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THE CORPORATION AND THE FEDERAL INCOME TAX: TRANSFERS TO A CONTROLLED CORPORATION*

By Boris I. Bittker†

Before the 1954 Code was enacted, the regulations provided that a corporation realized neither gain nor loss on the original issuance of its stock, even though the subscription or issue price exceeded, or was less than, the par or stated value of the stock.¹ The pre-1954 regulations also provided, however, that:

[I]f a corporation deals in its own shares as it might in the shares of another corporation, the resulting gain or loss is to be computed in the same manner as though the corporation were dealing in the shares of another.²

As applied, this regulation often resulted in the recognition of gain or loss on the disposition by a corporation of treasury shares, although no gain or loss would have been recognized if the corporation had used authorized but unissued shares. Moreover, some courts held that a corporation had dealt "in its own shares as it might in the shares of another corporation" in a transaction (such as the sale of stock to employees, as an incentive to future services) even though the shares of another corporation clearly would not have served the same function.³

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† Professor of Law, Yale University.

1. U.S. Treas. Reg. 118, § 39.22(a)-15(a) (1953).
2. Id. § 39.22(a)-15(b).
3. See generally Murphy, *How To Handle Treasury Stock; Distinction Between Treasury Stock and Unissued Stock: Is There Any Justification for This?*, N.Y.U. 10th Inst. on Fed. Tax. 1161 (1952); Anderson, *Gain or Loss to a Corporation Dealing in Its Own Shares*, 1953 So. Calif. Tax. Inst. 121.

In 1954, section 1032 was enacted, "to remove the uncertainties of present law."⁴ Putting treasury shares on a par with originally issued shares, section 1032 provides that the corporation shall not recognize gain or loss "on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation." While this legislation does not resolve all issues in this area, it at least lays down the principle that in ordinary cases the corporation will recognize neither gain nor loss on issuing or selling its own stock. Moreover, the regulations provide that section 1032 applies to a transfer of stock as compensation for services,⁵ although the statutory language is not explicit on this point.

If the subscriber or buyer pays cash for his shares, moreover, he will recognize neither gain nor loss. His acquisition of the stock for cash is simply a capital investment on his part, the gain or loss on which will be reckoned up only when he sells or otherwise disposes of his stock or when, to his chagrin, it becomes worthless. (This is on the assumption that he pays the fair market value for the shares; a "bargain purchase" might constitute compensation for services or other taxable income.)

If the purchaser acquires the stock for property rather than for money, however, he may have to recognize gain or loss on the transaction. The transfer of the property to the corporation in exchange for stock is a "sale or other disposition" of the property within the meaning of section 1001(a),⁶ upon which the transferor realizes gain if the value of the stock received by him exceeds the adjusted basis of the property given up or loss if the value of the stock is less than the adjusted basis of the property. By virtue of section 1002,⁷ the entire amount of this gain or loss is to be recognized by the transferor of the property unless the transaction comes within one of the "non-recognition" provisions of the Code.

Since property is frequently transferred for corporate stock or securities, especially on the organization of a new corporation, the following "non-recognition" provisions relating to such transactions are of great importance:

1. Section 351, providing that no gain or loss shall be recognized if property is transferred to a corporation solely in exchange for its stock or securities, and if the transferor or transferors control the corporation immediately after the exchange.⁸

4. S. Rep. No. 1622, 83d Cong., 2d Sess. 426 (1954).

5. U.S. Treas. Reg., § 1.1032-1 (1956).

6. Int. Rev. Code of 1954, § 1001(a). Unless otherwise indicated, textual references to specific sections refer to sections of the Internal Revenue Code of 1954.

7. Int. Rev. Code of 1954, § 1002.

8. Id. § 351.

2. Section 361(a), providing that no gain or loss shall be recognized if a corporation that is a party to a reorganization transfers property to another corporation a party to the reorganization.⁹

This article will deal with transfers under section 351. This section is of particular importance when individual proprietorships and partnerships are incorporated. It also embraces the transfer of property to a previously organized corporation by its controlling shareholders.¹⁰

Whether or not a transaction qualifies under section 351 is a question that may arise either at the time the transaction occurs or at some later date. When the transaction occurs, the applicability of section 351 is critical because it determines whether the transferor recognizes gain or loss on the transfer. But the applicability of section 351 may be put in issue later on, when the transferor sells the stock he received for the transferred property, for his basis for the stock depends upon whether the transaction in which he got the stock met the conditions of section 351. If it did, the basis of the stock is the same as the basis of the property he gave up.¹¹ If, on the other hand, the exchange was not within section 351, the basis of the stock is its fair market value at the time of the exchange. The corporation's basis for the property transferred to it similarly depends upon whether or not the transfer met the requirements of section 351.¹² As a result, controversy over the application of section 351 to a given transaction may arise decades after the transaction occurred. In *Manhattan Bldg. Co.*,¹³ for example, the corporation's gain or loss on the sale of a building in 1945 depended upon whether it acquired the property in 1922 in a transaction qualifying under the predecessor of section 351.

Section 351 dates from the Revenue Act of 1921,¹⁴ its announced purpose being to facilitate business re-adjustments. Under previous revenue acts, the creation of even a one-man corporation by the transfer of appreciated or depreciated property was an occasion on which gain or loss was recognized by the transferor.¹⁵ Since 1921, however, gain or loss has not been recognized on such a transaction.

The main features of today's section 351 may be found in the 1921 provision, although there have been several amendments in the inter-

9. Id. § 361(a).

10. Although § 361(a) is outside the scope of this article, it may be noted here that a transfer may qualify under both § 351 and § 361(a), e.g., when a corporation creates a subsidiary by transferring part of its property for all the stock of the subsidiary.

11. Int. Rev. Code of 1954, § 358.

12. Id. § 362.

13. 27 T.C. 1032 (1957), acq., 1957-2 Cum. Bull. 5.

14. 42 Stat. 280 (1921).

15. Jefferson Livingston, 18 B.T.A. 1184 (1930), acq., IX-2 Cum. Bull. 36 (1930).

vening period, most recently in 1954. Before turning to the details of section 351, it may be helpful to spend a few moments on its purpose and philosophy.

In recommending the enactment of section 351's predecessor in 1921, the Senate Finance Committee pointed out that exchanges of property were ordinarily taxable:

Probably no part of the present income tax law has been productive of so much uncertainty or has more seriously interfered with necessary business readjustments. The existing law makes a presumption in favor of taxation. The proposed act . . . specifies . . . certain classes of exchanges on which no gain or loss is recognized even if the property received in exchange has a readily realizable market value. These classes comprise the cases where . . . an individual or individuals transfer property to a corporation and after such transfer are in control of such corporation.

The preceding amendments [the predecessors of sections 351, 354, and 1031], if adopted, will, by removing a source of grave uncertainty and by eliminating many technical constructions which are economically unsound, not only permit business to go forward with the readjustments required by existing conditions but also will considerably increase the revenue by preventing taxpayers from taking colorable losses in wash sales and other fictitious exchanges.¹⁶

The basic premise of section 351 is that a transfer of appreciated or depreciated property to a corporation that is controlled by the transferor works a change of form only, which should not be an occasion for reckoning up the transferor's gain or loss on the transferred property.¹⁷ (So far as loss is concerned, section 267(a)(1) disallows any deduction based on a sale or exchange between an individual and a corporation of which he owns, directly or indirectly, more than fifty per cent of the stock, but this limitation, which overlaps section 351 to some extent, was not enacted until 1936.)

The premise upon which section 351 rests is sound, even though for most purposes the controlled corporation is treated as an entity separate from its shareholders. In point of fact, however, the language of

16. S. Rep. No. 275, 67th Cong., 1st Sess. 11-12 (1921) (reprinted in 1939-1 Cum. Bull. 181, 188-89).

17. See *Portland Oil Co. v. Commissioner*, 109 F.2d 479, 488 (1st Cir. 1940), where the court said: "It is the purpose of [§ 351] . . . to save the taxpayer from an immediate recognition of a gain, or to intermit the claim of a loss, in certain transactions where gain or loss may have accrued in a constitutional sense, but where in a popular and economic sense there has been a mere change in the form of ownership and the taxpayer has not really 'cashed in' on the theoretical gain, or closed out a losing venture."

So far as loss is concerned, § 267(a)(1) disallows any deduction based on a sale or exchange between an individual and a corporation of which he owns, directly or indirectly, more than fifty per cent of the stock, but this limitation, which overlaps § 351 to some extent, was not enacted until 1936.

section 351 embraces transfers that arguably ought to be treated as sales because the taxpayer has "cashed in" on his gain, either in whole or in part. Thus:

1. Section 351 is not restricted to transfers by a single individual to his one-man corporation; it also embraces transfers by two or more persons to a corporation that they control collectively. If *A* owns a patent with a cost of \$1,000 and a fair market value of \$10,000 and *B* owns land with a cost of \$20,000 and a value of \$10,000 and they transfer their property to a new corporation in exchange for the stock (each taking one-half), one might argue that the transfer is not merely a matter of form and that their economic positions have changed sufficiently so that *A*'s gain (\$9,000) and *B*'s loss (\$10,000) should be recognized. But it has long been established that section 351 embraces transfers of property by two or more persons who were not previously associated, on the ground that "instead of the transaction having the effect of terminating or extinguishing the beneficial interests of the transferors continue to be beneficially interested in the transferred property and have dominion over it by virtue of their control of the new corporate owner of it."¹⁸

While in many cases the transferors of property to a controlled corporation do "continue to be beneficially interested in the transferred property," there are occasions when their interest is so attenuated that the transaction can hardly be regarded as a matter of form alone. Thus, if 1,000 owners of corner grocery stores simultaneously transfer their assets to a newly organized corporation, each taking his share of the stock, the economic status of each man has changed vitally. In the same vein, what of a transfer of his assets by one corner groceryman for 0.01 per cent of the stock of a newly organized corporation, simultaneously with a transfer by *A. & P.* of its assets in exchange for 99.99 per cent of the stock? The language of section 351 is broad enough to confer tax-free status on both of these hypothetical transfers, but the cautious tax adviser would surely have some qualms about them. The hypothetical 1,000 storekeepers are discarding their roles as small tradesmen in order to become investors in a widely held corporation, and it would be a triumph of literalism to apply section 351 to their transaction. The same can be said of the corner groceryman who intends to turn his back on *Mrs. Klotz* and her complaints about his pork chops in order to devote his attention to the *Wall Street Journal*. As to *A. & P.*, however, the transaction does seem to be a change of form rather than of substance, and the spirit as well as the letter of section 351 is applicable.

18. *American Compress & Warehouse Co. v. Bender*, 70 F.2d 655, 657 (5th Cir. 1934).

