsuperscript{526} Typically, these code sections require the boot recipient to recognize his gain, "if any," but "not in excess of" the boot received. Id. §§ 351(b)(1), 356(a)(1), 1031(b). The first part of this language limits the recognized gain to the amount of the boot received. The realized gain and the boot received both act as caps on the amount of gain that can be recognized by the boot recipient.
\item \textsuperscript{527} Id. § 351(b)(1).
\item \textsuperscript{528} See, e.g., Jordan Marsh Co. v. Commissioner, 269 F.2d 453, 456 (2d Cir. 1959); Portland Oil Co. v. Commissioner, 109 F.2d 479, 488 (1st Cir.), cert. denied, 310 U.S. 650 (1940); Bolker v. Commissioner, 81 T.C. 782, 806 (1983), aff'd, 760 F.2d 1039 (9th Cir. 1985); see also supra notes 21-32 and accompanying text.
\item \textsuperscript{529} See, e.g., Helvering v. Cement Investors, Inc., 316 U.S. 527, 533 (1942); Hempt Bros.,
elsewhere, the general nonrecognition rule of section 351(a) is based on the theory that the transfer of property to a controlled corporation in exchange for its stock or securities is just a change in the form of ownership. Because the transferor controls the corporation and is merely receiving something that amounts to an investment in the corporation in exchange for his property, he is not cashing in on the transferred property. If the transferor receives cash or other property to boot, however, he is doing more than merely continuing his proprietary interest in that property. He is partly cashing in because he is receiving something other than a piece of paper that says he owns the company that now owns the property he transferred. The transferor is not cashing in completely, though, because he still controls the corporation since at least part of the consideration received by him in the transaction consists of a long-term investment in the corporation that owns the property that he just transferred. Section 351(b) takes what amounts to an intermediate position. The transferor recognizes a gain to the extent that he is cashing in, and he is cashing in to the extent that he receives boot. The transferor is not cashing in to the extent that he receives what amounts to an investment in his controlled corporation, and so the transferor does not recognize a gain to the extent that his realized gain is attributable to the stock or securities he receives.

Because section 351(b)(1) requires the transferor to recognize a gain on the lesser of gain realized or the amount of the boot received, he must compute his realized gain and compare it to the amount of boot he received. This rule requires a four step computation, which works as follows:

Step 1. To determine his realized gain, the boot recipient must first compute the amount realized. Thus, he must add up everything that he received in the transaction, including the nonrecognition property

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530. See supra text accompanying notes 21-32.
531. See, e.g., sources cited supra note 528.
532. See supra notes 171-372 and accompanying text.
533. Section 351(a) requires the transferor of property to receive the stock or securities of the transferee corporation. I.R.C. § 351(a).
534. See id. § 351(b)(1).
535. The transferor recognizes a gain, but only to the extent that he has received boot. Id.
536. Id.
537. See id. §§ 1001(a)-(b).
538. See id. § 1001(b).
he received. The formula for amount realized is as follows: Fair market
value of stock received plus fair market value of securities received plus
sum of cash received plus fair market value of each item of other boot
property received equals amount realized.539

Step 2. To determine his realized gain, the transferor then must sub-
tract the adjusted basis of the property that he transferred to the corpora-
tion in the exchange from his amount realized.540 The formula for gain
realized is as follows: Amount realized (step one) minus transferor's ad-
justed basis in property transferred to the corporation equals realized
gain (or loss).541 The transferor is not allowed to recognize a realized
loss.542 If the computation in step 2 shows a realized loss, the transferor
need not bother with steps 3 and 4.

Step 3. The transferor next computes the sum of the boot he re-
ceived. This computation would be as follows: Sum of cash received543
plus fair market value of each item of other boot property received544
equals sum of boot received.545

Step 4. The transferor takes whichever is lesser, the realized gain
(step 2) or the boot (step 3), as his recognized gain.546

The boot rules become more complex when the boot recipient trans-
fers more than one asset in the exchange. A 1968 revenue ruling,547 gen-
erally approved by the commentators,548 requires the boot recipient to
determine the amount and character of his recognized gain on an asset-
by-asset basis.549 Hence, it is improper to total the adjusted basis of the
various assets transferred by one transferor and to subtract this total
from the total amount realized by the transferor on the exchange.550 In-

539. See id.
540. Id. § 1001(a). When the boot recipient has transferred more than one asset to the
corporation, the Internal Revenue Service requires him to allocate the boot received to the
transferred assets on an asset-by-asset basis in proportion to their relative fair market values to
determine both the amount and the character of the gain to be recognized. B. BITTKER & J.
EUSTICE, supra, note 29, ¶ 3.05, at 3-18 to 3-19.
541. Id.
542. See id. § 351(b)(2); see also Rev. Rul. 68-55, 1968-1 C.B. 140.
544. See id. § 351(b)(1)(B).
545. See id. § 351(b)(1).
546. Id.
548. See B. BITTKER & J. EUSTICE, supra note 29, ¶ 3.05, at 3-18 & n.51; KAHN, supra note
244, at 310; Kahn & Gann, supra note 46, at 571; LIND & SCHWARZ, supra note 30, at 74;
Rothman, supra note 148, at A-38. See generally Rabinovitz, Allocating Boot in Section 351
550. See id.; see also Rabinovitz, supra note 548, at 339.
stead, each asset transferred is considered as separately exchanged for a
proportion of each type of consideration paid to the transferor.\textsuperscript{551} The
proration is made according to the relative fair market values of the
transferred assets.\textsuperscript{552} In other words, each asset is considered to be ex-
changed for its pro rata share of both the stock (or securities) and the
boot received by the transferor.

The first step in this process is to determine the aggregate fair mar-
ket value of all the assets transferred to the corporation by the party
receiving boot by adding the fair market value of each asset and to divide
the aggregate fair market value into the fair market value of each asset.\textsuperscript{553} This computation provides a percentage for each transferred asset
that is to be used in apportioning the boot and the total amount realized
among the transferred assets.\textsuperscript{554} Chart I in the example below shows the
results of such a computation. The transferor then, \textit{seriatim}, multiplies
the appropriate percentage by the total amount realized by the transferor
to figure the amount realized for each asset transferred.\textsuperscript{555} The trans-
feror also, \textit{seriatim}, multiplies the appropriate percentage by the total
boot received by him to figure the boot allocable to each transferred as-
et.\textsuperscript{556} He then determines the gain realized on each asset by subtracting
his adjusted basis in it from the amount realized.\textsuperscript{557} The transferor takes
as his recognized gain on that asset the amount realized on an asset or
the boot allocable to it, whichever is lesser.\textsuperscript{558} The transferor adds the
recognized gains so computed on each transferred asset to determine his
total gain recognized on the exchange.\textsuperscript{559} If he happens to realize a loss
on one (or more) of his transferred assets, the boot recipient cannot use
that loss (or those losses), which must go unrecognized because of section
351(b)(2), to offset the recognized gains.\textsuperscript{560}

\textit{Example.}

In an exchange satisfying the requirements of section 351, Anne, the

\begin{footnotes}
\footnote{552. \textit{See Rev. Rul. 68-55, 1968-1 C.B. 140; Rabinovitz, \textit{supra} note 548, at 339-40; see also Williams v. McGowan, 152 F.2d 570 (2d Cir. 1945); Johnson v. Commissioner, 42 T.C. 441 (1964), \textit{aff'd}, 355 F.2d 931 (6th Cir. 1965).}
\footnote{553. \textit{See Rabinovitz, \textit{supra} note 548, at 339.}
\footnote{554. \textit{Id.} at 340-46.}
\footnote{555. \textit{Id.}}
\footnote{556. \textit{Id.}}
\footnote{557. \textit{Id.} at 346-50.}
\footnote{558. \textit{Id.}}
\footnote{559. \textit{Id.}}
\footnote{560. \textit{Id.} (citing I.R.C. \S 351(b)(2) (1986)).}
sole shareholder of X Corp, transferred the following assets to X Corp in exchange for X Corp stock worth $120 and $80 cash:

<table>
<thead>
<tr>
<th>Character Asset</th>
<th>Adjusted Basis</th>
<th>Fair Market Value</th>
<th>Percent of Total Fair Market Value of Assets Transferred</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset #1</td>
<td>$70</td>
<td>$80</td>
<td>40%</td>
</tr>
<tr>
<td>Capital asset</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>held for more</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>than 6 months</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Asset #2</td>
<td>$180</td>
<td>$60</td>
<td>30%</td>
</tr>
<tr>
<td>Capital asset</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>held for more</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>than 6 months</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Asset #3</td>
<td>$10</td>
<td>$40</td>
<td>20%</td>
</tr>
<tr>
<td>Asset</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>held for less</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>than 6 months</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Asset #4</td>
<td>0</td>
<td>$20</td>
<td>10%</td>
</tr>
<tr>
<td>Asset which</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>would produce</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ordinary income</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>or loss on sale</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Aggregate Fair</td>
<td></td>
<td>$200</td>
<td></td>
</tr>
<tr>
<td>Market Value of</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Assets Transferred</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

According to section 351(b)(1), Anne must recognize her realized gain to the extent of the boot. According to a 1968 revenue ruling, Anne must determine the amount and character of the gain on an asset-by-asset basis. Chart I shows the results of the first step of the process (described above), which produces a percentage to be used to apportion the boot, which was the $80 cash, and the total amount realized, which was $200 ($120 fair market value of X Corp stock plus $80 cash boot = $200), to each of the transferred assets. Column four lists this percentage for each of the four transferred assets. Anne next multiplies these percentages by the total amount realized to determine the amount realized for each of the four transferred assets. She also multiplies these percentages by the aggregate amount of the boot to determine how much of the boot to allocate to each of the four transferred assets. The results of these computations are as follows:

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Anne subtracts her basis in each asset from the amount realized for each asset to determine the realized gain or loss for each asset. The computations are as follows:

**CHART III**

<table>
<thead>
<tr>
<th>Asset #1:</th>
<th>Amount realized</th>
<th>Adjusted basis</th>
<th>Gain realized</th>
</tr>
</thead>
<tbody>
<tr>
<td>$80</td>
<td>$70</td>
<td></td>
<td>$10</td>
</tr>
<tr>
<td>Asset #2:</td>
<td>$60</td>
<td>$180</td>
<td>($120) loss realized</td>
</tr>
<tr>
<td>Asset #3:</td>
<td>$40</td>
<td>$10</td>
<td>$30 gain realized</td>
</tr>
<tr>
<td>Asset #4:</td>
<td>$20</td>
<td>0</td>
<td>$20 gain realized</td>
</tr>
</tbody>
</table>

Anne recognizes her $10 realized gain on asset #1, because the $10 gain is lesser than the $32 of boot allocable to it. She recognizes a $16 gain on asset #3, because the $16 boot is less than the $30 realized gain. She recognizes an $8 gain on asset #4 because the $8 of boot is less than the $20 gain realized. The character of the recognized gain is determined by the character and the holding period of the transferred assets. Thus, the gain recognized on asset #1 is a long-term capital gain, the gain recognized on asset #3 is a short-term capital gain, and the gain recognized on asset #4 is ordinary income. Anne cannot use the $120 loss realized on the transfer of asset #2 to offset the recognized gains.


566. See I.R.C. §§ 1239, 1245(a), 1245 (b)(3), 1250(a), 1250(d)(3); Rabinovitz, supra note 548, at 356.

which, according to section 351(b)(2), must go unrecognized.\textsuperscript{568} Thus, for the full transaction Anne recognizes a gain of $34 (the sum of the gains recognized on assets #1, #3 and #4),\textsuperscript{569} even though the aggregate adjusted basis of the assets transferred by Anne, which was $260, exceeded the aggregate fair market value of the consideration paid to Anne,\textsuperscript{570} which was $200.