2. Section 351 embraces a transfer of property for securities, as well as a transfer for stock. If the shareholder of a one-man corporation transfers property to it in exchange for bonds of the corporation, it is not unreasonable to say that his economic position has not changed sufficiently to reckon up gain or loss, even though he is now a creditor of his corporation, as well as its sole shareholder. But can the same be said if *A* and *B* transfer property to a newly organized corporation, *A* taking back bonds and *B* taking all the stock? If this transaction passes muster, what if we vary the facts so that there are fifty transferors, one of whom receives bonds for his property, while all the others take stock only? Nothing in the language of section 351 puts these transactions beyond its protection, but for the transferor who receives bonds, the transfer is hard to distinguish from a sale.

Fortunately for the tax advisor, marginal cases of the types suggested in the two preceding paragraphs rarely arise. If they were of frequent occurrence, moreover, it is likely that section 351 would by now have been amended to provide a statutory guide to their solution. In the absence of statutory provisions, one can only point out that the courts have not hesitated to engraft judicial restrictions on the language of other portions of subchapter C of the Internal Revenue Code,¹⁹ and suggest that there is no reason to think that they would not exercise this prerogative under section 351 in extreme cases.²⁰ They might, for example, make use of the "continuity of interest" doctrine, which was created to prevent an undeserving transaction from qualifying as a tax-free corporate reorganization even though it came within the literal terms of the statutory language.²¹

So much for the purpose and philosophy of section 351. It is now time to turn to its details. The major requirements of the provision are these:

1. One or more persons must transfer "property" to a corporation.

19. Rice, *Judicial Techniques in Combating Tax Avoidance*, 51 Mich. L. Rev. 1021, 1040-48 (1953); Mintz & Plumb, *Step Transactions in Corporate Reorganizations*, N.Y.U. 12th Inst. on Fed. Tax. 247 (1954).

20. It has been argued that a remark in the Senate Report on the 1954 Code validates a transaction in which *A* receives bonds and *B* stock. The passage in question states that "if *M* and *N* each owning property having a value of \$100 transfers such property to a newly formed corporation *X*, and *M* receives all of the stock, such transaction would not be subject to tax under section 351." S. Rep. No. 1622, 83d Cong., 2d Sess. 264 (1954). As the context indicates, however, the example is concerned with a case in which *M* receives all the stock (and *N* receives nothing), because *N* is making a gift or paying compensation to *M* in the amount of \$100. We are not told that § 351 would be applicable if *N* had received bonds for his property.

21. For a discussion of this possibility, see text supported by notes 43-46 *infra*.

2. The transfer must be "solely in exchange for stock or securities in such corporation."
3. The transferor or transferors must be "in control" of the corporation "immediately after the exchange."

If these requirements are met, the transferor or transferors recognize neither gain nor loss on the exchange, and the transferor's basis for the property transferred controls both the transferee corporation's basis for the property received by it²² and the transferor's basis for the stock or securities received by him.²³

TRANSFER OF "PROPERTY"

Section 351 provides that gain or loss shall not be recognized if "property" is exchanged solely for stock or securities of a controlled corporation. The term "property" as used in section 351 is not defined by statute²⁴ but the absence of a definition has not been troublesome.

Although the term "property" as used in other provisions of the Code does not always embrace money, it does include money under section 351.²⁵ There is a compelling reason for so construing the term "property" under section 351. A newly organized corporation almost always needs cash for working capital, and if section 351 did not permit the tax-free transfer of money to such a corporation, it would either lose much of its usefulness or invite evasion in the form of a transfer of cash in an allegedly independent transaction after the other assets had been transferred under section 351.

Section 351 provides that "stock or securities issued for services shall not be considered as issued in return for property." This provision entered the Code in 1954, though it may have been implicit in earlier years. An exchange is not automatically cast out of section 351, however, merely because the corporation issues stock or securities for services. The effect of the 1954 provision, rather, is that stock or securities given in exchange for services, cannot be counted in determining whether the transferors of "property" "are in control" of the corporation immediately after the exchange.²⁶ But if the persons who transfer property are "in control," their exchange of property for stock or securities qualifies under section 351, even though at the same

22. Int. Rev. Code of 1954, § 362.

23. Id. § 358.

24. The definition in § 317(a) is applicable only to part I of subchapter C, which does not include § 351.

25. G.C.M. 24415, 1944 Cum. Bull. 219; George M. Holstein, III, 23 T.C. 923 (1955).

26. The term "control" is defined by § 368(c) to mean the ownership of eighty per cent of the voting power of stock entitled to vote and eighty per cent of all other stock. See text supported by notes 63-88 infra.

time stock or securities are issued for services to one or more other persons. Moreover, if a person who transfers property in exchange for stock or securities *also* receives stock or securities in exchange for services, his stock (whether received for property or services) is to be counted in determining whether the transferors of "property" have control of the corporation. To illustrate: if *A* and *B* transfer property to a newly organized corporation for seventy-eight per cent of its stock and *C*, as part of the same transaction, receives twenty-two per cent of the stock for services rendered to the corporation, the transfer does not qualify under section 351 because the transferors of property (*A* and *B*) have less than eighty per cent of the stock and hence do not have "control" as that term is defined by section 368(c) for purposes of section 351. If, however, *A* and *B* received eighty per cent or more of the stock, and *C* twenty per cent or less, the exchange would qualify. Moreover, if *A* and *B* received seventy-eight per cent of the stock for property and *C* received twenty-two per cent for a combination of services and property, the transfer would qualify (though as to *C*, the receipt of stock for services might produce taxable income), unless *C*'s transfer of property was only a sham designed to support a claim by *A* and *B* for non-recognition of gain or loss.²⁷ Finally, the disqualification of services by section 351 probably does not apply to stock or securities issued for property that was earned by the performance of services.²⁸

The discussion in the preceding paragraph has been based on the assumption that stock or securities are being issued for services performed *for the corporation*. The transaction takes on another complexion if the services were performed for someone else, such as one of the transferors of property. An example is the individual proprietor who incorporates his business, taking part of the stock himself and directing that the rest be issued to an employee as compensation for services already performed. Such a transaction is to be treated as though all the stock had been issued first to the proprietor in exchange for the assets of the business, with part of it being used by him to pay his debts. The incorporation would qualify under section 351 if the proprietor retained at least eighty per cent of the stock,²⁹ and even if he retained less than eighty per cent, it might qualify if the loss of "control" (as defined by section 368(c)) was not an integral part of

27. U.S. Treas. Reg., §§ 1.351-1(a)(1), 1.351-1(a)(2) (1955).

28. *Fahs v. Florida Mach. & Foundry Co.*, 168 F.2d 957 (5th Cir. 1948) (claim that the recipient of stock had an equitable interest in the transferred property rejected on the facts, with possible implication that on stronger facts the alleged equitable owner would be a transferor of "property"); see *The Roberts Co.*, 5 T.C. 1 (1945), acq., 1945-1 Cum. Bull. 6 (interest in property arising under attorney's contingent fee agreement is "property").

29. U.S. Treas. Reg., §§ 1.351-1(b)(1), 1.351-1(b)(2) (1955).

the transaction.³⁰ If the proprietor is regarded as paying his debt with stock, as suggested by the regulations,³¹ he will recognize gain or loss on the difference between the amount of the debt and the adjusted basis³² of the stock so used. In practice, of course, it may be difficult to determine whether stock is issued for services performed in the past for one of the transferors, as an incentive to the performance of services in the future for the transferee corporation, or both. In any event, the fair market value of the stock will be taxable compensation to the recipient; but the transferor will realize gain or loss on the transfer only if the stock serves to discharge a debt of his.

“STOCK OR SECURITIES”

Problems of Classification

Section 351 permits the tax-free transfer of property to a controlled corporation only if the transfer is “solely in exchange for stock or securities” in such corporation. While there have been few decisions construing the term “stock or securities” as used in section 351, it has been held that the term has the same meaning here as in sections 354(a)(1) and 361(a), providing for the non-recognition of gain or loss on an exchange in the course of a corporate reorganization.³³

As used in the reorganization sections, the term “stock or securities” does not include short-term notes. The reason for this restrictive construction of the term “stock or securities” is that the underlying purpose of the reorganization sections is to permit the tax-free transfer of property only if a transfer is not analogous to a sale.³⁴ Where the transfer is for cash, of course, it is quite clear that gain or loss should be recognized. Where short-term notes are received for the property, courts construing the reorganization sections have held that the transaction is so akin to a sale that gain should be recognized to the extent of the value of the short-term notes. In the leading case on this question, *Pinellas Ice and Cold Storage Co. v. Commissioner*,³⁵ the Supreme Court rested its decision partly on the theory that the transaction (a

30. See *G. & W.H. Corson, Inc.*, 22 P-H 1953 T.C. Mem. Dec. ¶ 53242; text supported by notes 76-88 *infra*.

It is barely possible that the transaction could be regarded, in the alternative, as a transfer of property by the proprietor in exchange for stock and an assumption of his indebtedness, followed by a payment of the debt by the corporation; on the tax consequences of such an assumption of the transferor's debt, see text supported by notes 48-62 *infra*.

31. U.S. Treas. Reg., § 1.351-1(b)(2), Example (1) (1955).

32. See text supported by notes 89-97 *infra*.

33. *Lloyd-Smith v. Commissioner*, 116 F.2d 642 (2d Cir. 1941).

34. U.S. Treas. Reg., § 1.368-1(b) (1955).

35. 287 U.S. 462 (1933).

transfer of property for cash and short-term notes) fell entirely outside the intended ambit of the reorganization sections:

[T]o be within the exemption the seller must acquire an interest in the affairs of the purchasing company more definite than that incident to ownership of its short-term purchase-money notes.³⁶

Although this was not only an appropriate but also a sufficient ground for its determination, the Court also said that the notes "were not securities within the intendment of the act." This part of the *Pinellas* opinion has been cogently criticized,³⁷ but it is by now so well imbedded in the law that the later decisions in this area have been pre-occupied principally with the tantalizing question: How long is too long? And even when the classification of notes as "securities" is said to depend upon an "overall evaluation of the nature of the debt," the length of time to maturity is regarded as the most important single earmark. Notes with a five year term or less seem to be unable to qualify as "securities," while a term of ten years or more is apparently sufficient to bring them within the statute.³⁸ It should also be noted that a short-term note or other debt may be found to be a substitute for stock if the corporation is under-capitalized or does not intend to treat the obligation as a true debt.³⁹

But the fact that short-term notes are not "stock or securities" as that term is used in section 351 does not automatically exclude a transaction from the benefits of section 351. For if the transfer otherwise qualifies under section 351, e.g., if the transferors exchange property for a combination of stock and short-term notes, the notes will come within the ambit of section 351(b). Under this provision, if the transferor of property receives not only "stock or securities" (so-called "non-recognition property"), which can be received tax-free under section 351(a), but also "other property or money" (so-called "boot"), his gain on the exchange (if any) will be recognized, but not in an amount in excess of the money plus the fair market value of the "boot." For example, if A transfers property with an adjusted basis of \$10,000 and a fair market value of \$50,000 to a corporation for all its stock

36. *Id.* at 470.

37. Griswold, "Securities" and "Continuity of Interest," 58 *Harv. L. Rev.* 705 (1945).

38. The cases are collected in *Camp Wolters Enterprises, Inc.*, 22 T.C. 737, 751 (1954), *aff'd*, 230 F.2d 555 (5th Cir.), *cert. denied*, 352 U.S. 826 (1956); *Weiss, Notes as Securities Within Section 112(b)(3) [1939 Code]*, 26 *Taxes* 228 (1948). See also *Warren H. Brown*, 27 T.C. 27 (1956), *acq.*, 1957-2 *Cum. Bull.* 4 (installment sales contract not a "security"); *John W. Harrison*, 24 T.C. 46 (1955), *aff'd*, 235 F.2d 587 (8th Cir. 1956) (shareholders' drawing accounts not "securities").

39. See *Bittker, Thin Capitalization: Some Current Questions*, 34 *Taxes* 830 (1956), reprinted with minor revisions in 10 *U. Fla. L. Rev.* 25 (1957).

plus \$5,000 of short-term notes (having a fair market value equal to their face amount), A's gain is \$40,000, but it is recognized only to the extent of \$5,000, the fair market value of the notes.⁴⁰

Most of the turmoil over the meaning of "stock or securities" has concerned debt instruments, and it has generally been assumed that the term "stock" is virtually self-defining. The regulations, however, state that stock rights and stock warrants do not come within the term "stock or securities."⁴¹ The inspiration for this statement is unknown, at least to this writer. It may be that stock rights and warrants should not be taken into account in determining whether the transferors of property are in "control" of the corporation immediately after the exchange,⁴² but if they do have control, there seems to be no good reason for disqualifying a transfer of property for stock rights or warrants or for treating them as "boot."

The "Continuity of Interest" Doctrine

In the *Pinellas* case,⁴³ the Supreme Court said not only that short-term notes are not "securities," but also that they do not give the transferor "an interest in the affairs" of the transferee corporation that will qualify under the reorganization provisions. This judicial requirement of a "continuity of interest" was developed more fully in later cases. In *LeTulle v. Scofield*,⁴⁴ for example, it was employed to disqualify a reorganization in which the transferor of property received bonds plus cash, but no stock, from the transferee corporation. The "continuity of interest" doctrine, which is set out in the regulations,⁴⁵ does not derive from any specific language in the reorganization sections. It is instead a doctrine of judicial origin based on what is conceived to be the unstated but fundamental statutory purpose of providing for non-recognition of gain or loss only if the reorganization exchange is distinguishable from a sale. It should be noted that there is a drastic difference between (a) holding that an exchange fails to qualify under section 351 because the transferor does not retain a continuing proprietary interest, and (b) holding that some of the instruments received by the transferor do not constitute "stock or securities." In the former case, the entire gain or loss will be recognized; in the latter situation, if the transferor also receives stock evidencing

40. For more on the tax treatment of the "boot," see text supported by note 47 *infra*.

41. U.S. Treas. Reg., § 1.351-1(a)(1)(ii) (1955).

42. See text supported by notes 86-88 *infra*.

43. *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933).

44. 308 U.S. 415 (1940).

45. U.S. Treas. Reg., § 1.368-1(b) (1955).

a substantial continuity of interest, gain will be recognized only to the extent of the unqualified instruments (or "boot").

Is the "continuity of interest" doctrine as developed under the reorganization sections applicable to exchanges under section 351? If so, the courts would deny the benefits of the section if a transferor receives nothing but bonds or other evidences of indebtedness in exchange for his property. This result is not defensible if eighty per cent or more of the corporation's stock is already owned by the transferor or transferors receiving bonds or other evidences of indebtedness; in such a case, they have an interest in the transferred property that serves the function of the "continuity of interest" doctrine, even though no stock is received on the exchange itself. But if two or more transferors organize a corporation, and one of them receives nothing but bonds, it is possible that the government will be able to invoke the *Pinellas* and *LeTulle* cases to disqualify the entire transaction.⁴⁶

"SOLELY" IN EXCHANGE—THE RECEIPT OF "BOOT"

Section 351 provides that no gain or loss shall be recognized if property is transferred to a controlled corporation "solely" in exchange for stock or securities in such corporation. It has already been pointed out that if the transferor or transferors receive from the controlled corporation not only "stock or securities" but also short-term notes, they are required by section 351(b) to recognize their gain (if any) to the extent of the fair market value of the notes. The rule of section 351(b) comes into play whenever the exchange would qualify under section 351(a) except for the fact that the transferor or transferors have received not only "stock or securities" (so-called "non-recognition property"), but also money or other property (so-called "boot"). At the same time, section 351(b) requires the recognition of gain only if gain has been "realized" under section 1001. Thus, if A transfers property with an adjusted basis of \$10,000 and a fair market value of \$50,000 to a controlled corporation in exchange for stock and securities worth \$30,000 and cash of \$20,000, his gain under section 1001 is \$40,000, but only \$20,000 of it is recognized under section 351(b).⁴⁷ If the adjusted basis of the property was \$45,000, in-

46. See note 20 supra.

47. If the realized gain (\$40,000) consists of ordinary income, long-term capital gain, and short-term capital gain, presumably some allocation of the recognized gain (\$20,000) is required, but neither the Code nor the regulations states how the allocation shall be made. In a somewhat analogous area, the regulations require an allocation according to the fair market value of the assets transferred. U.S. Treas. Reg., § 1.357-2 (1955) (based on S. Rep. No. 1622, 83d Cong., 2d Sess. 270 (1954)). This disregards the extent to which the transferred assets contributed to the realized gain; an allocation proportionate to the realized gain seems more equitable.

stead of \$10,000, A's gain under section 1001 would be only \$5,000, and only this amount would be recognized under section 351(b).

If the adjusted basis of the property in the foregoing example was more than \$50,000, A would realize a loss under section 1001, but by virtue of section 351(b)(2), the loss could not be recognized. Another barrier to recognition of the loss is section 267(a)(1), which, however, is less inclusive than section 351(b)(2).

Assumption of Liability

On many section 351 exchanges, particularly where a going business is incorporated, the transferee corporation assumes liabilities of the transferor or takes property subject to liabilities. What is the effect of its doing so? For many years it was widely assumed that such a transaction would not require the recognition of a gain under section 351 or under the analogous reorganization sections. In *United States v. Hendler*,⁴⁸ however, the Supreme Court held that the assumption and payment by a transferee corporation of a liability of the transferor would constitute "boot" to the transferor, at least in some circumstances, under the reorganization provisions.

Immediately after winning this decision, the Department of the Treasury recognized that a host of incorporations and reorganizations in the past, thought to be tax-free when consummated, might in fact have been partially taxable because of the assumption of liabilities. Unless estoppel or a similar doctrine was applicable,⁴⁹ the transferee corporation would be entitled to "step up" its basis for the assets received by it by the amount of gain that should have been recognized on the exchange.⁵⁰ and such a "stepped up" basis would impair the revenue by increasing the corporation's depreciation deduction for any depreciable assets received on the exchange and by reducing its gain or increasing its loss on any subsequent disposition of the assets. Similarly, the transferor could step up the basis of the stock or securities received by him on the exchange. It was also perceived that if gain was to be recognized upon a reorganization or incorporation whenever the transferee assumed a liability of the transferor or took property subject to a liability, the usefulness of section 351 and similar non-recognition provisions would be seriously impaired.

The upshot was that the Department of the Treasury promptly urged Congress to enact legislation that would relinquish the victory it had just won in the *Hendler* case by providing that an assumption of liability by the transferee corporation (or its receipt of property subject to a liability) in an otherwise non-taxable exchange would not

48. 303 U.S. 564 (1938).

49. See notes 92, 98 *infra*.

50. See text supported by notes 98-100 *infra*.

constitute "boot" to the transferor. Congress responded in 1939 with the statutory principles that are now, with minor changes, embodied in the "general rule" of section 357(a) and the exception of section 357(b).⁵¹ Another exception to the general rule, section 357(c), was added in 1954.⁵²

By virtue of the "general rule" of section 357(a), the transferee corporation's assumption of liability or its acquisition of property subject to a liability is not to be treated as money or other property or to prevent the exchange from qualifying under section 351. Thus, the incorporation of property or of a going business will ordinarily qualify as a tax-free transaction under section 351, even though the corporation assumes, or acquires property subject to, liabilities. The liabilities will affect the basis of the stock or securities received by the transferor, however.⁵³

Although the principle of section 357(a) makes good sense as a general rule, it might tempt the transferor of property under section 351 to borrow against the property just before the exchange, with the intention of keeping the borrowed funds and of causing the corporation either to assume the liability or to take the property subject to it. For the transferor, this chain of events would be the equivalent of receiving cash "boot" from the corporation in exchange for unencumbered property, but if the general rule of section 357(a) were applicable, the corporation's assumption of the liability or acquisition of the property subject to it would not be treated as "boot." To frustrate transactions of this type, section 357(b) provides an exception to the general rule of section 357(a): the assumption or acquisition is to be treated as money received (i.e., as "boot" under section 351(b)) by the transferor if "taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption or acquisition was made, it appears that the principal purpose of the taxpayer . . . was a purpose to avoid Federal income tax on the exchange, or . . . if not such purpose, was not a bona fide business purpose." Although the statute itself speaks only of "a bona fide business purpose," the regulations provide that the income tax returns of the transferor and of the corporation for the year of the exchange must state "the corporate business reason" for the assumption of any liability.⁵⁴ Section 357(b) goes on to tinker, with uncertain

51. See generally Surrey, Assumption of Indebtedness in Tax-Free Exchanges, 50 Yale L.J. 1 (1940).

The Hender victory became completely pyrrhic in 1939, when the tax therein imposed was refunded to the taxpayer by Congress. 53 Stat. 1402 (1939).

52. 68A Stat. 117 (1954).