VII. RELATIONSHIP WITH OTHER SUBCHAPTER C SECTIONS

Each of the topics covered in Subchapter C (incorporations,\textsuperscript{571} distributions,\textsuperscript{572} redemptions,\textsuperscript{573} liquidations,\textsuperscript{574} reorganizations\textsuperscript{575} and a few discrete tax avoidance transactions, e.g., preferred stock bailouts\textsuperscript{576}) has its own complex set of rules. Incorporations, for example, are covered by sections 351, 357, 358, 362(a), 1032(a) and a few other sections.\textsuperscript{577} Distributions are covered by sections 301, 311, 312, 316 and a few other sections.\textsuperscript{578} As complex as each set of rules, standing by itself, is, a particular transaction sometimes is covered by more than one of these sets. Unfortunately, these overlaps deepen the complexity of what already is an arcane area of the law. The tax professional, of course, is

\begin{footnotesize}
\begin{enumerate}
\item[I.R.C. § 351(b)(2); see Rev. Rul. 68-55, 1968-1 C.B. 140.]
\item[See Rev. Rul. 68-55, 1968-1 C.B. 140; Rabinovitz, supra note 548, at 354-56.]
\item[See Rabinovitz, supra note 548, at 354-56.]
\item[See I.R.C. §§ 351, 357, 358, 362(a), 1032(a) (1986).]
\item[See id. §§ 301, 305, 306, 311, 312, 316, 317(a).]
\item[See id. §§ 301, 302, 303, 304, 306(a)(2), 311, 312, 317(b), 318.]
\item[See id. §§ 331, 332, 334, 336, 337, 338. See also I.R.C. § 381(a)(1).]
\item[See id. §§ 354, 355, 356, 357, 358, 361, 362(b), 368, 381, 382.]
\item[See id. § 306. Other Subchapter C sections primarily aimed at loophole-closing are sections 304, 341 and 382. Section 304 is aimed at disguised distributions achieved through stock transactions involving related corporations. See id. § 304. Section 341 turns a shareholder’s gain on certain dispositions of stock in a collapsible corporation from a long-term capital gain into ordinary income in certain circumstances. See id. § 341. Section 382 imposes limitations on the carryover of operating losses from one corporation to another to prevent shopping for loss corporations. See id. § 382. Virtually every code section in Subchapter C has at least one subsection designed to inhibit or prevent a particular tax abuse. See, e.g., id. § 357(c)(1) (gain recognized to transferor in section 351 or section 368(a)(1)(D) reorganization to the extent that transfer of liabilities exceed basis in transferred assets); id. § 337(b)(1)(A) (liquidating corporation not entitled to section 337(a) nonrecognition treatment on sale of inventory). Some of the primary weapons for curbing the tax-avoidance machinations of close corporations and their shareholders are completely outside Subchapter C. Notable are the sections on the accumulated earnings tax and on a personal holding company tax. See id. §§ 531-537 (accumulated earnings tax); id. §§ 541-565 (personal holding company tax).]
\item[See id. §§ 351, 357, 358, 362(a), 1032(a); see also id. § 1245(b)(3) (extent that section 1245 recapture overrides section 351); id. § 1250(d)(3) (extent that section 1250 recapture overrides section 351); id. § 1223(1) (transferor’s holding period in stock or securities received in section 351 exchange); id. § 1223(2) (transferee corporation’s holding period in assets received in section 351 exchange).]
\item[See id. §§ 301, 311, 312, 316.]
\end{enumerate}
\end{footnotesize}
required to master the most arcane of the arcane! The purpose of this section is to discuss the overlaps between section 351 and the other Subchapter C rules.

A. Preemption of Section 304 Over Section 351

The Tax Equity and Fiscal Responsibility Act of 1982\textsuperscript{579} (TEFRA) struck a compromise between conflicting provisions of sections 304 and 351.\textsuperscript{580} The most troublesome overlap occurred when a shareholder in control of two corporations transferred his stock in one of them to the other in exchange for newly issued stock of the other plus cash (or any other form of boot property).\textsuperscript{581} To illustrate, suppose that Anne, who owns 100% of the stock of both X Corp and Y Corp transfers some of her Y Corp stock to X Corp in exchange for more X Corp stock plus $10 cash. If section 304(a)(1) controls,\textsuperscript{582} the fair market value of the new X


\textsuperscript{582} Section 304(a)(1) applies when a person controlling one corporation transfers some of
Corp stock plus the cash payment to Anne is treated as a distribution in redemption of Anne's Y Corp stock (subject to special earnings and profits rules). Since Anne owns 100% of the Y Corp stock both before and after the transaction, this fictional redemption fails each of the section 302(b) tests. Hence, Anne would treat her amount realized as dividend income to the extent that it is matched by earnings and profits. To its credit, before TEFRA the government applied section 304 treatment only to the cash and let the stock pass tax-free to the shareholder. Still the cash payment would be ordinary income to the shareholder, provided it was covered by earnings and profits. If section 351(b) controls, however, the $10 cash would be boot, and Anne would recognize a gain on the lesser of realized gain, if any, and the $10 boot. Moreover Anne's gain would be a capital gain, because under section 351(b) the character of the recognized gain depends on that of the transferred property, and Anne has transferred a capital asset (her Y Corp stock).

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583. Id. At one time the government treated both the cash and the value of the stock as a taxable distribution, see Stickney, 399 F.2d at 833, but later withdrew the claim as to the stock. See Rev. Rul. 73-2, 1973-1 C.B. 171; see also B. Wolfman, Federal Income Taxation of Business Enterprise 508 (2d ed. 1982).

584. See I.R.C. § 312(a)(7).

585. The tests contained in section 302(b)(1), (b)(2) and (b)(3) all require a reduction in the shareholder's proportionate interest in the redeeming corporation. I.R.C. §§ 302(b)(1)-(b)(3); see also United States v. Davis, 397 U.S. 301, 313 (1970) (meaningful reduction in shareholder's proportionate interest and corporation required for section 302(b)(1)). Section 302(b)(4) does not require a reduction in the shareholder's proportionate interest in the redeeming corporation. Instead it requires a genuine contraction of the corporation's business. I.R.C. §§ 302(b)(4), (e)(5); see also Treas. Reg. § 1.304-2 (example (4)) (as amended in 1968).

586. See I.R.C. §§ 302(d), 301(c)(1).

587. Id. § 304(a)(1); Rev. Rul. 73-2, 1973-1 C.B. 171; see also Coates Trust, 480 F.2d at 471; B. Wolfman, supra note 583.


589. I.R.C. § 351(b). Anne transferred property (her Y Corp stock) to a corporation (X Corp) in exchange for stock of the transferee corporation (the newly issued X Corp stock), and, since she owned 100% of the X Corp stock, she was in control of the transferee corporation immediately after the exchange. Hence, the transaction satisfied the requirements of section 351(a). See id. § 351(a). Since she also received cash, she must recognize a gain equal to the lesser of her realized gain or the amount of cash realized. See id. § 351(b)(1). See also Beller, supra note 580; Faber, supra note 580; Javaras & Sheffield, supra note 580; and Tiger, supra note 580.

590. See Stickney, 399 F.2d at 831; see also Bowen, supra note 171, at 927.

Section 304(b)(3)(A), new with TEFRA,\textsuperscript{592} broadly states that section 304(a)(1) preempts section 351.\textsuperscript{593} However, the preemption of section 351 is not complete. The first is that section 351(a) still applies to the extent that the transaction consists of an exchange of stock for stock in the acquiring corporation.\textsuperscript{594} Hence, in the hypothetical above Anne would not treat the X Corp stock that she received in exchange for her Y Corp stock as part of a section 301 distribution. Instead, she would treat the stock-for-stock part of the transaction as a tax-free exchange under section 351 and would use section 358 to determine her basis in her new X Corp stock. Only the cash payment made by X Corp to Anne would come within the section 304 rules.\textsuperscript{595} The second exception is that section 357 supercedes section 304 when (1) a liability encumbers the stock transferred to the acquiring corporation\textsuperscript{596} or (2) the acquiring corporation assumes a liability of the transferring shareholder.\textsuperscript{597} The section 357 preemption applies only if the debt was incurred by the shareholder to acquire the transferred stock that he transfers in the exchange.\textsuperscript{598} The transferred liability does not count as part of the fictional distribution in redemption of the shareholder's stock in the acquired corporation.\textsuperscript{599} Congress elected to allow the transferred debt to pass tax-free under section 357 rather than to tax it under section 304, because the transfer of the debt is an alternative to a debt-financed direct acquisition by the acquiring corporation.\textsuperscript{600}


\textsuperscript{596} I.R.C. § 304(b)(3)(B)(i)(II).

\textsuperscript{597} Id. § 304(b)(3)(B)(i)(I).

\textsuperscript{598} Id. § 304(b)(3)(B).

\textsuperscript{599} Id. §§ 304(a)(1), (b)(3), 357(a); see H.R. CONF. REP. NO. 760, 97th Cong., 2d Sess. 409, 543, reprinted in 1982 U.S. CODE CONG. & ADMIN. NEWS 1190, 1317; Tiger, supra note 580, at 108-10.

B. Preferred Stock Bail-outs and Section 351

Section 306, the preferred stock bail-out section, and section 351 intersect at several points. The first is the transfer of section 306 stock for stock of a controlled corporation—a section 351 exchange. Additionally, the transferor must treat the newly received stock of the transferee corporation as section 306 stock, even if those shares are common stock. For example, if Anne transfers ten shares of section 306 stock of Y Corp to X Corp, her controlled corporation, in exchange for six shares of X Corp common stock, X Corp must treat those ten Y Corp shares as section 306 stock. Anne also must treat the six X Corp common shares as tainted section 306 stock. If Y Corp disposes of its ten Y Corp shares, its tax consequences will be measured by section 306(a). Similarly, if Anne disposes of her tainted six shares of X Corp common stock, section 306(a) will determine the tax consequences.

Section 306(c)(3), new with TEFRA, is a second intersection between sections 306 and 351. It is designed to thwart a type of preferred stock bail-out accomplished by causing a newly created holding company to issue preferred stock in a section 351 exchange. To illustrate, suppose that Anne is a 100% shareholder of Y Corp, a corporation with $100 of earnings and profits. Anne forms a holding company, X Corp, and transfers all of her Y Corp stock to X Corp in exchange for all of

602. Stock in another corporation constitutes property for purposes of section 351. See Portland Oil Co. v. Commissioner, 109 F.2d 479 (1st Cir.), cert. denied, 310 U.S. 650 (1940). Thus, the exchange between Anne and the transferee corporation meets all the requirements of section 351—a transfer of property to a controlled corporation in exchange for stock of a controlled corporation. I.R.C. § 306(e)(1)(C); Treas. Reg. § 1.306-3(e) (as amended in 1978).
603. See Treas. Reg. § 1.306-3(d) (as amended in 1978); see also Javaras & Sheffield, supra note 580, at 565.
604. See Treas. Reg. § 1.306-3(d) (as amended in 1978); see also Javaras & Sheffield, supra note 580, at 565.
606. See Treas. Reg. § 1.306(3)(d) (as amended in 1978); see also Javaras & Sheffield, supra note 580, at 565.
607. See Treas. Reg. § 1.306(3)(d) (as amended in 1978); see also Javaras & Sheffield, supra note 580, at 565.
608. See I.R.C. § 306(a), (b).
609. Id.
both X Corp’s common and preferred stock. The preferred stock is worth $75. Although the issuance of the X Corp preferred stock provides her with the same bail-out opportunity as would a preferred stock dividend by Y Corp, the X Corp preferred stock would not have been section 306 stock under pre-TEFRA law, because the issuing corporation, X Corp had no earnings and profits at the time of the issuance. Moreover, while the government might have been able to argue that, technically, the fair market value of the X Corp stock, both common and preferred, should be treated as a distribution in redemption of Anne’s Y Corp stock under section 304, neither pre-TEFRA nor post-TEFRA law applies section 304 to a stock-for-stock exchange. It instead allows the exchange to be tax-free to the transferring shareholder under section 351.