53. See text supported by notes 93-94 infra.

54. U.S. Treas. Reg., §§ 1.351-3(a) (6), 1.351-3(b) (7) (1955).

effect, with the burden of proof in cases of alleged improper purpose. Section 357(b) was amended in 1954 to provide that if an improper purpose exists with respect to any liability, the total amount of all liabilities involved in the exchange shall be considered as money received by the taxpayer; according to the Senate Report on the 1954 Code, the amendment was "intended merely to clarify existing law."⁵⁵

The special provision of section 357(b) would probably apply not only to the hypothetical case of a liability created just before the section 351 exchange in order to wring some cash out of the transaction, but also to the assumption by a transferee corporation of personal obligations (grocery bills, rent, alimony, etc.) that are not ordinarily taken over in a section 351 exchange, unless there was a bona fide business purpose for such unusual action. On the other hand, the general rule of section 357(a) rather than the exception of section 357(b) should ordinarily be applicable to mortgages placed on business assets in the ordinary course of business, trade obligations, bank loans, customers' deposits, and the like; and this should be true even though at the time of the section 351 exchange the transferor is able to pay such obligations himself but chooses instead to have the transferee corporation assume, or take property subject to, them. The applicability of section 357(a) is less clear, however, if the transferee corporation is on the verge of giving the transferor a combination of stock or securities and cash but is then directed by the transferor to assume (or take property subject to) his liabilities instead of paying cash. If an arrangement for the payment of cash by the transferee corporation is "called off" at the last minute in favor of an assumption of liabilities, section 357(b) may be applicable.⁵⁶

The 1954 Code introduced an additional restriction on the "general rule" of section 357(a). Under section 357(c), if the sum of the liabilities encumbering the transferred property or assumed by the transferee corporation exceeds the adjusted basis of the property transferred, the excess shall be considered as a gain on the sale or exchange of the property.⁵⁷ The effect of section 357(c) may be illustrated by this example: A transfers, for the stock of a controlled corporation, property with an adjusted basis of \$10,000 but subject to a mortgage of \$30,000. Under section 357(c), A must recognize gain in the amount of \$20,000. Since A has so far received a return of \$30,000 (the proceeds of the mortgage) on an investment of \$10,000, his taxable gain of \$20,000 under section 357(c) corresponds to his eco-

55. S. Rep. No. 1622, 83d Cong., 2d Sess. 270 (1954).

56. For a suggestive analogy, see *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945).

57. For an analogous provision, which also entered the Code in 1954, see § 311(c).

nomic gain. This gain will be reported as ordinary income, long-term capital gain, or short-term capital gain, according to the nature and holding period of the transferred property.⁵⁸ Any further gain realized on the sale of the stock will be recognized when that event occurs.

In determining whether section 357(c) is applicable, the aggregate amount of the liabilities is compared with the aggregate adjusted basis of the assets transferred. To return to the example in the preceding paragraph, if *A* had transferred not only property with a basis of \$10,000 subject to a mortgage of \$30,000, but also unencumbered property with a basis of \$10,000, his gain on the exchange would be only \$10,000 (liability of \$30,000 less aggregate basis of \$20,000).⁵⁹ Although at first blush it may seem strange that *A* can reduce his gain by transferring other property along with the mortgaged property, the theory underlying section 357(c)'s use of the total basis of all property transferred as the measure of *A*'s gain may be that the properties transferred constitute a single investment of \$20,000, from which *A*'s total return so far amounts to \$30,000. If there are two or more transferors, it would seem appropriate to apply section 357(c) on a person by person basis, rather than to aggregate all property transferred by all transferors, but neither the statute nor the regulations is explicit on this point.⁶⁰

58. U.S. Treas. Reg., § 1.357-2 (1955) (referred to in note 47 supra). Because the nature of the gain under § 357(c) depends upon whether the transferred property is a capital asset or not, the transfer of a factory, an apartment house, or business equipment subject to a liability in excess of the property's basis will evidently produce ordinary income, since the property is not a capital asset, even though gain on a sale of the property would have been treated as capital gain by virtue of § 1231. Since the property is being transferred to a controlled corporation, however, this result under § 357(c) is perhaps justified by the same reasons of policy that underlie § 1239, which denies the benefits of § 1231 to a sale of depreciable property by an individual to a corporation of which he owns more than eighty per cent of the stock.

Note that § 357(c) requires gain to be recognized regardless of the market value of the transferred property. Thus, to continue with the example in the text, *A* must report \$20,000 of gain even though the market value of the transferred property is only \$25,000. He might argue against this result, on the ground that there is a substantial likelihood of default by the corporation (at least if it did not assume the mortgage), but the mandate of § 357(c) is clear and it is difficult to believe that it would be held unconstitutional.

59. U.S. Treas. Reg., § 1.357-2(a) (1955).

60. Although the language of § 357(c) ("the total of the adjusted basis of the property transferred pursuant to such exchange") may imply that the total basis of all properties transferred by all transferors is to be employed in determining the gain, an absurd result would be produced thereby. Thus, if *A* transferred properties with a total basis of \$20,000 but subject to a mortgage of \$30,000 and *B* simultaneously transferred unencumbered property with a basis of \$7,000, the gain to be recognized under § 357(c)—if computed by aggregating *A* and *B*—would be \$3,000 (mortgage of \$30,000 less total basis of \$27,000).

It is possible for a transfer of property to be subject both to section 357(b), because of the transferor's improper purpose, and to section 357(c), because liabilities exceed the basis of the transferred property. In this event, section 357(b) takes precedence, with the result that the entire amount of liabilities, not just the excess over the property's adjusted basis, is "boot."⁶¹

Both section 357(b) and section 357(c) compute the transferor's gain on the assumption that the indebtedness giving rise to the gain will be paid by the transferee corporation. If the transferor is called upon to pay the debt as a result of the transferee's default, his outlay should either be added to the basis of the stock or securities received on the exchange or deducted.⁶²

"CONTROL"—THE EIGHTY PER CENT RULE

Section 351 applies only if the transferors of property are "in control" of the corporation, as defined in section 368(c), immediately after the exchange. Their "control" need not be acquired through the exchange itself, however; section 351 embraces a transfer of property to a corporation already controlled by the transferor, as well as transfers to newly organized corporations.

The term "control" is defined by section 368(c) to mean the owner-

This result is curious, since *A* has enjoyed an economic gain of \$10,000; and it would be even more curious if the \$3,000 gain thus computed were allocated between *A* and *B*, since the value of the property transferred by *B*, and hence the value of the stock or securities received by him, may be less than the adjusted basis of the property transferred by him. An aggregate approach to § 357(c) would also produce difficulties in the calculation of the transferors' bases for the stock and securities received by them. Since the language of § 357(c) does not unmistakably require *A* and *B* to be lumped together, it should be applied person-by-person, so that on the foregoing facts *A* would recognize \$10,000 of gain regardless of the basis of property transferred by other persons.

61. Despite this intention to penalize the taxpayer with an improper purpose, he may be better off under § 357(b) than he would be under § 357(c). To take the example of a taxpayer who transfers properties with a total basis of \$20,000 subject to a mortgage of \$30,000, § 357(c) requires the recognition of \$10,000 of gain regardless of the market value of the stock or securities received. See note 58 *supra*. But if the properties transferred (and hence the stock or securities received) are worth only \$25,000, § 357(b), taken in conjunction with § 351(b), would require the recognition of only \$5,000 of gain. Another situation in which § 357(b) would be more generous to the taxpayer than § 357(c) is this: assume the transfer of depreciable business property, such as a factory or equipment, having a basis of \$20,000 and fair market value of \$30,000, subject to a mortgage of \$30,000. If the transaction is subject to § 357(c), the taxpayer must recognize \$10,000 of ordinary income, for the reason set forth in note 58 *supra*. But if the taxpayer is motivated by an improper purpose, the liability becomes "boot" under §§ 357(b) and 351(b), and the gain may qualify as capital gain under § 1231.

62. See text supported by note 94 *infra*.

ship of (1) at least eighty per cent of the total combined voting power of all classes of stock entitled to vote, and (2) at least eighty per cent of the total number of shares of all other classes of stock of the corporation. (This definition of "control" is applicable to the reorganization provisions of the Code, as well as to section 351.)⁶³ In most cases section 368(c) presents no problems of interpretation, either because the corporation issues only one class of stock or because the transferors receive all stock of all classes. This is fortunate, since there are almost no guides to the meaning of "total combined voting power" or of "stock entitled to vote." The term "stock entitled to vote" presumably does not include stock having the power under local law to vote on such extraordinary events as charter amendments, merger, sales of assets, etc., since all classes of stock have voting power of this character; if they were regarded as "stock entitled to vote," the statutory category of "other classes of stock" would be a vacuum. As to stock with contingent voting rights, such as preferred stock that may vote for directors if dividends are passed for a stated period, the regulations⁶⁴ state that such stock is generally not "voting stock" until the specified event occurs, but it may be that "stock entitled to vote," the term employed in section 368(c), is not identical with "voting stock," as that term is used in section 302 and elsewhere.

Once the "stock entitled to vote" has been identified and segregated, it is necessary to determine whether the transferors of property own eighty per cent or more of its "total combined voting power." Presumably this requires a realistic weighting of the stock's right to vote, so that ownership of less than eighty per cent of the total market value or the total number of shares may qualify, but difficulties may arise if the shares are not fungible as regards their power to vote. It is usually assumed that the computation of "total combined voting power" is not to take account of shareholders' voting agreements or similar arrangements even though they may alter the balance of power; but the question is not foreclosed by case law or rulings.

If there are "other classes of stock," the transferors, to qualify under section 351, must own at least eighty per cent of the total number of shares. There is no good reason why the statute should require control of such stock to be ascertained by total number, a test that has no relevance to the policy underlying section 351, rather than by market value (except perhaps to avoid the necessity of an appraisal), nor why it lumps all shares together regardless of class or privileges.

63. Moreover, the phrases "total combined voting power" and "stock entitled to vote," as used in § 368(c), are to be found in § 302(b)(2)(B) and § 334(b)(2)(B); see also §§ 333(b), 333(c), and § 1504(a); Tannenbaum, *Nonvoting Stock for the Consolidated Return*, 29 *Taxes* 679 (1951); Hellerstein, *Consolidated Federal Income Tax Returns*, 5 *Am. U. Tax Inst.* 415, 420-22 (1953).

64. U.S. Treas. Reg., § 1.302-3(a)(3) (1955).

Two or More Transferors

As the language of section 351 explicitly recognizes, there will sometimes be more than one transferor of property; in such cases, the transaction will qualify as tax-free under section 351 if the transferors *as a group* are in control of the corporation immediately after the exchange. Apparently it is permissible for one transferor to receive voting stock while another transferor receives non-voting stock.⁶⁵

When there are two or more transferors, each one will ordinarily, as a result of arm's length bargaining, receive stock or securities with a fair market value equal to that of the assets transferred by him; but on occasion there may be discrepancies between the value of the assets given up and the value of stock or securities received. Do such variations in value affect the tax consequences of the transaction?

Before 1954, the statute provided for non-recognition of gain or loss in the case of an exchange by two or more persons "only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange."⁶⁶ The policy underlying this requirement, which if violated would lead to the full recognition of gain or loss by all parties to the exchange, was obscure, and there were also uncertainties in its application.⁶⁷

65. This occurred in *Mather & Co. v. Commissioner*, 171 F.2d 864 (3d Cir.), cert. denied, 337 U.S. 907 (1949), although this issue was not discussed there; see also *George M. Holstein, III*, 23 T.C. 923 (1955). Regarding an exchange in which one transferor receives only common stock, while another transferor receives only bonds, see text at page 6 supra.

66. Int. Rev. Code of 1939, § 112, 53 Stat. 37.

67. See generally Hoffman, *The Substantial Proportionment Requirement of § 112(b)(5)* [1939 Code], 5 Tax L. Rev. 235 (1950). In applying the requirement, the courts vacillated between the so-called "control" test and the "relative value" test. Both are best explained by an illustration. Assume that A, B, and C transfer properties worth \$75,000, \$20,000, and \$5,000 respectively, and that in exchange they receive from the corporation stock or securities worth \$77,500, \$17,500, and \$5,000. Applying the "control" test, A gave up seventy-five per cent of the total assets and received seventy-seven and one-half per cent, thus "gaining" two and one-half per cent of control ("control" in this sense means merely the percentage of total value "controlled," not voting power); B gave up twenty per cent and received seventeen and one-half per cent, thus "losing" two and one-half per cent; and C's "control" was unchanged. Changes as minor as shown here would be disregarded because the stock or securities received need be only "substantially" in proportion to the assets given up. If, however, A received stock or securities worth \$80,000, while B's share was only \$15,000, the resulting "gain" of five per cent for A and "loss" of five per cent for B would probably be so great as to disqualify the exchange. If the "relative value" test is applied to the original illustration, A would have a "gain" of \$2,500 on his \$75,000 investment, or three and one-third per cent, while B would have a "loss" of \$2,500 on his \$20,000 investment, or twelve and one-half per cent. The "spread" between A's "gain" and B's "loss" would disqualify the transaction. The leading case upholding the "control" test is *Mather & Co. v. Commissioner*,

The pre-1954 requirement was eliminated by the 1954 Code, the Senate Report on the 1954 Code stating that section 351 is to be applied "irrespective of any disproportion of the amount of stock or securities received by (a transferor) as a result of the transfer."⁶⁸ The report goes on, however, to say that if the disproportion in value "results in an event taxable under other provisions of this code, your committee intends that such distribution will be taxed in accordance with its true nature."⁶⁹ This theme is embodied in the regulations, which provide that "in appropriate cases the transaction may be treated as if the stock and securities had first been received in proportion [to the value of the property transferred] and then some of such stock and securities had been used to make gifts [subject to gift tax under section 2501] . . . to pay compensation [taxable as income under section 61(a)(1)] . . . or to satisfy obligations of the transferor of any kind."⁷⁰ If a transaction is so "realigned," in addition to the tax consequences suggested by the extract from the regulations, the transferor may recognize gain or loss on the disposition of the stock or securities and may be entitled to a deduction under section 162(a), relating to business expenses. A "realignment" of stock may also affect the computation of "control," since the transferors of property may be treated as constructively owning, immediately after the exchange, more shares than are issued to them, at least if their use of shares to make gifts, pay compensation, etc., is not an integral step in the entire transaction.⁷¹ It may be noted that as originally proposed, the regulations required a "realignment" of the stock or securities

171 F.2d 864 (3d Cir.), cert. denied, 337 U.S. 907 (1949), and the leading support for the "relative value" test is *Bodell v. Commissioner*, 154 F.2d 407 (1st Cir. 1946). Neither test effectively screened out transactions that reflected changes of substance rather than of form, nor did they seem to have any other connection with the policy underlying § 351(c). Moreover, if a transaction failed under whichever test the court thought applicable, all transferors recognized their realized gain or loss. This might mean that a transferor would have a deductible loss (because the value of the stock or securities received was less than the adjusted basis of the property transferred by him), although he enjoyed a "gain" on the exchange itself; and vice versa. Finally, all the usual difficulties of valuing assets, especially the intangibles of a going concern, meant that an exchange might turn out to be disproportionate, despite the best efforts of the parties to qualify under § 351. For all these reasons, it was not surprising that the substantial proportionment test was eradicated by the 1954 Code.

68. S. Rep. No. 1622, 83d Cong., 2d Sess. 264 (1954).

69. *Ibid.*

70. U.S. Treas. Reg., § 1.351-1(b)(1) (1955); see also the cross-references in §§ 351(d)(3), 351(d)(4).

71. See text supported by notes 74-88 *infra* on the term "immediately after the exchange"; also consider the implications of realignment in determining whether stock was issued for services.

whenever they were disproportionate to the assets transferred;⁷² the regulations as issued require a "realignment" only "in appropriate cases."⁷³

CONTROL "IMMEDIATELY AFTER THE EXCHANGE"

The statute requires the transferors of property to be in control of the corporation "immediately after the exchange." The regulations say of this requirement:

The phrase "immediately after the exchange" does not necessarily require simultaneous exchanges by two or more persons, but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure.⁷⁴

Under this interpretation, the stockholdings of two or more transferors can be aggregated in determining whether they control the corporation "immediately after the exchange" if their transfers are part of a single transaction. Thus, if *A* owns all the stock of a corporation, consisting of 100 shares, and if the corporation is to be expanded by issuing 200 shares to *B* for property and 200 more shares to *C* for other property, *B* and *C* will be in control of the corporation "immediately after the exchange" (by virtue of owning 400 out of 500 shares, or eighty per cent), even though *B*'s exchange is not simultaneous with *C*'s.

There has been litigation in abundance over the requirement that the transferors control the transferee corporation "immediately after the exchange," the principal problem being whether the statute is satisfied if the transferors own eighty per cent or more of the stock for a moment, but thereafter reduce their ownership below the eighty per cent benchmark required by sections 351 and 368(c). Such a loss of "control" may occur if the transferors dispose of part of their stock to donees or purchasers, if the corporation issues additional stock to investors or employees, or in some other manner. Section 351(c) provides that in determining control, the fact that a corporate transferor distributes stock received in the exchange to its shareholders shall not be taken into account.⁷⁵ The Senate Report on the 1954 Code states that this provision, which was enacted in 1954, was added because it was not clear whether such a distribution would prevent application of section 351 under existing law.⁷⁶ The new provision, unfortunately,

72. 19 Fed. Reg. 8237, 8268 (1954).

73. U.S. Treas. Reg., § 1.351-1(b)(1) (1955).

74. Id. § 1.351-1(a)(1).

75. While a distribution of stock by a corporate transferor will not take the exchange outside of § 351, the distribution may be taxable to the distributees as a dividend or otherwise.

76. S. Rep. No. 1622, 83d Cong., 2d Sess. 265 (1954).

does not shed any light on the meaning of the phrase "immediately after the exchange" in circumstances to which it is not applicable.

At first blush, the statutory phrase "immediately after the exchange" seems to focus upon a point in time to the exclusion of any requirement that control persist thereafter. And some early decisions held, or expressed the view, that the statute was satisfied if the transferors controlled the corporation momentarily, despite a prompt loss of control by a sale or other disposition of stock as an integral part of the plan of incorporation or even pursuant to a pre-existing contract.⁷⁷ The tendency today, however, is to hold that momentary control is not sufficient if the transferors agreed beforehand to transfer enough of their stock to lose "control" or if such a transfer is an integral part of the plan of incorporation.

A recent illustration of the current attitude is *Manhattan Bldg. Co.*,⁷⁸ which concerned the transfer of certain assets by one Miniger to Electric Auto-Lite Co. in exchange for 250,000 shares of common stock and \$3,000,000 in bonds. Miniger had purchased the assets in question with borrowed funds, under an agreement requiring him to transfer the assets to Auto-Lite in exchange for the stock and bonds, to deliver the bonds and 75,000 shares of stock to the lender (a firm of investment bankers), and to turn over 49,000 shares to Auto-Lite as a contribution to capital. The question before the court was whether the predecessor of section 351 was applicable to this transaction, under which Miniger owned one hundred per cent of the stock fleetingly, but less than the requisite eighty per cent when the plan was fully consummated:

This depends upon whether the transfer of assets to Auto-Lite in exchange for its stock and bonds and the transfer of stock and bonds to the underwriters were mutually interdependent transactions. The test is, were the steps taken so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series. *American Bantam Car Co.*, 11 T.C. 397 (1948) . . . [aff'd per curiam, 177 F.2d 513, 43 AFTR 820 (3d Cir. 1949)], certiorari denied 339 U.S. 920 (1950). In the present case when the transfer of assets to Auto-Lite occurred on July 17, 1922, Miniger was under a binding contract to deliver the bonds and 75,000 shares of stock to the underwriters and to return 49,000 shares to the corporation. The contract between Miniger and the underwriters shows this clearly. Miniger could not have completed the purchase of the assets without the cash supplied by the underwriters and could not have secured the bonds and stock except for the assets. After the exchanges Miniger had 127,500 shares, [out of 202,500 shares

77. See, e.g., *Portland Oil Co. v. Commissioner*, 109 F.2d 479 (1st Cir. 1940).
78. 27 T.C. 1032 (1957), acq., 1957-2 Cum. Bull. 5.

outstanding] less than 80 per cent, of the voting stock. At no time did he have the right to hold more. . . . The 1922 transaction was taxable as the petitioner contends.⁷⁹

The *American Bantam Car Co.* case,⁸⁰ cited in the extract above and often relied on, is also concerned with a loss of "control" by the transferors of property as a result of an underwriting agreement, but in this case the court held that the requirements of section 351 were met. The owners of a manufacturing business transferred its assets, with \$500 in cash, to a new corporation in exchange for all of the common stock, under a plan calling for a sale of preferred stock to the public by underwriters who were to receive, in addition to their underwriting discounts and commissions, certain amounts of the common stock when and if they succeeded in selling the preferred stock to the public. The transfer of the assets to the new corporation for 300,000 shares of common stock occurred on June 3, 1936; five days later, the new corporation executed a contract with the underwriters for the sale of the preferred stock and the shareholders agreed to deliver 100,000 shares of their common stock to the underwriters in specified installments as and if the preferred stock was sold; and in October, 1937, the underwriters received 87,900 shares of the common stock for their services. Although the transferors thus held less than eighty per cent of the common stock after October, 1937, when they transferred the 87,900 shares to the underwriters, the Tax Court held that the requisite control in the transferors existed in June, 1936—"immediately after the exchange"—and that the loss of "control" in October, 1937, was not an integral part of the transaction:

The standard required by the courts to enable them to say that a series of steps are interdependent and thus should be viewed as a single transaction do not exist here. It is true that all the steps may have been contemplated under the same general plan of May 1936; yet the contemplated arrangement for the sale of preferred stock to the public was entirely secondary and supplemental to the principal goal of the plan—to organize the new corporation and exchange its stock for the Austin assets. The understanding with the underwriters for disposing of the preferred stock, however important, was not a *sine qua non* in the general plan, without which no other step would have been taken. While the incorporation and exchange of assets would have been purposeless one without the other, yet both would have been carried out even though the contemplated method of marketing the preferred stock might fail. The very fact that in the contracts of June 8, 1936, the associates retained the right to cancel the marketing order and, consequently the underwriters' means to own common stock

79. Id. at 1042.

80. 11 T.C. 397 (1948), aff'd per curiam, 177 F.2d 513 (3d Cir. 1949), cert. denied, 339 U.S. 920 (1950).

issued to the associates, refutes the proposition that the legal relations resulting from the steps of organizing the corporation and transferring assets to it would have been fruitless without the sale of the preferred stock in the manner contemplated.⁸¹

Although the Tax Court rejected "the proposition that the legal relations resulting from the steps of organizing the corporation and transferring assets to it would have been fruitless without the sale of the preferred stock in the manner contemplated," it is readily apparent from the facts that additional capital was essential and that the incorporation was only the first step in a plan which, if successful, would result in a loss of control. On the other hand, had the capital not been raised "in the manner contemplated," the transferors might have been able to devise some other method, and in that sense the incorporation viewed alone was not necessarily a useless step.