Consonant with the general approach of section 306, section 306(c)(3) does not make the exchange taxable to Anne. Instead it dictates a test that in Anne’s case results in tainting the X Corp preferred shares as section 306 stock. The first step in the section 306(c)(3) test is to hypothesize that the transferring shareholder, Anne, received money, $75, instead of the X Corp preferred stock that she actually did receive. As a result of this fictional receipt of money, Anne is brought within the overlap between sections 304 and 351. As described above, section 304 would require Anne to treat the $75 cash as a distribution in redemption of her Y Corp stock. Such a redemption would

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615. Section 304(a) determines the tax consequences on disposition of “section 306 stock,” a term defined in section 306(c). See I.R.C. § 306(a), (c).

616. See id. § 306(c)(3).


618. See supra notes 581-94 and accompanying text.

619. See I.R.C. § 304(a)(1), (c)(3).
fail all of the 302(b) tests, because Anne owns 100% of the Y Corp stock both before and after the transaction (by dint of the section 318 attribution rules after the transaction). Thus, according to section 302(d), the cash would be treated as a section 301 distribution. According to section 304(b)(2), the amount of the distribution to be treated as a dividend is determined as if the cash were distributed by the acquiring corporation to the extent of its earnings and profits and then by the issuing corporation to the extent of its earnings and profits; i.e., it is a dividend, if covered by the earnings and profits of either or both of the corporations. For purposes of the section 306(c)(3) test, the fictional $75 distribution would be considered a dividend, because it is matched by Y Corp's $100 of earnings and profits. As mentioned above, this fictional finding does not mean that Anne actually has dividend income from this transaction, since the purpose of this test is merely to determine whether the X Corp preferred stock is to be section 306 stock. Because Anne would have had a dividend if she had received money instead of the X Corp preferred stock that she actually did receive, that X Corp preferred stock is section 306 stock.

C. Reorganizations and Section 351

The most elaborate and abstruse overlaps in all of Subchapter C, if not in all tax law, are those between the reorganization sections and section 351 and its related sections. Although the themes supporting each of these two systems is similar, the applicability of one of the systems over the other can sometimes present different tax consequences. Unfortunately, the Internal Revenue Code itself offers no

620. See id. §§ 302(b)(1)-(3), 318(a)(2)(C); see also United States v. Davis, 397 U.S. 301, 313 (1970); Treas. Reg. § 1.304-2(c) (example (4)) (as amended in 1968).
621. See I.R.C. § 302(d).
622. Id. § 304(b)(2)(A).
623. Id. § 304(b)(2)(B).
624. Id. § 306(c)(3). Section 306(c)(3) makes non-common stock acquired in a section 351 exchange "section 306 stock" if the receipt of money in lieu of stock would have been treated as a dividend under the rules of section 304(b)(2).
626. Id.
628. The theoretical underpinning for the nonrecognition rules of section 351 exchanges and section 368(a)(1) reorganizations is that the transactions governed by those sections are changes in the form and not in the substance of ownership. Hence, they should not be taxable. See id. §§ 351, 368(a)(1).
629. For example, section 357(c)(1) applies to section 351 exchanges and D reorganizations, but not to other types of reorganizations. Id. § 357(c)(1). Neither section 351 nor the reor-
help in resolving the conflicts between the two systems. Moreover, the little other authority on the topic is shady and conjectural.  

The following represent the basic overlapping patterns:

1. B reorganizations

Anne transferred all of her Y Corp stock to X Corp in exchange for X Corp voting stock. Immediately after the exchange Anne owned stock possessing 80% or more of the voting power in X Corp and 80% or more in number of each other class of X Corp stock. The exchange met the requirements of both sections 351\(^6\) and 368(a)(1)(B).\(^6\) Anne transferred property (her Y Corp stock) to a corporation (X Corp) in exchange for stock in such corporation (the newly issued X Corp stock) and controlled the transferee corporation (X Corp) immediately after the exchange, thereby meeting all the requirements of section 351(a).\(^6\) The transaction also met all the requirements for a B reorganization: the acquiring corporation (X Corp) acquired the stock of another corporation (Y Corp), the acquiring corporation used only its own voting stock to acquire that stock, and it controlled that other corporation (Y Corp) immediately after the acquisition.\(^6\)

\(\text{organization sections contains a subsection analogous to section 304(b)(3), which expressly coordinates sections 304 and 351. Id. §§ 304(b)(3), 351, 368.}\)


\(\text{631. I.R.C. §§ 351(a), 368(c).}\)

\(\text{632. Id. §§ 368(a)(1)(B), (c).}\)

\(\text{633. Id. §§ 351(a), 368(c).}\)

\(\text{634. Id. §§ 368(a)(1)(B), (c).}\)
2. C reorganizations

Anne was the 100% shareholder of Y Corp. Y Corp transferred all of its assets to X Corp in exchange for X Corp voting stock. Immediately after the exchange, Y Corp owned stock possessing 80% or more of the voting power in X Corp and 80% or more in number of each other class of X Corp stock. Y Corp liquidated, distributing its sole asset, its X Corp stock, to its sole shareholder, Anne. The exchange met the requirements of both sections 351\(^{635}\) and 368(a)(1)(C).\(^{636}\) Y Corp transferred property (all of its assets) to a corporation (X Corp) in exchange for stock in such corporation (the newly issued X Corp stock) and controlled the transferee corporation (X Corp) immediately after the exchange, thereby meeting all the requirements of section 351(a).\(^{637}\) Y Corp promptly lost control of X Corp by distributing its X Corp stock to Anne, but under section 351(c) a distribution of the transferee corporation’s stock by a corporate transferor to its shareholders is disregarded in determining control for purposes of section 351.\(^{638}\) The transaction also met all the requirements for a C reorganization: It was an acquisition by one corporation (X Corp), in exchange for all or part of its voting stock, of substantially all of the properties of another corporation (Y Corp’s assets), and the acquired corporation (Y Corp) distributed the stock it received (its sole asset) as part of the reorganization plan.\(^{639}\)

3. D and G reorganizations

Anne is the 100% shareholder of X Corp. X Corp incorporated Y Corp and transferred all or a part of its assets to Y Corp in exchange for all of Y Corp’s stock. X Corp then distributed its Y Corp stock to Anne in a transaction qualifying under sections 354 or 355. The transaction met the requirements of both sections 351\(^{640}\) and 368(a)(1)(D).\(^{641}\) X Corp transferred property (all or a part of its assets) to a corporation (Y Corp) in exchange for stock in such corporation (all of the Y Corp stock) and controlled the transferee corporation (Y Corp) immediately after the exchange, thereby meeting the requirements of section 351(a).\(^{642}\) X Corp promptly lost control of Y Corp by distributing its Y Corp stock to Anne immediately after the exchange, but under section 351(c) a distribution

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\(^{635}\) Id. §§ 351(a), 368(c).
\(^{636}\) Id. §§ 368(a)(1)(C), (c).
\(^{637}\) Id. §§ 351(a), 368(c).
\(^{638}\) Id. § 351(c).
\(^{639}\) See id. § 368(a)(1)(C), (G).
\(^{640}\) Id. §§ 351(a), 368(c).
\(^{641}\) Id. § 368(a)(1)(D).
\(^{642}\) See id. §§ 351(a), 368(c).
of the transferee corporation by a corporate transferor to its shareholders is disregarded in determining control for purposes of section 351.\textsuperscript{643} The transaction also met all the requirements for a D reorganization: a corporation (X Corp) transferred all or a part of its assets to another corporation (Y Corp), and, immediately after the transfer, the transferor (X Corp) was in control of the transferee corporation (Y Corp): pursuant to the plan of reorganization, the transferee corporation (Y Corp) distributed its stock (to Anne) in a transaction qualifying under section 354 or 355.\textsuperscript{644}

The transaction also would have met the requirements of a G reorganization, if it were part of a bankruptcy or insolvency proceeding. If it were, then it would have involved a transfer by a corporation (X Corp) of all or part of its assets to another corporation (Y Corp) "in a title 11 or similar case"\textsuperscript{645} pursuant to the plan of reorganization, the transferor corporation (X Corp) distributed its stock (to Anne) in a transaction qualifying under section 354 and 355.\textsuperscript{646}

4. F reorganizations

The C and D reorganizations described above would also qualify as F reorganizations, if they constituted a "mere change in identity, form, or place of organization of one corporation, however effected."\textsuperscript{647} Since they also qualified as section 351 exchanges, a transaction can qualify both as an F reorganization and a section 351 exchange as well as a C or D reorganization.\textsuperscript{648}

\textsuperscript{643} Id. § 351(c).
\textsuperscript{644} Id. §§ 354, 355, 368(a)(1)(D), (C).
\textsuperscript{645} Id. § 368(a)(3)(D)(i)(II).
\textsuperscript{646} See id. §§ 354, 355, 368(a)(1)(G), (c).
\textsuperscript{648} The hoariest of these larger transactions is the liquidation-reincorporation device. The retransfer of the assets in the reincorporation, the second step in the device, is the part of the larger transaction that ostensibly meets the requirements of section 351. See Stevens Pass, Inc. v. Commissioner, 48 T.C. 532 (1967); Rev. Rul. 80-284, 1980-2 C.B. 118; Gabinet, supra note 630, at 862; Mintz & Plumb, supra note 171, at 274.
5. A section 351 exchange as a step in a larger transaction, including a "flunked" reorganization

A section 351 exchange can serve as a step in innumerable larger transactions. To take an illustration adapted from a pair of controversial 1980 revenue rulings,⁶⁴⁹ suppose that X Corp wanted to acquire Y Corp for cash or securities. The holders of 81% of the Y Corp stock were willing to sell their Y Corp stock to X Corp for cash or securities, but Anne, the holder of the other 19% of the Y Corp stock, had a low basis in her shares and wanted to avoid a taxable sale or exchange of her shares. Because Y Corp's articles of incorporation contained a stock transfer restriction that effectively granted Anne a veto power over the sale or exchange of Y Corp stock, X Corp and Y Corp constructed a plan designed to accommodate Anne as well as to achieve the X Corp's acquisition of Y Corp.⁶⁵⁰ Pursuant to the plan, X Corp and Y Corp organized a new corporation, Z Corp. X Corp transferred cash for all of the Z Corp common stock, and Y Corp transferred all of its assets to Z Corp in exchange for all of the Z Corp voting preferred stock and Z Corp securities. The Z Corp common stock held 90% of the voting power in Z Corp.⁶⁵¹ The voting preferred held the other 10% of the voting power. It was this part of the transaction—the transfers of cash by X Corp and assets by Y Corp to Z Corp in exchange for Z Corp stock and securities—that was intended to qualify as a section 351 exchange. As part of the overall plan, Y Corp thereafter redeemed the Y Corp stock not held by Anne for the Z Corp securities that it received in the section 351 exchange.⁶⁵² After all of the exchanges had been completed, Z Corp owned all of the assets of Y Corp, X Corp owned all of the Z Corp common stock, Y Corp owned all of the Z Corp voting preferred stock, Anne owned all of the Y Corp stock, and the other former Y shareholders owned Z Corp securities received in exchange for their Y Corp stock.⁶⁵³

The problem was that Y Corp's exchange with Z Corp literally qual-
ified as a section 351 exchange, but the larger transaction, X Corp's acquisition of Y Corp, flunked as a tax-free C reorganization for failing the continuity-of-interest requirement. Should Y Corp's exchange with Z Corp have been viewed as a tax-free section 351 exchange or a taxable step in a flunked C reorganization? Taking a position inconsistent with several earlier rulings, the 1980 revenue rulings viewed the overall transactions as taxable reorganizations, eclipsing the purported section 351 exchanges.