In addition to holding that the underwriting agreement was "not a *sine qua non* in the general plan, without which no other step would have been taken," the Tax Court in the *American Bantam Car Co.* case emphasized that, although there was an informal oral understanding before the exchange occurred, a written agreement was not executed until five days after the exchange. This fact, it thought, distinguished the case before it from other cases in which the transferors would lose control under a contract pre-dating the exchange, so that "at the moment of the exchange the recipient of the stock did not own it, but held it subject to a binding contractual obligation to transfer a portion."⁸² Perhaps the convenience of a mechanical rule justifies this stress upon the formal execution of a document, as distinguished from the meeting of the minds; certainly nothing else does. But why should an agreement to sell, even if reduced to writing before an exchange of property, take it wholly outside of section 351, rather than merely produce gain or loss on the shares disposed of? The agreement might, of course, be evidence that the loss of control was an integral part of the whole transaction, but this is not necessarily so. For example, two equal partners in a going business form a corporation in order to limit their liability; one of them, in need of funds to discharge debts of a personal nature, agrees in advance of the exchange to sell half of his stock to a third person. If the agreement to sell must be taken into account, the two transferors of property will own only seventy-five per cent of the stock "immediately after the exchange," with the result that both must recognize gain or loss on the exchange, even though one of them may not have even known of the other's commitment to sell part of the stock. In such circumstances, it may be that a contract pre-dating the exchange will not be fatal.

81. Id. at 406-07.

82. Id. at 406.

Although the courts have not distinguished between commercial and non-commercial transactions in deciding whether a loss of control after the exchange is fatal, much can be said for treating these situations differently. If the transferors of property receive all of the stock of the transferee corporation and then reduce their ownership below the requisite eighty per cent by giving some of the stock to their wives or children, the courts will usually find it possible to apply section 351. For example, *Wilgard Realty Co. v. Commissioner*,⁸³ concerned a transfer of property for all the stock of a newly organized corporation. On the same day that the transferor received the stock, he gave more than twenty per cent of it to members of his family. The court held that the transfer of the property to the corporation was a tax-free exchange under section 351, not on the narrow ground that the transferor owned the shares of the corporation for an instant, but on a broader ground:

In the absence of any restriction upon [the transferor's] freedom of action after he acquired the stock, he had "immediately after the exchange" as much control of the [corporation] as if he had not before made up his mind to give away most of his stock and with it consequently his control. And that is equally true whether the transaction is viewed as a whole or as a series of separate steps. . . . Where the recipient of the stock on the exchange has not only the legal title to it "immediately after the exchange" but also the legal right then to determine whether or not to keep it with the control that flows from such ownership, the requirements are fully satisfied. It is immaterial how soon thereafter he elects to dispose of his stock by gift or otherwise and whether or not such disposition is in accord with a preconceived plan not amounting to a binding obligation.⁸⁴

This case must be contrasted, however, with one in which the facts were nearly identical except that more than twenty per cent of the shares were issued directly by the corporation to the transferor's donee. The district court held that issuing the stock directly to the donee was fatal under section 351 and the court of appeals affirmed.⁸⁵ It is surprising to find important tax consequences hinging on so trivial a formality. Indeed, one might argue with respect to the extract quoted above from the *Wilgard Realty Co.* case that the requisite control should be found even if the transferor has already bound himself to transfer the shares, and, indeed, even though the assets were incorporated in order to facilitate the making of gifts. Otherwise, the taxpayer is given an option that contravenes the policy of section 351. If he wishes the transaction to qualify under section 351, he can either give the donees an interest in the assets themselves (so that they will

83. 127 F.2d 514 (2d Cir.), cert. denied, 317 U.S. 655 (1942).

84. *Id.* at 516.

85. *Fahs v. Florida Mach. & Foundry Co.*, 168 F.2d 957 (5th Cir. 1948).

be "transferors" of property under section 351 when the corporation is organized) or give the stock to the donees in a later, independent transaction. If, on the other hand, the donor wishes to avoid section 351 (e.g., to take a loss on the exchange; or to procure a stepped-up basis for the assets and stock), he can follow the procedure of the transferor in the *Florida Mach. and Foundry Co.* case. Moreover, the principle of section 351, non-recognition of gain or loss on formal transfers, is as applicable when the transferor and his donees control the corporation as when the transferor alone controls it. For these reasons, neither an obligation to transfer part of the stock nor the fact that the loss of control was an integral part of the entire transaction should be given the weight in gift cases that they have in commercial transactions.

Do the transferors have control "immediately after the exchange" if another person has an option to acquire enough shares, either from the corporation or from the transferors themselves, to terminate their control? In the *American Bantam Car Co.* case,⁸⁶ the Tax Court relied in part on the fact that the transferors would lose control only if the underwriters sold enough preferred stock to the public to earn the promised common stock. This approach, which looks to the likelihood that the option will be exercised, has much to commend it.⁸⁷ The option can be properly disregarded if there is a genuine possibility that it will not be taken up; but if its exercise is a foregone conclusion (e.g., if only a nominal consideration is payable for valuable stock), it may take the transaction outside of section 351, unless the option-holder can himself be regarded as a transferor of property to be aggregated with the other transferors in computing control or unless the transfer of property and the option are not integral steps in a single transaction.⁸⁸

THE TRANSFEROR'S BASIS

When gain or loss goes unrecognized at the time of an exchange, the transferor's basis for the property given up is ordinarily preserved and applied to the property received. Section 358 applies this principle to an exchange under section 351. In the simplest situation, an ex-

86. 11 T.C. 397 (1948), *aff'd per curiam*, 177 F.2d 513 (3d Cir. 1949), cert. denied, 339 U.S. 920 (1950).

87. See *Commissioner v. National Bellas Hess, Inc.*, 220 F.2d 415 (8th Cir. 1955).

88. For more on the meaning of the phrase "immediately after the exchange," see, in addition to the cases already cited, *May Broadcasting Co. v. United States*, 200 F.2d 852 (8th Cir. 1953); *S. Klein On The Square, Inc. v. Commissioner*, 188 F.2d 127 (2d Cir.), cert. denied, 342 U.S. 824 (1951); *Mojonnier & Sons, Inc.*, 12 T.C. 837 (1949); *Mintz & Plumb, Step Transactions in Corporate Reorganizations*, N.Y.U. 12th Inst. on Fed. Tax. 247 (1954).

change under section 351 of property solely for stock or securities (so-called "non-recognition property"), section 358(a)(1) provides that the basis of the stock or securities received shall be the same as the basis of the property transferred. If several classes of stock or stock and securities are received, section 358(b)(1) requires an allocation of the basis of the property transferred among the various classes of stock and securities received on the exchange,⁸⁹ and the regulations provide that the allocation shall be in proportion to the market values of the stock and securities received.⁹⁰ Thus, if the basis of the transferred property was \$5,000, and the transferor received in exchange common stock worth \$6,000 and bonds worth \$4,000, the basis of the stock would be \$3,000 ($6,000/10,000 \times 5,000$) and the basis of the bonds would be \$2,000 ($4,000/10,000 \times 5,000$). Assuming no further fluctuation in value, on selling his stock the transferor will realize \$3,000 of gain and on selling his bonds he will realize \$2,000. This total gain of \$5,000, it will be noted, is equal to the gain that went unrecognized on the exchange itself because of section 351(a), viz., the difference between the basis of the property transferred and the value of the stock and bonds received in exchange.

Section 358 is also applicable if the transferor received "boot" on the exchange. In this case, section 351(b)(1) would have required him to recognize his gain on the exchange (if any was realized, i.e., if the value of what he received exceeded the adjusted basis of the property he gave up) to the extent of the value of the "boot." Section 358(a)(2) provides that the "boot" (except money) shall be given a basis equal to its fair market value. And section 358(a)(1) provides that the basis of the "non-recognition property" (i.e., the stock or securities received on the exchange) is the same as the basis of the property given up, minus the money and the fair market value of the "boot" received, plus the gain recognized on the exchange.⁹¹ These principles can be illustrated by assuming that the transferor of property with an adjusted basis of \$4,000 received on the exchange stock and bonds worth \$8,000, cash in the amount of \$1,500 and other property worth \$500. His realized gain of \$6,000 (value received of \$10,000, less adjusted basis of \$4,000) would be recognized under section 351(b) to the extent of the "boot," or \$2,000. The basis of the "other property" re-

89. Although § 358(b)(1) is new in the 1954 Code, the practice of earlier years was in accord with its principle.

90. U.S. Treas. Reg., § 1.358-2(b) (1955).

91. Section 358(a)(1)(B)(i), providing for a further upward adjustment if any part of the property received on the exchange was treated as a dividend, is primarily concerned with certain transactions under § 306, according to the senate report on the 1954 Code. S. Rep. No. 1622, 83d Cong., 2d Sess. 271 (1954). In unusual circumstances, however, it might be applicable to an exchange under § 351. See text supported by notes 115-19 infra.

ceived, under section 358(a)(2), would be its fair market value, \$500. The basis of the stock and bonds (the "non-recognition property") would be \$4,000 (adjusted basis of property given up, \$4,000, less cash of \$1,500 and other property of \$500, plus gain recognized of \$2,000), to be allocated between the stock and bonds in proportion to their respective market values. If the stock and bonds were then sold for their market value (\$8,000), the owner would recognize \$4,000 of gain, which, added to the \$2,000 of gain recognized at the time of the section 351 exchange, is equal to his full economic gain of \$6,000 (total value of \$10,000 received on the exchange, less adjusted basis of original property of \$4,000).⁹²

If the transferee corporation assumed a liability of the transferor or took property subject to a liability, section 358(d) provides that the amount of the liability shall be treated "as money received" by the transferor upon the exchange. This requirement, which is applicable whether or not the liability gave rise to income at the time of the exchange under section 357(a),⁹³ has the effect of reducing the basis that would otherwise be allocated under section 358(a)(1) to the "non-recognition property" by the amount of the liability. Thus, if A transfers property with a cost basis of \$50,000 to a corporation for all of its stock plus the assumption of a \$30,000 mortgage, A's basis for the stock will be \$20,000. If A then sells the stock for \$25,000, he will realize \$5,000 of gain. Provided the mortgage is discharged in due course, this tax treatment accords with economic reality: A's net investment was \$20,000 (the cost of the land less the amount of the mortgage) and he ultimately realized \$25,000. If the transferee cor-

92. The reader will have noted that the basis of the property received on the exchange reflects, under § 358(a)(1)(B)(ii), the "amount of gain to the taxpayer which was *recognized*" on the § 351 exchange. What if the transferor treats an exchange as non-taxable, but later claims a stepped-up basis for the stock and securities received by him on the ground that gain should have been recognized? There is authority by analogy for allowing him to use the stepped-up basis, at least where the failure to recognize gain on the exchange was not fraudulent or otherwise blameworthy. See *Bennet v. Helvering*, 137 F.2d 537 (2d Cir. 1943); *Margaret S. Bullock*, P-H 1944 T.C. Mem. Dec. ¶ 44406. See also *Fahs v. Florida Mach. & Foundry Co.*, 168 F.2d 957 (5th Cir. 1948), holding that the transferee corporation, whose basis for the transferred assets is also dependent upon whether the exchange was a taxable transaction, is not estopped by the errors of the transferor. But if the transferor insists upon a stepped-up basis, the government may assess an additional tax against him for the year of the exchange, notwithstanding the running of the statute of limitations. Int. Rev. Code of 1954, § 1312(6); U.S. Treas. Reg., § 1.1312-6(c), Example (1)(ii) (1956) (which assumes that the transferor is not estopped to claim a stepped-up basis); *Burford*, Basis of Property After Erroneous Treatment of a Prior Transaction, 12 Tax L. Rev. 365, 370 (1957). Note, however, that § 1314(d) prevents an assessment for a pre-1932 taxable year.

93. See text supported by note 53 *supra*.

poration fails to pay the debt at maturity and *A* is called upon to pay it, however, *A* would presumably be entitled to increase the basis of his stock (if he still owns it) by the amount of his outlay or to take a deduction under section 165 or section 166. There is a possibility that if the stock had been sold by *A*, the character of the deduction might be related back to the profit or loss on the sale by analogy to *Arrow-smith v. Commissioner*.⁹⁴

On selling the stock or securities received tax-free under section 351(a), the transferor determines his holding period under section 1223(1) by including ("tacking") the period during which he held the transferred property, provided (in the case of an exchange after March 1, 1954) the transferred property was either a capital asset or a section 1231(b) asset. If the transferred property consisted of a mixture of capital assets, section 1231(b) assets, and non-capital assets (as in the ordinary case of incorporating a going business),⁹⁵ it may be necessary to make an allocation under section 1223(1), with the result that some of the shares or securities received will have a holding period dating from the section 351 exchange while others will have longer holding periods.⁹⁶ "Tacking" is permitted by section 1223(1) if the stock or securities have "the same basis in whole or in part" as the property transferred; this requirement may confine the application of section 1223(1) to wholly tax-free exchanges, to the exclusion of exchanges in which the transferor received "boot" and was therefore required to compute the basis of his stock or securities under sections 358(a) (1) (A) and (B).⁹⁷

Can the transferor transfer some assets for stock and others for

94. 344 U.S. 6, rehearing denied, 344 U.S. 900 (1952).

95. See *Williams v. McGowan*, 152 F.2d 570 (2d Cir. 1945).

96. Cf. *Harry M. Runkle*, 39 B.T.A. 458 (1939), compromised, 117 F.2d 1014 (6th Cir. 1941).

97. If property with an adjusted basis of \$5,000 is exchanged for stock worth \$6,000 and securities worth \$4,000, the basis of the stock is \$3,000 and the basis of the securities is \$2,000. The stock and securities have "the same basis in whole or in part" as the transferred property, so that "tacking" is permissible under § 1223(1). But if the transferor had received stock worth \$4,000 and other property worth \$6,000, the basis of the stock would be \$4,000 (adjusted basis of transferred property, \$5,000, less "boot" received of \$6,000, plus gain recognized of \$5,000). The basis of the stock in this instance is determined *by reference to* the basis of the transferred property, but it is probably not "the same basis in whole or in part" as the transferred property's. If the transferor had received stock worth \$6,000 and other property worth \$4,000, the basis of the stock would be \$5,000 (adjusted basis of transferred property, \$5,000, less "boot" received of \$4,000, plus gain recognized of \$4,000), which is the same in amount as the basis of the transferred property; but § 1223(1) might be construed to require a basis taken over without adjustments of the type prescribed by § 358(a) (1), even though the final result of the gyrations is equal to the basis of the transferred property.

securities, in order to control the basis or holding period of the stock and securities received? It is doubtful that such an earmarking of the transferred property would succeed if both transfers were interdependent steps in a single transaction. Section 358 and the regulations promulgated under it seem to contemplate that the aggregate basis of the property transferred will be assigned to the properties received, leaving little room for any "planning" of basis by the foresighted taxpayer, and section 1223(1) is no more helpful since its applicability depends upon section 358.

THE TRANSFEREE CORPORATION'S BASIS

Section 362(a) provides that the basis to the transferee corporation of the property received on the exchange shall be the transferor's basis for the property, increased in the amount of gain recognized⁹⁸ to the transferor upon the exchange.

Neither the Code nor the regulations state how the carried-over basis is to be allocated by the transferee corporation among the various assets received. For example, if the controlled corporation issues stock in exchange for an asset with an adjusted basis to the transferor of \$10,000 and a value of \$10,000 and another asset with an adjusted basis of \$20,000 and a value of \$50,000, is the aggregate basis of \$30,000 to be divided between the two assets in proportion to their market values or should the old basis of each asset be preserved intact? In *Birren & Son, Inc. v. Commissioner*⁹⁹ it was held under the predecessor of section 362(a) that the transferee corporation steps into the shoes of the transferor, preserving intact the old basis for each asset received on the exchange.¹⁰⁰ This rule, which has the virtue of avoiding an appraisal of the assets at the time of the exchange, will ordinarily be helpful to the taxpayer when a going concern is incorporated. If the transferor's aggregate basis for all the assets of the business had to be allocated by the transferee corporation in propor-

98. In *Fahs v. Florida Mach. & Foundry Co.*, 168 F.2d 957 (5th Cir. 1948), it was held that the transferee corporation was not estopped to claim a stepped-up basis, even though the transferor had treated the exchange itself as nontaxable. In so holding, the court relied on the fact that the transferor did not "control" the corporation, as well as on the transferor's good faith. Even if the transferor did "control" the corporation, however, it is doubtful that the transferee corporation would be denied the use of the stepped-up basis. See note 92 *supra*. Moreover, the corporation's insistence upon a stepped-up basis does not open up the statute of limitations as to the transferor. See U.S. Treas. Reg., § 1.1312-6(c), Example (1)(i) (1956) (which assumes that the transferee corporation is not estopped to claim a stepped-up basis).

99. 116 F.2d 718 (7th Cir. 1940).

100. See also *R. M. Gunn*, 25 T.C. 424 (1955), *aff'd per curiam*, 244 F.2d 408 (10th Cir.), *cert. denied*, 355 U.S. 830 (1957).

tion to the market values of the various assets, a portion of the total basis, and perhaps a substantial portion, would usually have to be allocated to good will. This would often be disadvantageous to the transferee corporation because it would reduce the basis of inventory and similar property (which presumably will be sold within a reasonable period) and machinery, equipment and plant (on which depreciation is allowed), while increasing the basis of good will, which will ordinarily not be sold or depreciated. Under the *Birren* case, however, there will be no such re-allocation of basis.

If the section 351 exchange was partly taxable because "boot" was received, section 362(a) provides that the basis to be assigned to the transferred assets is to be increased by the amount of gain recognized. But neither the Code nor the regulations state how this increase should be allocated among the various assets. One method would be for the corporation to take over the transferee's basis for each asset, under the *Birren* case, increased by the same percentage that the gain recognized bears to the aggregate old basis. Thus, if the total old basis was \$25,000 and the gain recognized was \$5,000, the basis of each transferred asset would be increased by twenty per cent. This method has the advantage of simplicity, since it requires no appraisal of the transferred assets, but it is open to the objection that an asset's increase in basis may bear no relationship to its contribution to the recognition of gain. In the alternative, the gain could be allocated among the assets in proportion to their market values at the time of the exchange or in proportion to their actual increase in value above basis. Both alternatives would require an appraisal, but the latter one would have the merit of assigning the increase in basis to the assets "responsible" for it.

If the corporation disposes of any of the assets transferred to it under section 351 in a transaction that produces capital gain or loss, the transferor's holding period can be "tacked" under section 1223(2). It may be, moreover, that the transferor's holding period can be "tacked" under section 1223(2) even though the property became a capital asset only when it was acquired by the transferee corporation.¹⁰¹

TRANSFER UNDER SECTION 351 V. "SALE"

It is sometimes necessary to determine whether the transfer of property to a controlled corporation qualifies as a transfer under section 351 or constitutes, instead, an ordinary sale of the property.

101. See *Commissioner v. Gracey*, 159 F.2d 324 (5th Cir. 1947); and note that § 1223(2) was not amended in 1954, as was § 1223(1), to nullify the *Gracey* rule. It is not clear, however, whether § 1223(2) is applicable if gain was recognized on the § 351 exchange. See the discussion of this point with respect to § 1223(1) in note 97 supra.

If section 351 governs, the transfer is either wholly tax-free or taxable to the extent of any "boot" received, but no loss will be recognized. If, on the other hand, the transfer is a sale, the transferor will recognize his gain or loss in full under sections 1001 and 1002. For this reason, the owners of property that has declined in value sometimes wish to "sell" it to a corporation controlled by them and deduct their loss without losing control of the property.¹⁰² The transferee corporation's basis for the transferred assets will also be affected by whether the transfer falls under section 351 or is a sale; if section 351 is applicable, the corporation must carry over the transferor's basis, while if the transaction is a sale, the corporation's basis will be its cost.