The 1980 rulings hardly can be said to be dispositive of how to deal with all section 351 exchanges that are part of a larger transaction. For one thing, they have been criticized for how they dealt with the factual situations discussed in them. No case has held that section 351 does not apply to a transaction that fails to qualify as a reorganization. Indeed, some authority suggests that the appropriate characterization of the transactions described in the two 1980 revenue rulings not as failed reorganizations, i.e., sales, but instead as overall section 351 transactions with the newly formed holding company (Z Corp) as the transferee corporation and the other parties as the transferors. Moreover, the factual permutations for these larger transactions are so extensive that it is impossible to posit generalized rules to govern such situations. What might fit acquisitions might or might not fit a liquidation-reincorporation. Even within one type of transaction, e.g., acquisitions, the patterns are so variegated that the approach in these particular revenue rulings may be ill-fitting. Thus, they are offered merely to illustrate the types of problems generated when an ostensible section 351 exchange is a part of a larger transaction.

6. Situations when section 351 and reorganization sections result in different tax consequences


654. See Bowen, supra note 171; Gabinet, supra note 630; Samuels, supra note 171; B. Brrtker & J. Eustice, supra note 29, at ¶ 3.19.

655. Gabinet, supra note 630, at 961.

656. See also Curry v. Commissioner, 43 T.C. 667 (1965).
of gain or loss\textsuperscript{659} (except to recognize gain to the extent of boot received),\textsuperscript{660} substituted basis for transferors,\textsuperscript{661} and carryover basis for transferees.\textsuperscript{662} Indeed, the two systems even use some of the same code sections, e.g., section 358. The systems nevertheless can produce conflicting tax consequences for a transaction qualifying under both schemes.

The first is the section 381(a)(2) carryover of tax attributes in A, C, D, F or G reorganizations. The “acquiring” corporation in those reorganizations succeeds to the tax attributes of the “transferor” (or “distributor”) corporation,\textsuperscript{663} e.g., it takes over the transferor corporation’s earnings and profits account. The section 381 carryover does not apply in section 351 exchanges.\textsuperscript{664}

Second, section 351(a) generally allows the transferor to receive securities tax-free.\textsuperscript{665} A transferor in a reorganization can receive securities tax-free only to the extent that the transferor has surrendered securities.\textsuperscript{666} The receipt of securities, in some instances, can even cause disqualification of the transaction as a reorganization, making the transaction entirely taxable to all parties.\textsuperscript{667}

Third, section 356(a)(2) requires a transferor who recognizes gain

\textsuperscript{659} Sections 351(a), 357(a) and 1032(a) provide the basic nonrecognition rules for the section 351 system. See I.R.C. \textsection{} 351(a), 357(a), 1032(a). Sections 354(a)(1), 355(a)(1), 357(a), 361(a) and 1032(a) provide basic nonrecognition rules for reorganizations. See id. \textsection{} 354(a)(1), 355(a)(1), 357(a), 361(a), 1032(a).

\textsuperscript{660} See id. \textsection{} 351(b)(1), 356(a)(1), 356(b)(1). Section 356 is the reorganization boot section. Id. \textsection{} 356.

\textsuperscript{661} See id. \textsection{} 358(a)(1) (applicable in both section 351 exchanges and reorganizations).

\textsuperscript{662} Section 362(a)(1) provides carryover basis for the corporate transferee and section 351 exchanges. Id. \textsection{} 362(a)(1). The transferee corporation increases its basis by the amount of gain recognized to the transferor. Id. Section 362(b) provides a carryover basis for a transferee corporation in a reorganization. Id. \textsection{} 362(b). Transferee corporation increases its basis by the amount of gain recognized to the transferor. Id.

\textsuperscript{663} Id. \textsection{} 381(a)(2).

\textsuperscript{664} Neither section 351 nor section 381 provides for a carryover-of-tax attributes for a section 351 exchange. See id. \textsection{} 351, 381. See also Rev. Rul. 76-188, 1976-1 C.B. 99; Rev. Rul. 79-289, 1979-2 C.B. 145; Samuels, supra note 171, at 959.

\textsuperscript{665} I.R.C. \textsection{} 351(a).

\textsuperscript{666} See id. \textsection{} 354(a)(2)(A), 355(a)(3)(A), 356(d)(2).

\textsuperscript{667} For example, the consideration furnished by the acquiring corporation in a B reorganization must consist entirely of its own voting stock. Id. \textsection{} 368(a)(1)(B). If it uses any other type of consideration, including its own securities, the transaction fails to qualify as a B reorganization. See, e.g., Hevelly v. Commissioner, 621 F.2d 1227 (3d Cir. 1980), cert. denied, 451 U.S. 1012 (1981); Chapman v. Commissioner, 618 F.2d 856 (1st Cir. 1980); Bercy Indus., Inc. v. Commissioner, 70 T.C. 29 (1978), rev’d on other grounds, 640 F.2d 1058 (9th Cir. 1981); Rev. Rul. 85-139, 1985-2 C.B. 123; Rev. Rul. 79-4, 1979-1 C.B. 150; Rev. Rul. 75-360, 1975-2 C.B. 110; Rev. Rul. 75-123, 1975-1 C.B. 116; Rev. Rul. 70-65, 1970-1 C.B. 77-78; Rev. Rul. 70-108, 1970-1 C.B. 78-79. See also Samuels, supra note 171, at 959.
on account of boot to treat his recognized gain as a dividend if the exchange had the effect of a distribution of a dividend.\textsuperscript{668} Section 351(b)(1) has no corresponding rule.\textsuperscript{669} Instead, the character of the recognized gain under section 351(b)(1) depends on the character of the property transferred and, in the case of a transferred capital asset or section 1231 asset, the transferor’s holding period in that asset.\textsuperscript{670}

Fourth, if liabilities transferred to a controlled corporation in either a section 351 exchange\textsuperscript{671} or a D reorganization\textsuperscript{672} exceed the transferor’s basis in the transferred assets, section 357(c)(1) requires the transferor to recognize a gain on the excess of the transferred liability over the transferor’s basis.\textsuperscript{673} Section 357(c)(1) applies only to section 351 exchanges and D reorganizations. It does not apply to other types of reorganizations.\textsuperscript{674}

7. Tax consequences of transactions literally qualifying as section 351 exchanges and reorganization

There are no certain approaches for determining tax consequences of a transaction that qualifies as both a section 351 exchange and a reorganization. A 1976 revenue ruling\textsuperscript{675} illustrates one approach. P Corp transferred all of its assets to newly formed S Corp in exchange for all of S Corp’s stock. The exchange qualified as both a section 351 exchange and a C reorganization.\textsuperscript{676} S Corp assumed P Corp's liabilities that exceeded P Corp’s basis in its property transferred to S Corp. The government determined that P Corp must recognize gain on the excess of the transferred liabilities over its basis in the transferred property under section 357(c)(1)(A),\textsuperscript{677} a section applicable to section 351 exchanges but not to C reorganizations.\textsuperscript{678}

Section 357(c)(1)(A), the government reasoned, does not except from this coverage a transaction that qualifies as a C reorganization as

\textsuperscript{668.} I.R.C. § 356(a)(2). The dividend portion of the recognized gain is limited to the distributee's ratable share of the distributing corporation's undistributed accumulated earnings and profits. \textit{Id.} For a full discussion of section 356(a)(2), see generally Rands, \textit{supra} note 171.  
\textsuperscript{669.} See I.R.C. § 351(b)(1).  
\textsuperscript{670.} B. Bittker & J. Eustice, \textit{supra} note 29, ¶ 3.05, at 3-17.  
\textsuperscript{671.} I.R.C. §§ 351, 357(c)(1)(A).  
\textsuperscript{672.} Id. § 368(a)(1)(D); see id. § 357(c)(1)(B).  
\textsuperscript{673.} Id. §§ 357(c)(1)(A)-(B).  
\textsuperscript{674.} Id.; Rev. Rul. 76-188, 1976-1 C.B. 99-100; Samuels, \textit{supra} note 171, at 955-56 n.5.  
\textsuperscript{675.} Rev. Rul. 76-188, 1976-1 C.B. 99-100. For a discussion of this revenue ruling, see Samuels, \textit{supra} note 171, at 959-60.  
\textsuperscript{676.} Rev. Rul. 76-188, 1976-1 C.B. 99-100.  
\textsuperscript{677.} Id.  
\textsuperscript{678.} See I.R.C. § 357(c)(1)(A)-(B) (1986); Rev. Rul. 76-188, 1976-1 C.B. 100.
well as a section 351 exchange.\textsuperscript{679} The government also determined that S Corp should succeed to the tax attributes of P Corp under section 381,\textsuperscript{680} a section applicable to C reorganizations but not to section 351 exchanges.\textsuperscript{681} The government again reasoned that section 381 literally applies to a C reorganization and does not except from its coverage a transaction that qualifies as a section 351 exchange, as well as a C reorganization.\textsuperscript{682}

According to this approach, a specific rule contained in one system but not the other would override a general rule contained in the other.\textsuperscript{683} For example, the specific recognition rule of section 357(c)(1)(A) overrides the general nonrecognition rule of section 361(a).\textsuperscript{684} This specific-over-general approach is by no means the only approach that can (or should) be taken.\textsuperscript{685} Another approach suggested by some, is to accord preeminence to the reorganization sections in light of their greater comprehensiveness.\textsuperscript{686} Yet another approach would be to evaluate each instance of overlap on a case-by-case basis, looking at both the economics of the transaction and theoretical underpinning of the two systems to determine which system is more appropriate for the particular transaction.\textsuperscript{687} For example, if an exchange of assets for stock is essentially an acquisition of one corporation by another, the tax consequences would be determined under the reorganization sections rather than under section 351 and its related sections.\textsuperscript{688}

VIII. "MIDSTREAM" INCORPORATIONS

Many section 351 exchanges involve incorporations of ongoing businesses. Since these incorporations take place in the "midstream" of the enterprise, they are sometimes referred to as "midstream" incorporations.\textsuperscript{689} The purpose of this section is to examine the tax issues of the

\textsuperscript{680} Id.
\textsuperscript{681} See I.R.C. § 381(a)(2); Rev. Rul. 76-188, 1976-1 C.B. 100.
\textsuperscript{682} Rev. Rul. 76-188, 1976-1 C.B. 100.
\textsuperscript{683} See id.; Samuels, supra note 171, at 959-60.
\textsuperscript{684} See I.R.C. §§ 357(c)(1)(A), 361(a); see also Samuels, supra note 171 at 959-60; Rev. Rul. 76-188, 1976-1 C.B. 100.
\textsuperscript{685} For other approaches, see generally B. Bittker & J. Eustice, supra note 29, ¶ 3.19; Samuels, supra note 171, at 961 (discussion of legislative history).
\textsuperscript{686} Cf. Samuels, supra note 171, at 961-62.
\textsuperscript{689} See Note, Section 351 of the Internal Revenue Code and "Mid-stream" Incorporations, 38 U. Cin. L. Rev. 96, 96 (1969); see also Keller, supra note 505, at 480.
midstream incorporation—the tax consequences of transferring, among other things, trade secrets, goodwill, accounts payable, accounts receivable, bad-debt reserves, expensed items with useful life remaining, and rights to collect deferred payments on contracts to a controlled corporation.

A. Technical Know-how, Trade Secrets, Goodwill, and Customer Lists

The value of technical know-how, trade secrets, goodwill, customer lists and the like is often attributable to services performed in the past or to be performed in the future by the transferor. Since stock or securities are not to be considered as issued in return for "property" for purposes of section 351 if they are issued to pay for services rendered or to be rendered for the benefit of the corporation, it has been questioned whether the exchange of such intangibles for stock or securities of a controlled corporation ought to be covered by section 351. As discussed earlier in this Article, however, these intangibles generally count as "property" and hence can be transferred tax-free under section 351, even though services were used to produce them.

B. Accounts Payable and Receivable

As discussed earlier, the transfer of accounts payable to a controlled corporation no longer generates section 357(c)(1) gain for a transferor. Moreover, the transferee corporation is now allowed to deduct payments it makes to discharge the payables.

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691. See, e.g., Treas. Reg. § 1.351-1(b)(2) (example 1) (as amended in 1967).
692. See supra notes 41-71 and accompanying text.
694. See supra notes 373-520 and accompanying text.
695. See I.R.C. § 357(c)(3) (1986). For a detailed discussion, see supra notes 373-520 and accompanying text.
The law is clear that accounts receivable constitute "property" for section 351 purposes and that the nonrecognition rule of section 351(a) overrides the assignment-of-income doctrine when a cash-method tax-payer exchanges accounts receivable for stock or securities of a controlled corporation.\(^{697}\) The transferor has no taxable income either at the time of the section 351 exchange or on the later collection of the receivables by the transferee corporation.\(^{698}\) The reasoning for this result is that if a cash-method transferor were taxed on the transfer of the accounts receivable, the specific congressional intent reflected in section 351(a), that the incorporation of an ongoing business should be facilitated by making the incorporation tax-free, would be frustrated.\(^{699}\) The cash-method transferor has a zero basis in the receivables.\(^{700}\) Thus, if he transfers receivables only, he takes a zero basis in the stock or securities as his substituted basis under section 358(a)(1).\(^{701}\) Theoretically, the transferor ultimately will recapture the income unrecognized at the time of the 351 exchange in his recognized gain on a later disposition of his stock, since the contribution of the receivables to the corporation increases the value of his stock without increasing his basis in his stock.\(^{702}\) The postponement of this recognition, together with the capital gain treatment accorded his gain on the sale of his stock (if ever restored to the Code), can result in a substantial tax benefit to the transferor.\(^{703}\) Since the corporation takes a carryover basis in transferred assets,\(^{704}\) it likewise will have a zero basis in the receivables after the transfer.\(^{705}\)


\(^{701}\) See I.R.C. § 358(a)(1); see also Pate, supra note 700, at 860.

\(^{702}\) See P.A. Birren & Son, Inc. v. Commissioner, 116 F.2d 718 (7th Cir. 1940); Kniffen v. Commissioner, 39 T.C. 553 (1962); Briggs v. Commissioner, 15 T.C.M. (CCH) 440 (1956).

\(^{703}\) See Pate, supra note 700, at 860.

\(^{704}\) See I.R.C. § 362(a)(1).

\(^{705}\) See P.A. Birren & Son, 116 F.2d at 719-20; Travis v. Commissioner, 47 T.C. 502, 518 (1967), aff'd, 406 F.2d 987 (6th Cir. 1969); Raich, 46 T.C. at 610; Ezo Prod. Co. v. Commissioner, 37 T.C. 385, 393 (1961); Greenberg, Special Problems of the Professional Association, 20
Thus, it will take the full amount of any of the receivables that it collects into its income. Since, under section 1221(4), accounts receivable are considered not to be capital assets, the transferee corporation must treat the amounts collected as ordinary income.

The pattern differs for the accrual-method taxpayer who transfers receivables. Ordinarily, he would have included the face value of the receivables minus his bad-debt reserve in his income prior to the section 351 exchange. Thus, there is no assignment-of-income issue. The accrual-method transferor takes whatever amount he included in his income as his basis in the receivables. According to section 358(a)(1), he uses this basis as his basis in the stock or securities that he receives in the section 351 exchange. Since the transferee corporation takes a carry-over basis in the receivables under section 362(a)(1), it uses the same figure for its basis. Any amounts it collects on the receivables up to its basis is a return of its basis and, thus, is nontaxable. If the transferee corporation also uses the reserve method of treating bad debts, as likely will be the case, it must establish a bad-debt reserve for the transferred accounts receivable equal to the difference between their face value and

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711. See I.R.C. § 362(a)(1).


713. Both the accrual-method transferor and the transferee corporation usually reduce their basis in the accounts receivable by the amount of the bad debt reserve. Rev. Rul. 78-280, 1978-2 C.B. at 139-40.

714. For the tax treatment of a transferee corporation using the specific charge-off method of treating bad debts allowable under section 166(a), see Rev. Rul. 78-280, 1978-2 C.B. 140.
their section 362(a)(1) basis. The establishment of this reserve is not an addition to the bad-debt reserve; thus, the corporation cannot deduct the initial amount in the reserve. According to a revenue ruling, collections on the receivables surprisingly will not be considered income to the corporation. The corporation will not be entitled to a specific charge-off if it is unable to collect an amount equal to its basis. Instead it will reflect that inability in setting a reasonable reserve for bad debts in future periods.

C. Inventory and Other Property Held Primarily for Sales Customers

Inventory and other property held primarily for sales to customers may be transferred tax-free for stock or securities in a section 351 exchange. The transferor has turned ordinary income property into stock, a capital asset, but, since section 1223(1) denies any tacking of his holding period, he must hold the stock for more than six months to obtain a long-term capital gain treatment. Moreover, he must be wary of the collapsible corporation provisions of section 341 if the transferor sells his stock, and the Court Holding doctrine if the corporation quickly sells the transferred property.

D. Services Performed for the Business Before Incorporation

Stock issued for services rendered to the corporation is specifically excluded from section 351 treatment by section 351(d)(1), which states broadly that "stock or securities issued for services shall not be consid-

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717. Id.

718. Id.; see also Himelick v. Commissioner, 32 B.T.A. 792 (1935).


720. See I.R.C. § 351(a) (1986); see also Lyon & Eustice, Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case, 17 TAX L. REV. 295, 426-27 (1962).

721. See I.R.C. § 1223(1) (tacking permitted to transferor taking a substituted basis in an exchange, but only if he transfers a capital or section 1231 asset); id. 1221(1) (inventory property held primarily for sale to customers in the ordinary course of business—not capital assets).

722. See id. § 1222(3); see also Lyon & Eustice, supra note 720, at 426-27.

723. See I.R.C. § 341(a)(1), (b)(1), (b)(3)(A) (1986); Lyon & Eustice, supra note 720, at 427; see also Katz v. Commissioner, 19 T.C.M. (CCH) 1035 (1960); Jacobs v. Commissioner, 21 T.C. 165 (1953), aff'd, 224 F.2d 412 (9th Cir. 1955).

724. Commissioner v. Court Holding Co., 324 U.S. 331 (1945); see also Lyon & Eustice, supra note 720, at 427. For a full discussion of the Court Holding Doctrine, see D. KAHN, supra note 244, at 133-37.

ered as issued in return for property.” 726 The regulations, however, confine the exclusion to those services “rendered or to be rendered to or for the benefit of the issuing corporation.” 727 As discussed above, section 351(a) allows the tax-free transfer of accounts receivable to a controlled corporation. 728 Typically, these receivables are attributable to services performed for customers (or property sold to customers) in the regular course of business. 729 But what about stock (or securities) that is issued to a party who performed services for the business itself and not for customers before incorporation? For example, suppose that Anne, a proprietor, hired Bob to paint the inside of her retail store. After Bob completed the painting, Anne discovered that she did not have the cash to pay Bob for his work. Several months later Anne decided to incorporate her retail business. Since she was cash-short and had not yet paid Bob for his services, she persuaded Bob to accept stock in her new corporation. Technically, Bob’s services were not rendered for the benefit of the issuing corporation. They were rendered for the benefit of Anne and her proprietorship. Does this distinction allow Bob to escape disqualification from section 351 nonrecognition treatment? Probably not. According to one appellate court, 730 it has been “held” that stock received for services rendered for the “predecessor of the transferee corporation” is not transferred for “property” and hence falls outside the coverage of section 351. 731 Bob is also likely to run amok the assignment-of-income doctrine, 732 which is discussed immediately below.

E. Assignment-of-income Doctrine

The government and the courts have been more inclined to tax the transferor under assignment-of-income principles, when the transfer was of a right to collect income only and not part of an incorporation of an

726. Id.; see also Pate, supra note 700, at 861.

727. Treas. Reg. § 1.351-1(a)(1)(i) (as amended in 1967). According to Professor Pate, although stock issued in return for the transfer of unrealized receivables for services rendered to third parties might not count as property under section 351(d)(1) itself, the regulations’ narrower definition indicates that receivables should be accorded nonrecognition treatment. Pate, supra note 700, at 861.

728. I.R.C. § 351(a); see also Hempt Bros., 490 F.2d at 1175-78; Rev. Rul. 80-198, 1980-2 C.B. 113.

729. See Pate, supra note 700, at 861.

730. See Pate, supra note 700, at 861.


ongoing business in which the transferor conveyed all of his business assets, not just the receivables, to the corporation.\textsuperscript{733} Several of these taxable transactions have been heavily laden with a tax avoidance motive.\textsuperscript{734} One notorious case, \textit{Brown v. Commissioner},\textsuperscript{735} involved a lawyer who had filed a suit to collect legal fees owed to him. During the pendency of the suit, he formed a corporation and assigned his chose in action to it.\textsuperscript{736} The lawsuit was settled and a large payment was made to the corporation.\textsuperscript{737} The lawyer made a gift of the stock of the corporation to his wife, who then liquidated the corporation and reported a gain from the liquidation on her own income tax return.\textsuperscript{738} The lawyer reported no income on the transaction.\textsuperscript{739} The court held that the lawyer was required to include the settlement proceeds in his gross income, because he had made an anticipatory assignment of income.\textsuperscript{740} In another case, a farmer was taxed on the proceeds from the sale of his crops, which proceeds he had assigned to his controlled corporations.\textsuperscript{741} One final example: Shareholders-employees were held to have taxable income when the corporation issued them stock to discharge its obligation to pay their salaries, which were four years in arrears.\textsuperscript{742} The result in this last case would seem mandated by the language of both section 351(d)(1)\textsuperscript{743} and the regulations\textsuperscript{744} as the shareholders-employees received the stock in exchange for services rendered for the corporation.