Recognizing these principles, the owners of land that has appreciated in value have sometimes endeavored to "sell" the land to a controlled corporation for subdividing, so that the appreciation will be taxed to them as capital gain (possibly over a period of years, under section 453(b)) and the corporation (which will be in the "trade or business" of selling the subdivided land) will start with a higher basis and hence will realize correspondingly less ordinary income. If successful, this plan permits the profits ultimately realized by selling the land to outsiders to be divided between the individual (reporting capital gain) and the corporation (reporting ordinary income), whereas a transfer of the land to the corporation under section 351 would result in the corporation's realization of the entire profits as ordinary income. A "sale" may also be preferred over a section 351 exchange as a means of stepping up the basis of depreciable property; if business equipment or real property has a low adjusted basis but a high current market value, the owner may "sell" it to a controlled corporation in order to give the corporation a stepped-up basis for depreciation at the cost to him of a capital gain tax under section 1231.¹⁰³ In both of the preceding cases, where the owner of property is seeking to give his corporation a stepped-up basis for assets at the cost of a capital gain to himself, an alternative to a "sale" is a transfer of the property under section 351 in exchange for stock plus short-term notes or other

102. Even if such a transaction is treated as a sale rather than as a tax-free transfer under § 351, the transferors may run afoul of § 267, which forbids the deduction of a loss on a sale by an individual to a corporation of which he owns, directly or indirectly, more than fifty per cent in value of the outstanding stock. Moreover, the judicial doctrine embodied in *Higgins v. Smith*, 308 U.S. 473 (1940) (disallowing a claimed loss on a sale by a shareholder to his one-man corporation), may create a penumbra around § 267 in which losses that are not within the statutory language of § 267 will nevertheless be non-deductible.

103. Section 1239, enacted in 1951, takes the profit out of some, but not all, transactions of this type by denying the benefits of § 1231 to a person who sells depreciable property to a corporation of which he or specified members of his family own more than eighty per cent in value of the outstanding stock.

“boot.”¹⁰⁴ The section 351 route is not always a feasible alternative, however, since the use of short-term notes or other “boot” may have business disadvantages.

Turning now to the question of distinguishing a “sale” from a transfer under section 351, we might consider several categories of transactions:

1. If property is to be transferred to a controlled corporation solely for stock or securities, it is difficult to see how the parties can avoid section 351(a).¹⁰⁵ Section 351 is applicable “if property is transferred to a corporation . . . solely in exchange for stock or securities,” and the impact of this language can hardly be avoided by affixing the label “sale” to the transfer. In more naive days, it was sometimes thought that the organizers of a corporation, wishing to deduct a loss on depreciated property, could purchase the corporation’s stock for cash and then successfully “sell” the property to it for the cash paid in, but the quietus was put on such transactions as early as 1932,¹⁰⁶ and the device is not likely to be revived. A contrary construction of section 351, would, moreover, be indefensible because it would convert section 351 into an optional provision, in contravention of the congressional purpose.

2. Even if the transaction is cast in the form of a “sale” of property for stock or securities plus cash or other property, its tax consequences should be governed by sections 351(a) and (b), so that the transferor should recognize gain to the extent of the “boot” but not loss.¹⁰⁷ As in category 1 above, the language of section 351 is broad enough to embrace the transaction, and a contrary construction would endow the transferor with an option that was not intended by Congress.¹⁰⁸ Nor should the tax consequences of such a transfer be altered by dividing it into a “sale” of some of the property for cash and a transfer of the

104. For an example, see Rev. Rul. 56-303, 1956-2 Cum. Bull. 193.

105. A caveat must be introduced, however, for the case of a transfer that does not satisfy the “continuity of interest” doctrine; as suggested in text supported by note 21 supra, it may be that a transaction will be treated as a sale rather than as a transfer under § 351 if the transferor owns no stock in the transferee corporation and receives none on the exchange or if his economic position is otherwise altered so drastically that the underlying assumptions of § 351 are not applicable.

106. See *Labrot v. Burnet*, 57 F.2d 413 (D.C. Cir. 1932).

107. See note 105 supra.

108. As suggested supra, if the transferor’s purpose is to give the property a stepped-up basis in the hands of the corporation, rather than to enjoy a deductible loss, a transfer under § 351 for stock or securities and “boot” may be a satisfactory alternative to a “sale,” as it was for the transferor in Rev. Rul. 56-303, supra note 104.

balance for stock or securities, if the two steps are integral parts of a single transaction.¹⁰⁹

3. If, on the other hand, the property is transferred to a controlled corporation solely for cash or property, the transfer cannot qualify under either section 351(a) (which requires that the sole consideration be stock or securities) or section 351(b) (which permits the receipt of "boot," but only if the transferor has *also* received stock or securities). Section 351 seems equally inapplicable if the corporation issues no stock or securities, but agrees to pay for the property at a specified time in the future or in installments.¹¹⁰ This conclusion, though it finds support in the language of section 351, allows form to control the tax results of the transaction, since to the parties there may be no economic difference between a controlled corporation's promise to pay and its notes or debentures. Moreover, it was held in the *Brown* case,¹¹¹ that an installment sales contract (under which property was "sold" to a controlled corporation, the sales price to be paid in ten equal annual installments) was not a "security" as that term is used in section 351. The court distinguished between an instrument evidencing "a continuing interest in the affairs of the corporation" and one intended "to effect a termination of such a continuing interest," a distinction that will not be easy to apply.

In the foregoing discussion, we have focussed on whether section 351 is or is not applicable to a transaction. It would be perilous to assume that a transaction falling outside section 351 is *necessarily* a "sale" merely because it bears that label. For example, if property is transferred to a controlled corporation solely for cash, section 351 is inapplicable for the reasons stated above, but the taxpayer may still have to establish that the transfer is a "sale" rather than a contribution to capital of the property coupled with a distribution of cash taxable as a dividend.

One final caveat: whenever property is "sold" to a controlled corporation, the taxpayer must be prepared to establish that appearances correspond with reality. The Internal Revenue Service has more than once argued, sometimes with success, that a corporation's promise to pay for property should be disregarded, either because the corporation's capitalization was too "thin"¹¹² or for some other reason, and that a "sale" should for this reason be treated either as a section 351 transfer or as a contribution to capital.¹¹³ Finally, it should be noted

109. See *Houck v. Hinds*, 215 F.2d 673 (10th Cir. 1954).

110. See *Warren H. Brown*, 27 T.C. 27 (1956), acq., 1957-2 Cum. Bull. 4.

111. *Ibid.*

112. See note 39 *supra*.

113. *R. M. Gunn*, 25 T.C. 424 (1955), *aff'd per curiam*, 244 F.2d 408 (10th Cir.), *cert. denied*, 355 U.S. 830 (1957); *Gooding Amusement Co. v. Commissioner*, 236 F.2d 159 (6th Cir. 1956), *cert. denied*, 352 U.S. 1031 (1957); *Miller's*

that the shoe may be on the other foot: the taxpayer may seek to escape the consequences of a "sale" by arguing that a transaction was "really" a transfer under section 351. While he is probably not barred by estoppel from such a reversal, the claim that his own paperwork did not mean what it said may strike the courts as less than sporting.¹¹⁴

SECTION 351 EXCHANGE V. DIVIDEND

The regulations under section 351 suggest the possibility that a distribution by a corporation of its stock or securities "in connection with an exchange subject to section 351(a)" may have "the effect of the distribution of a taxable dividend."¹¹⁵ Although this part of the regulations does not identify the circumstances under which such a distribution might occur, there are at least these possibilities:

1. A transfer of property to a controlled corporation in exchange for stock and securities having a value greater than the property transferred. The excess value might be treated as a distribution under section 301.¹¹⁶

2. A transfer of property to a controlled corporation in exchange for securities, if the transfer was merely a device, lacking in business purpose, for extracting the securities from the corporation.¹¹⁷

3. A reincorporation of assets received by liquidating a predecessor corporation.¹¹⁸

Although the regulations, in warning of the possibility that a dividend may occur in conjunction with a section 351 exchange,¹¹⁹ speak

Estate v. Commissioner, 239 F.2d 729 (9th Cir. 1956); *Sun Properties, Inc. v. United States*, 220 F.2d 171 (5th Cir. 1955); see Pennell, *Tax Planning at the Time of Incorporation*, 35 *Taxes* 830 (1956).

114. See Harry F. Shannon, 29 T.C. No. 80 (1958).

115. U.S. Treas. Reg., § 1.351-2(d) (1955). Section 351(d) does not include a cross-reference to the basis dividend provision, § 301, and § 301(f)(3) might be read to imply that there is no overlap between §§ 301 and 351. But this would put too much weight on statutory cross-references that were intended simply as convenient guides to the busy practitioner. See § 7806(a). In any event, as the examples in the text indicate, the fact that a transfer complies with the terms of § 351 does not mean that it cannot be accompanied by a § 301 distribution. See Darrell, *Corporate Organizations and Reorganizations Under the Internal Revenue Code of 1954*, 32 *Taxes* 1007, 1010 (1954).

116. See U.S. Treas. Reg., § 1.301-1(j) (1955).

117. See Rev. Rul. 55-15, 1955-1 Cum. Bull. 361, which suggests that the government might assert that a transfer in these circumstances was "really" a contribution to capital, coupled with a distribution of securities taxable under § 301.

118. See U.S. Treas. Reg., § 1.301-1(1) (1955); MacLean, *Problems of Reincorporation and Related Proposals of the Sub-chapter C Advisory Group*, 13 *Tax L. Rev.* 407, 417 (1958).

119. See U.S. Treas. Reg., § 1.351-2(d) (1955).

only of a "distribution of stock or securities," it is equally possible that a distribution of money or other property would, in the circumstances described above, be taxed as a dividend under section 301, rather than as "boot" under section 351 (b).

REINCORPORATION

If a corporation pays a dividend by issuing its bonds or debentures to its shareholders, the distribution will be taxed in the same manner as a distribution of cash. But if the corporation is liquidated and the stockholders, by prearrangement, then transfer the assets to a newly organized corporation in exchange for stock and bonds or debentures, can they treat the transaction for tax purposes as (a) a liquidation of the old corporation (which is an occasion for recognizing capital gain or loss, or possibly even tax-free),¹²⁰ and (b) a tax-free exchange of property for the stock and securities of the new corporation, under section 351? If so, they will have accomplished their purpose without realizing the ordinary income that is ordinarily produced by a distribution of securities by a going corporation. It is possible, of course, that the courts would disregard the liquidation of the old corporation and the creation of the new as a sham, giving effect only to the distribution of securities and taxing it as a dividend. Another approach would be to give effect to the liquidation, but to treat the reincorporation as consisting of (a) an exchange of assets for stock, tax-free under section 351, and (b) a separable distribution of securities, taxable as a dividend.¹²¹ Reincorporations have come to the fore in recent years, at least in the discussion of tax advisors, as tax avoidance devices of burgeoning potentialities, and the problem just mentioned is only a small segment of this area.¹²²

120. Int. Rev. Code of 1954, §§ 331(a) (1), 333.

121. See U.S. Treas. Reg., § 1.301-1(1) (1955).

122. See MacLean, *supra* note 118.