\textsuperscript{733} See, e.g., Brown v. Commissioner, 115 F.2d 337, 339 (2d Cir. 1970); Weinberg v. Commissioner, 44 T.C. 233, 245 (1965), \textit{aff'd in part and remanded in part}, 386 F.2d 836 (9th Cir. 1967), \textit{cert. denied}, 392 U.S. 929 (1968); Davidson v. Commissioner, 43 B.T.A. 576, 584-86 (1941), \textit{acq.}, 1941-1 C.B. 3; see also Keller, supra note 505, at 532.


\textsuperscript{735} 115 F.2d 337 (2d Cir. 1940).

\textsuperscript{736} Id. at 338.

\textsuperscript{737} Id.

\textsuperscript{738} Id. at 338-39.

\textsuperscript{739} Id.; see also Rev. Rul. 80-198, 1980-2 C.B. 115.

\textsuperscript{740} Brown, 115 F.2d at 339.

\textsuperscript{741} See \textit{Weinberg}, 44 T.C. at 241-42; see also Keller, supra note 505, at 532. The government and the courts in other cases have used section 482 to reallocate expenses or revenues between farmers and their controlled corporations. See, e.g., Rooney v. United States, 305 F.2d 681 (9th Cir. 1962).

\textsuperscript{742} See \textit{Fender Sales, Inc. v. Commissioner}, 22 T.C.M. (CCH) 550 (1963), \textit{rev'd}, 338 F.2d 924 (9th Cir. 1964), \textit{cert. denied}, 382 U.S. 813 (1965); Note, supra note 689, at 98-99.

\textsuperscript{743} I.R.C. § 351(d)(1) (1986).

\textsuperscript{744} Treas. Reg. §§ 1.351-1(a)(2) (example 3), 1.351-1(b)(2) (example 2) (as amended in 1967).
F. Expensed Property with Useful Life Remaining

Owners of unincorporated businesses are permitted to deduct the cost of materials and supplies on hand in the year of their purchase, if it is reasonably expected that those supplies or materials will be consumed within a one year period. Since an ongoing business is likely to have such expensed items on hand at virtually all times, such expensed items are also likely to comprise a part of the property transferred to the new corporation upon incorporation of a partnership or proprietorship. Presumably, part of the value of the stock or securities received by the transferors in a section 351 exchange is attributable to value of these expensed items: the transferors “recover” value in exchange for these expensed items. Does the tax-benefit rule require the transferors to take the fair market value of the expensed items into their income? There is no authority to indicate that the government has ever invoked the tax-benefit rule in this context. Perhaps the dearth of authority can be construed as an indication that the government is willing to allow this rather common incorporation transaction to go untaxed. The authorities closest in point involved bad-debt reserves, which are no longer permitted for most taxpayers.

In a 1962 revenue ruling, the government posited that an accrual-method taxpayer must recognize income to the extent of the bad-debt reserve when he transferred accounts receivable to a controlled corporation in a transaction that generally would qualify for nonrecognition treatment under section 351. Since the transferor based a deduction on the reserve that he no longer needed, the tax-benefit rule required him to bring back the amount of the bad-debt reserve into his income during the year of the section 351 exchange.

In Nash v. United States, the Supreme Court rejected the government's position. The rationale for the rejection, however, was more clearly articulated by a lower court in Estate of Schmidt v. Commissioner. As the Schmidt court explained, before the transfer of the busi-

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746. See sources cited supra note 710.
750. Id. at 3-4; see also Rev. Rul. 78-280, 1978-2 C.B. at 139-40; see generally Manning, supra note 493; White, supra note 89; Comment, An Asset-Based Approach to the Tax Benefit Rule, 72 Cal. L. Rev. 1257 (1984); Comment, The Tax Benefit Rule: Recovery Reevaluated, 36 U. Miami L. Rev. 533 (1982).
751. 355 F.2d 111, 113 (9th Cir. 1966). The Supreme Court cited Schmidt with approval in
ness, a proprietor owns all of the business assets and is obligated to pay all of its debts.\textsuperscript{752} The bad-debt reserve system allows him to estimate the sum of the uncollectible receivables in advance and charge them against his income rather than requiring him to wait until an actual loss is incurred and then charge it off as a bad debt.\textsuperscript{753} If the amount of the reserve is reasonable, the value of the accounts receivable is not their face amount, but that amount less the reserve.\textsuperscript{754} It is that value that the proprietor transfers to the corporation.\textsuperscript{755} The value of the stock received in the exchange equals the net, not the gross, value of the business, and that figure can be derived by deducting the existing reasonable reserves from the face amount of the receivables.\textsuperscript{756} While perhaps the proprietor no longer “needs” the reserve, he in no sense “recovers” its value in a section 351 exchange.\textsuperscript{757} What he “recovers” are pieces of paper—stock certificates—representing the receivables’ net value, not their gross value.\textsuperscript{758}

At this point it seems clear that the government is not particularly anxious to tax bad-debt reserves that are transferred to a controlled corporation in a section 351 exchange.\textsuperscript{759} The transferor ought to be taxed on any unreasonable additions that he made to the reserve, but it does not seem that the government would need to invoke the tax-benefit rule to tax them. More properly, the transferor should be required to amend his return for the year when he made the unreasonable additions.\textsuperscript{760} It has been suggested that the tax-benefit rule might produce taxable income to the transferor when the value of the stock or securities received in the section 351 exchange exceeds the net value of the receivables.\textsuperscript{761} If the transfer is not of all the assets of an ongoing business but just the

\textit{Nash}. \textit{Nash}, 398 U.S. at 5. For a discussion of the ambiguities in the \textit{Nash} opinion itself, see O’Hare, supra note 708, at 220-21. According to Rev. Rul. 78-280, \textit{Nash} said that the tax-benefit rule was inapplicable because there is no recovery when the stock received in the exchange equals the net value of the accounts receivable. \textit{Nash}, 398 U.S. at 4-5.

753. \textit{Id}.
754. \textit{Id}.
755. \textit{Id}.
756. \textit{Id}.
757. \textit{Id}.
758. \textit{Id}.
761. See O’Hare, supra note 708, at 221; see also \textit{Nash}, 398 U.S. at 4-5.
receivables of that business, any excess of the value of the stock or securities over the net of the face value of the receivables and the bad-debt reserve ought to be income to the transferor under the tax-benefit rule: the transferor is truly recovering value for something he deducted on a previous tax return. But does anyone really want to tax the bad-debt reserve when the transfer of the receivables is part of an incorporation of an ongoing business, which includes the transfer of other assets as well as the receivable? To do that, the taxpayers would have to allocate part of the value of the stock or securities to the receivables and part to the other assets. 762 Nash probably precludes taxing such a transaction anyway. 763

Nash is an inexact fit for the transfer of expensed items. A bad reserve is a means of valuing accounts receivable to correct an overstatement of their value by factoring in the element of uncollectability. It thus serves a valuing function. The expensed items do almost the opposite. The transferor has already benefitted from a deduction and still is getting something of value in return for them (the value of the stock attributable to the expensed item). Under Hillsboro National Bank v. Commissioner, 764 the government probably could successfully invoke the tax-benefit rule. But should it? Do we want to tax the transfer of things such as paper clips, scissors, and stationary upon the incorporation of a small business? Maybe not—for the sake of both administrative convenience and not impeding incorporations. Anyway, in abusive situations, the government can invoke section 482 to avert a distortion of either the transferor's or corporation's income. 765 Yet, the government has succeeded in applying the tax-benefit rule to transfers of expensed items under other Subchapter C nonrecognition sections; 766 hence, one must be

762. See O'Hare, supra note 708, at 221.

763. Nash did involve the transfer of receivables as part of an incorporation of an ongoing business, which included the transfer of other assets as well as the receivables. Nash, 398 U.S. at 5.


765. I.R.C. § 482 (1986); see, e.g., Dolese v. Commissioner, 811 F.2d 543, 546 (10th Cir. 1987); Foster v. Commissioner, 756 F.2d 1430, 1432-33 (9th Cir. 1985); Stewart v. Commissioner, 714 F.2d 977, 989 (9th Cir. 1983); Ruddick Corp. v. United States, 643 F.2d 747, 749 (Ct. Cl. 1981), on remand, 3 Cl. Ct. 61 (1983), aff'd, 732 F.2d 168 (Fed. Cir. 1984); Eli Lilly & Co. v. United States, 372 F.2d 990, 999 (Ct. Cl. 1967); Ballentine Motor Co. v. Commissioner, 321 F.2d 796, 800 (4th Cir. 1963); Rooney v. United States, 305 F.2d 681, 683 (9th Cir. 1962); Central Cuba Sugar Co. v. Commissioner, 198 F.2d 214, 216 (2d Cir.), cert. denied, 344 U.S. 874 (1952); National Sec. Corp. v. Commissioner, 137 F.2d 600, 602 (3d Cir.), cert. denied, 320 U.S. 794 (1943); G.D. Searle & Co., 88 T.C. at 359-67; see also Adess, supra note 518, at 962-66; Berger, Gilman & Stapleton, supra note 518, at 527; Miller, supra note 518, at 235.

alert to that possibility in the section 351 context.

G. Anti-tax Avoidance Code Sections

Over the years Congress has recurringly enacted new code sections that empower the I.R.S. to combat tax avoidance schemes. Several of these can apply in the section 351 context.

1. Reallocations of income and deductions between related businesses: section 482

In several reported cases, the government has successfully invoked section 482 to require a section 351 transferor and his transferee corporation to reallocate their income or expenses between one another to clearly reflect their income in the year of the section 351 exchange. In *Rooney v. United States*, for example, a farmer transferred his farming assets, including a growing crop, to a newly formed corporation in exchange for all of its stock. On his tax return for the year, the farmer deducted his expenses in planting the crop, but excluded the income for selling the crop, which instead was reported by the corporation, which had collected the proceeds from its sale. Since the farmer deducted the bulk of the farm expenses but treated none of the farm income as his own, he claimed a net operating loss, which he sought to carry back to prior years. Relying on section 482, both the government and the court disallowed the farmer’s expense deduction and reallocated it to the corporation, which used it to offset its income from selling the crop. In *Estate of Walling v. Commissioner*, two partners transferred their barge business to a controlled corporation in a section 351 exchange. They warranted that the transferred barges were seaworthy and met licensing requirements. Several months after the transfer, the corporation dry-docked the barges, repaired them and obtained appropriate inspection certificates. As required by their warranty, the transferors paid the


768. 305 F.2d 681 (9th Cir. 1962).

769. Id. at 682.

770. Id.

771. Id.

772. Id. at 683-86.

773. 373 F.2d 190 (3d Cir. 1967).

774. Id. at 193.

775. Id. at 192.

776. Id.
cost of the repairs. They deducted those payments as section 162(a) expenses. An appellate court concluded, however, that the transferee corporation should have borne part of the repair expenses on its tax return because those expenses were at least partly attributable to the period following the section 351 transfer.

2. Changing method of accounting: section 446(b)

The government also can invoke section 446(b), which grants it the power to require a taxpayer to change his method of tax accounting, if the method he is using does not clearly reflect his income. In Palmer v. Commissioner, a builder using the completed-contract method of accounting transferred a nearly completed construction project to a controlled corporation in a section 351 exchange. Since the contractor had not completed the contract prior to the section 351 exchange, he claimed that he was not required to report any of the income generated by the project on his individual income tax return. He asserted that the income from the construction project should be taxed to the transferee corporation, which, conveniently, had substantial tax losses to offset that income. While the case might have been decided under assignment-of-income or tax-avoidance principles, the government and the court instead required the contractor to switch to the percentage-of-completion method of accounting, resulting in taxable income to the contractor for the work he had completed prior to the section 351 exchange.

3. Trafficking in loss corporations: sections 269 and 382

The government can also invoke sections 269 or 269A to prevent abusive taxpayer schemes in the section 351 area. Section 269 empowers the government to disallow a deduction, credit or allowance to a person (or corporation) acquiring control of a corporation when the principal purpose for the acquisition is to obtain the tax benefit of a deduction, credit or allowance belonging to the acquired corporation.
For example, a proprietor with a profitable business might find a defunct shell corporation with a loss carryover and purchase all of its stock from its original shareholders at a nominal price. Shortly after the stock purchase, the proprietor could transfer the business assets of his proprietorship in exchange for more stock or securities of the shell corporation—a section 351 exchange.\(^7\) Since the principal purpose for the acquisition of control was to avoid federal income tax, the government would invoke section 269 to prohibit the use of the shell's loss carryover to offset the post-transfer profits of the proprietor's business.\(^7\)

Section 382 limits the use of a net-operating loss carryforward by a corporation if the corporation has had more than a 50% change in its stock ownership.\(^7\) Section 382 likely would apply to the transaction described in the preceding paragraph. Indeed, the operation of section 382 is so restrictive that it has reduced the need for section 269 when the tax benefit at issue is a corporate net-operating loss carryforward.\(^7\)

4. Personal service corporations: section 269A

Section 269A empowers the government to allocate, among other things, income, deductions and credits between a "personal service corporation" and "its employee-owners" to prevent tax avoidance, or to more clearly reflect the income of the corporation and its employee-owners.\(^7\) A corporation is a "personal service corporation," if its principal activity is personal services "substantially perform[ed] by employee-owners."\(^7\) This definition obviously covers innumerable close corporations.

Although section 269A's predecessor was originally enacted to prevent profitable corporations from shopping for corporations with net operating loss carryovers,\(^7\) its coverage is broader than the particular abuse it was originally intended to curb.

IX. CONCLUSION

There is no formulaic method to conclude a lengthy and detailed Article on one of the major systems within Subchapter C. The paper

\(^7\) See I.R.C. § 351.
\(^7\) See Treas. Reg. § 1.269-3(b)(1)(example) (1962).
\(^7\) I.R.C. § 382.
\(^7\) See Lind & Schwarz, supra note 30, at 638-39.
\(^7\) I.R.C. § 269A.
\(^7\) I.R.C. § 269A(b)(1); see also Foglesong v. Commissioner, 691 F.2d 848, 851 n.3 (7th Cir. 1982).
\(^7\) See I.R.C. § 129 (1939).
contains no one main point to recapitulate. There is no central argument to be driven home with a last second punch. What might be suitable is some speculation on the future of the section 351 system.

Congress virtually has spewed out changes in Subchapter C in recent years, e.g., the General Utilities repeal, but has left the section 351 system intact. This is so, because, as mentioned in the beginning of the Article, the system is relatively coherent and sensible. It works pretty well. Accordingly, it is unlikely that Congress will completely revamp the 351 regime. Nonetheless, one aspect of the system is a prime candidate for change.

As discussed above, section 351 curiously permits non-recognition treatment for a shareholder who transfers property to a controlled corporation in exchange for debt securities. The shareholder is making himself a creditor of the corporation when before he was the outright owner of the property. In contrast, the reorganization rules make the change from an equity to a debt position a taxable event. Sentiment has been expressed in Congress that the treatment of securities in incorporations should be conformed with their treatment in reorganizations, i.e., make the change from an owner to a creditor a taxable event.

Would such a change be a wise tax-policy move? Though the change from an equity-holder to a creditor position would seem to provide a theoretical justification for taxation, perhaps the small business owner should be accommodated and be allowed to take back securities from his controlled corporation. The use of shareholder-held debt in a closely held corporation’s capital structure serves an important non-tax hedge against bankruptcy (although theoretically, imposing a tax on the receipt of securities in exchange for property in an incorporation is probably sound). Moreover, Congress should move cautiously as it probably does not really want to begin taxing incorporations on a regular basis—something it would do if the receipt of securities in an incorporation is made a taxable event.

797. See supra text accompanying notes 1-2.
798. See supra text accompanying note 6.
APPENDIX

The government has prepared a detailed checklist in Rev. Proc. 83-59, 1983-2 C.B. 575 that tax counsel can submit along with a request for a ruling on the applicability of section 351 to a particular transaction.

SECTION 351

CHECKLIST QUESTIONNAIRE

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SECTION 2. BACKGROUND

SECTION 3. CHANGES

SECTION 4. INFORMATION TO BE INCLUDED IN REQUESTS FOR RULINGS UNDER SECTION 351 OF THE CODE

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   2. Business
   3. Jurisdiction

.02 Information regarding the transferors
   1. Identification
   2. Method of accounting

.03 Transfer to corporation
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   2. Services and indebtedness
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      a. Assets
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         (2) Partners and Partnerships
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         (4) Copyrights
         (5) Franchises, trademarks or trade names
         (6) Technical "know-how"
         (7) Stock of another corporation
         (8) Other information
            (a) Solicitation
            (b) Retained rights
            (c) Licenses, leases, etc.
            (d) Leaseback
            (e) Reserve for bad debts
            (f) Continuity of interest
(g) Acquisition indebtedness

(9) Formation of bank holding company
   (a) Definition
   (b) Formation
   (c) Control
   (d) Qualified minority shareholders
   (e) Operating company
   (f) Securities

b. Liabilities
   (1) Amount
   (2) Manner in which incurred and business purpose for assumption
   (3) Indebtedness between transferee and transferor

.04 Consideration from the transferee

1. Stock
   (a) Property
   (b) Services

2. Indebtedness
   (a) Property
   (b) Services

3. Other property
   (a) Cash
   (b) Stock rights, warrants, or certificates of contingent interest

4. Section 306 stock

.05 Control by transferors

1. Stock outstanding immediately before transaction
   (a) Description of terms
   (b) Total number held by transferors
   (c) Total number held by large shareholders

2. Stock outstanding immediately after transaction
   (a) Total number outstanding
   (b) Total number and percent of each class held by each transferor

3. Plan and date of exchanges
   (a) Plan
   (b) Date or dates of exchanges
   (c) Escrowed or contingent stock

4. Additional stock issues
   (a) Additional stock
   (b) Public offering
(1) Total number of shares involved
(2) Underwriters involved
(c) Stock rights, warrants, or subscriptions

5. Disposition of stock by transferors
(a) Number of shares
(b) Consideration
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(d) Reasons for disposition
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(g) Control of transferee

.06 General
1. Business purpose for transaction
2. Value for value
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4. Disposition of property
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.07 Special corporations
1. Investment Company
2. Small Business Corporation
3. Bankrupt Transferors
4. Personal Service Corporation

.08 Copies of documents to be submitted with request
1. Balance sheets
2. Plan or agreement of exchange
3. Securities
   (a) A brief
   (b) A copy

.09 Foreign Transferee
.10 Taxpayer's memorandum

SECTION 5. INQUIRIES
SECTION 6. EFFECT ON OTHER DOCUMENTS

SECTION 1. PURPOSE

The purpose of this revenue procedure is to update Revenue Procedure 81-57, 1981-2 C.B. 674 which sets forth in a checklist questionnaire the information necessary to be included in a request for a ruling under section 351 of the Internal Revenue Code, relating to transfers to a corporation controlled by the transferor or transferors.
SECTION 2. BACKGROUND

The Internal Revenue Service receives many requests for rulings in which the information furnished about the proposed transaction is not sufficient to permit a determination to be made. In such cases it is necessary to obtain additional facts from the taxpayer before the request for a letter ruling can be considered. This procedure is time consuming for both Service personnel and taxpayers and delays issuance of the final ruling letter. This checklist will facilitate the filing and processing of requests for rulings under section 351 of the Code by showing specific information and representations to be included so the request will be as complete as possible when initially filed. Because the information and representations necessary to rule on a particular transaction depend upon all the facts and circumstances, information or representations in addition to those set forth in this revenue procedure may be required.


SECTION 3. CHANGES

SECTION 4. INFORMATION TO BE INCLUDED IN REQUESTS FOR RULINGS UNDER SECTION 351 OF THE CODE

.01 Information regarding transferee corporation.

1. Name, taxpayer identification number, and place and date of incorporation of the transferee corporation (transferee).

2. Description of the business of the transferee, and its method and period of accounting.

3. Identify the District Office having audit jurisdiction over the return of the transferee and the known transferors (collectively referred to as taxpayers). State whether, to the best of the knowledge of the taxpayers, and the taxpayer’s representative(s), the identical issue is in a return of the taxpayers (or of a related taxpayer within the meaning of section 267 of the Code or a member of an affiliated group of which the taxpayer
is also a member within the meaning of section 1504) and, if so, whether
the issue (1) is being examined by a District Director, (2) has been ex-
amined and the statutory period of limitation on assessment or refund of
tax has not expired or a closing agreement covering the issue or liability
has not been entered into by a District Director, (3) is being considered
by an Appeals Office in connection with the taxpayers’ return for an ear-
erlier period, or that issue has been considered by an Appeals Office and
the statutory period of limitation on assessment or refund of tax has not
expired or a closing agreement covering the issue or liability has not been
entered into by an Appeals Office, or (4) is pending in litigation in a case
involving the taxpayers or a related taxpayer. The request must contain
a statement whether, to the best of the knowledge of the taxpayers and
the taxpayer's representative(s), the identical or similar issue has been the
subject matter of a prior ruling request and whether it was ruled on by
the Service to the taxpayers or to the taxpayers’ predecessor and, if so,
when and with what results. If after the request is filed but before a
ruling is issued, the taxpayers know that an examination of the issue by a
District Director has been started, the taxpayers must notify the Na-
tional Office of such an action. If a return is filed before a ruling is re-
ceived from the National Office concerning the return, a copy of the
request must be attached to the return. This alerts the District Office and
avoids premature District action on the issue.

.02 Information regarding the transferors.

1. Name and taxpayer identification number of all known
transferors.

2. State the method and period of accounting used by such
transferors.

.03 Transfer to corporation.

1. Property—Identify and describe fully all types of property tan-
gible and intangible, to be transferred to the transferee by each trans-
feror. Identify specifically each transferor and the property being
transferred by that transferor. Also, furnish a description of the busi-
ness, if any, of each transferor and the property transferred that is related
to that business.

2. Services and Indebtedness—State whether services have been or
will be performed by any transferor for or on behalf of the transferee in
connection with the transaction. Submit a representation as follows: (i)
No stock or securities will be issued for services rendered to or for the
benefit of the transferee in connection with the proposed transaction, and
(ii) No stock or securities will be issued for indebtedness of the transferee
that is not evidenced by a security or for interest on indebtedness of the
transferee which accrued on or after the beginning of the holding period of the transferor(s) for the debt. See section 351(d) of the Code.

3. Assets and Liabilities.

(a) Assets—State whether any of the assets to be transferred were received by the transferor(s) as part of a plan of liquidation of another corporation.

(1) Unreported Income—State whether income items, such as accounts receivable or commissions due, are being transferred to the transferee. If so, and the transferor(s) of these items uses the cash method of accounting, submit a REPRESENTATION as follows: (i) The transferor(s) neither accumulated receivables nor made extraordinary payment of payables in anticipation of the transaction, and (ii) The transferee will report items which, but for the transfer, would have resulted in income or deduction to a transferor in a period subsequent to the transfer and such items will constitute income or deductions to the transferee when received or paid by it. Further, submit a REPRESENTATION as follows: The proceeds received in collection of the income items will be included as ordinary income in computing the taxable income of the transferee. (Rev. Rul. 80-198, 1980-2, C.B. 113). If a transferor is on the completed contract method of accounting, explain fully how the transferor has reported income, costs and expenses related to each contract and how the transferee will report such items subsequent to the transfer.

(2) Partners and Partnerships—State whether the partners’ interests in the partnership or the partnership’s assets will be transferred and whether the partnership will be liquidated.

(3) Patents or patent applications—If patents or patent applications are being transferred, submit a REPRESENTATION as follows: The patents or patent applications qualify as “property” within the meaning of section 351 of the Code. See Rev. Rul. 64-56, 1964-1 C.B. (Part I) 133. Also, submit a REPRESENTATION as follows: The transferor(s) will transfer all substantial rights in such patents or patent applications within the meaning of section 1235 of the Code. See Rev. Rul. 69-156, 1969-1 C.B. 101.

(4) Copyrights—If copyrights are being transferred, state whether the copyright for all media are being transferred and whether any contracts for the exploitation of a copyright in a particular media are being transferred. Submit a REPRESENTATION as follows: All rights, title and interests for each copyright, in each medium of exploitation, will be transferred to the transferee.

(5) Franchises, trademarks or trade names—If franchises, trade-
marks or trade names are being transferred, submit a REPRESENTATION as follows: The transferor will not retain any significant power, right, or continuing interest, within the meaning of section 1253(b) of the Code, in the franchises, trademarks or trade names being transferred.


(7) Stock of another corporation—State whether stock of another corporation is part or all of the property being transferred to the transferee. If so, state the percentage of the transferred stock and the percentage of the transferee’s stock which is owned actually and constructively by the transferor. Also, state whether the stock is being transferred subject to any liabilities or whether any liabilities of the transferor are being assumed in connection with the transfer of such stock. See section 304 of the Code. If the stock to be transferred is other than common stock, submit a REPRESENTATION as follows: None of the stock to be transferred is “section 306 stock” within the meaning of section 306(c) of the Code.

(8) Other information.
(a) Solicitation—Submit a REPRESENTATION as follows: The transfer is not the result of the solicitation by a promoter, broker, or investment house.
(b) Retained rights—Submit a REPRESENTATION as follows: The transferor(s) will not retain any rights in the property transferred to the transferee.
(c) Licenses, leases, etc.—Describe any licenses, leases, etc., to be granted in exchange for stock or securities.
(d) Leaseback—Describe any property to be transferred to the transferee that will be leased back to a transferor, other shareholder, or a related party. Furnish the terms of the lease and identify the lessee.
(e) Reserve for bad debts—Submit a REPRESENTATION as follows: The value of the stock received in exchange for accounts receivable will be equal to the net value of the accounts transferred, i.e., the face amount of the accounts receivable previously included in income less the amount of the reserve for bad debts.
(f) Continuity of interest—If the exchange is part of a larger transaction that fits a pattern common to acquisitive reorganizations (see section 3.0123 of Rev. Proc. 83-22), submit the following REPRESENTATION: (i) With respect to the larger transaction, share-
holders of the acquired corporation will receive, in exchange for their stock of the acquired corporation, stock of the acquiring corporation equal, in the aggregate, to a number of shares having a value, as of the date of the exchange, of at least 50 percent of the value of all of the formerly outstanding stock of the acquired corporation as of the same date; (ii) There is no plan or intention on the part of the shareholders of the acquired corporation to sell or otherwise dispose of a number of shares of stock of the acquiring corporation to be received in the transaction that would reduce such shareholders' ownership to a number of shares having, in the aggregate, a value of less than 50 percent of the total fair market value of the acquired corporation's stock outstanding as of the effective date of the proposed transaction; and, (iii) There have not been any significant changes in the stock ownership of the acquired corporation in the last five years that would cause the continuity of interest requirement not to be satisfied.

(g) Acquisition indebtedness—If stock of a corporation is being transferred, submit a REPRESENTATION as follows: Any debt relating to the stock being transferred that is being assumed (or to which such stock is subject) was incurred to acquire such stock and was incurred when such stock was acquired, and each transferor is transferring all of the stock for which the acquisition indebtedness being assumed (or to which such stock is subject) was incurred.

(9) Formation of bank holding companies

b. Liabilities.

....

(1) Submit a REPRESENTATION as follows: The adjusted basis and the fair market value of the assets to be transferred by the transferor(s) to the transferee will, in each instance, be equal to or exceed the sum of the liabilities to be assumed by the transferee plus any liabilities to which the transferred assets are subject. See section 357(c) of the Code.

(2) Submit a REPRESENTATION as follows: The liabilities of the transferor(s) to be assumed by the transferee were incurred in the ordinary course of business and are associated with the assets to be transferred. If the liabilities to be assumed were not so incurred, state the business reason or purpose for the assumption of these liabilities. See section 357(b) of the Code.

(3) Submit a REPRESENTATION as follows: There is no indebtedness between the transferee and the transferor(s) and there will be no indebtedness created in favor of the transferor(s) as a result of the transaction.

.04 Consideration from the transferee.
1. Stock—Describe the terms of each class and the number of shares of each class to be issued to each transferor for:
   (a) Property—See .031 above and identify the property of each transferor.
   (b) Services—See .032 above and identify the services. Indicate those transferors who will also receive stock for property.
2. Indebtedness—State the principal amount of indebtedness and its terms to be created in favor of each transferor for:
   (a) Property—See .031 above and identify the property of each transferor.
   (b) Services—See .032 above and identify the services.
3. Other property in addition to stock and indebtedness—Indicate the amount and provide a complete description of any other property that will be issued to each transferor including, but not limited to:
   (a) Cash.
   (b) Stock rights, warrants, or certificates of contingent interest, with the terms of each.
4. Section 306 stock—If any stock other than common stock will be received in the exchange, explain why it is believed this stock is not “section 306 stock” within the meaning of section 306(c)(3) of the Code.
5. Control by transferors.
   1. Stock of transferee outstanding immediately before transaction.
      (a) Furnish a description of the terms and the total number of shares of each class outstanding.
      (b) State the total number of shares of each class held by a shareholder who will be a transferor in the exchange.
      (c) State the total number of shares of each class held by each shareholder owning five percent or more of a class and the number of shareholders owning the balance of each class outstanding.
   2. Stock of transferee outstanding immediately after transaction.
      (a) State the total number of shares of each class.
      (b) State the total number and percent of shares of each class held by each transferor.
   3. Plan and dates of exchanges.
      (a) Submit a REPRESENTATION as follows: The transfers and exchanges will occur under a plan agreed upon before the transaction in which the rights of the parties are defined. See section 1.351-1(a)(1) of the regulations.
      (b) Submit a REPRESENTATION as follows: All exchanges will occur on approximately the same date.
(c) State whether any of the stock issued will be placed in escrow, or whether any of the stock will be issued later under a contingent stock arrangement.

4. Additional stock issues.
   (a) State whether any stock will be issued in the near future in addition to that being issued under the plan. If so, give full particulars.
   (b) If a public offering is planned, submit the following information:
       (1) The total number of shares of each class involved.
       (2) If underwriters are involved, explain whether the underwriter will purchase these shares for their own account or will act as agent for the transferee. See Rev. Rul. 78-294, 1978-2 C.B. 141.
   (c) If any rights, warrants, or subscriptions of the transferee are outstanding or will be issued or offered, state the total number of shares of each class of stock involved and explain the circumstances in which they were or will be issued or offered.

5. Disposition of stock by transferor(s).
   (a) Indicate the number of shares of each class that each transferor will dispose of after the exchange.
   (b) State the consideration to be received in exchange for the transferee stock disposed.
   (c) Provide the names of the acquiring parties and their relationship to the transferee or shareholder-transferor.
   (d) State the circumstances and reasons for the disposition, including any agreements between the parties.
   (e) If there are, or will be, any options to purchase stock from any of the transferors, give full particulars.
   (f) Submit a REPRESENTATION as follows: There is no plan or intention on the part of the transferee to redeem or otherwise reacquire any stock or indebtedness to be issued in the proposed transaction.
   (g) Submit a REPRESENTATION as follows: Taking into account any issuance of additional shares of transferee stock; any issuance of stock for services; the exercise of any transferee stock rights, warrants, or subscriptions; a public offering of transferee stock; and the sale, exchange, transfer by gift, or other disposition of any of the stock of the transferee to be received in the exchange, the transferor(s) will be in "control" of the transferee within the meaning of section 368(c) of the Code. See Rev. Rul. 59-259, 1959-2 C.B. 115, and section 1.351-1(a)(1) of the regulations.

.06 General.
1. Business reasons or purpose—Explain the business reasons for the transaction.

2. Value for value—Submit a REPRESENTATION as follows: Each transferor will receive stock, securities or other property approximately equal to the fair market value of the property transferred to the transferee or for services rendered or to be rendered for the benefit of the transferee.

3. Activities of transferee—Submit a REPRESENTATION as follows: The transferee will remain in existence and retain and use the property transferred to it in a trade or business.

4. Disposition of property—Submit a REPRESENTATION as follows: There is no plan or intention by the transferee to dispose of the transferred property other than in the normal course of business operations.

5. Related, connected, or step transactions—Describe any loans, sales, exchanges, or other transactions, other than recurring arm's length sales, purchases, etc., in the normal course of business, that will occur or are contemplated whether or not considered as related to or in connection with the exchange.

6. Expenses—Submit a REPRESENTATION as follows: Each of the parties to the transaction will pay its or his/her own expenses, if any, incurred in connection with the proposed transaction.

.07 Special Corporations.

1. Investment Company—Submit a REPRESENTATION as follows: The transferee will not be an investment company within the meaning of section 351(e)(1) of the Code and section 1.351-1(c)(1)(ii) of the regulations.

2. Small Business Corporation—State whether the transferee intends to make the election under section 1362(a) of the Code to be taxed as a “small business corporation” as defined in section 1361(a).

3. Bankrupt Transferor—Submit a REPRESENTATION as follows: The transferor is not under the jurisdiction of a court in a title 11 or similar case (within the meaning of section 368(a)(3)(A)) and the stock or securities received in the exchange will not be used to satisfy the indebtedness of such debtor. See section 351(e) of the Code.

4. Personal Service Corporation—Submit a REPRESENTATION as follows: The transferee will not be a “personal service corporation” within the meaning of section 269A of the Code.

.08 Copies of documents to be submitted with request.
1. Balance sheets—Latest of transferee or other business involved. If transferee is a new corporation, submit a pro-forma balance sheet.
2. Plan or agreement of exchange—If one has been committed to writing.
3. Securities—If it is contended that any part or all of the indebtedness described in 4.042(a) above is "securities" within the meaning of section 351 of the Code submit:
   (a) A brief explaining why.
   (b) A copy of the note or other evidence of the indebtedness and loan agreement, if any. However, see section 4.0112 of Rev. Proc. 83-22.
4. Foreign Transferee—If the transfer is to a foreign corporation, see section 367 of the Code and the regulations thereunder and Rev. Proc. 68-23, 1968-1 C.B. 821.

SECTION 5. INQUIRIES

Inquiries in regard to this revenue procedure should refer to its number and should be addressed to the Associate Chief Counsel (Technical) Attention CC:C:R, Internal Revenue Service, Washington, D.C. 20224.