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COMMENTS

ESTABLISHING A "SALE" IN TRANSFERS TO CONTROLLED CORPORATIONS UNDER SECTION 351 OF THE INTERNAL REVENUE CODE

Introduction

The Internal Revenue Code adheres to the legal principle that a corporation is to be treated as a separate legal entity in the great majority of business transactions. In the absence of any special provisions, transfers of appreciated or depreciated property to a corporation in return for stock are taxable events upon which gain[1] or loss[2] is realized.[3] However, under certain special provisions a gain or loss may be deferred until a later period, or in the technical language of the Code, the "realized" gain or loss is not "recognized" upon the exchange.[4] Section 351 of the 1954 Code[5] is one such provision and, under the circumstances to which it refers, does not require the recognition of gain or loss upon the transfer of property to a corporation in return for its stock or securities.[6]

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1. The gain is the excess of the "amount realized" upon the sale or other disposition over the "adjusted basis" of the property for determining gain. INT. REV. CODE OF 1954, § 1001(a).

2. The loss is the excess of the "adjusted basis" for determining loss over the "amount realized." *Ibid.*

3. The "amount realized" is the sum of any money plus the fair market value of any property received. INT. REV. CODE OF 1954, § 1001(b).

4. INT. REV. CODE OF 1954, §§ 351(b), 1002. Basis is not to be reduced for losses not recognized, nor increased for gains not recognized. The basis is the same as that of the property exchanged, decreased in the amount of any money and "other property" received by the taxpayer and increased in the amount of gain that was recognized upon such exchange. Gann v. Commissioner, 61 F.2d 201 (7th Cir.), *cert. denied*, 287 U.S. 650 (1932).

5. The 1954 and 1939 Code provisions are essentially identical except for the elimination of the proportionate interest requirement and the new provisions relating to services and the distribution of stock received by a corporate transferor of property. Apart from the differences in the definition of "control," the 1938, 1936, 1934, 1932, 1928, 1926, 1924 and 1921 Revenue Acts contained provisions identical with the provisions of the 1939 Code. The sections for the respective years are: Int. Rev. Code of 1939, ch. 1, § 112(b)(5), 53 Stat. 37; Revenue Act of 1938, ch. 289, § 112(b)(5), 52 Stat. 485; Revenue Act of 1936, ch. 690, § 112(b)(5), 49 Stat. 1679; Revenue Act of 1934, ch. 277, § 112(b)(5), 48 Stat. 704; Revenue Act of 1932, ch. 209, § 112(b)(5), 47 Stat. 196; Revenue Act of 1928, ch. 852, § 112(b)(5), 45 Stat. 816; Revenue Act of 1926, ch. 27, § 203(b)(4), 44 Stat. 12; Revenue Act of 1924, ch. 234, § 203(b)(4), 43 Stat. 256; Revenue Act of 1921, ch. 136, § 202(c)(3), 42 Stat. 230. In the prior Revenue Acts, gain or loss was recognized. In this paper the predecessors to § 351 will be referred to as: [351].

6. The corresponding counterpart in the 1939 Code is § 112(b)(5). Int. Rev. Code of 1939, ch. 1, § 112(b)(5), 53 Stat. 37. Substantial changes between the sections will be noted throughout this paper.

The original intent of the legislators who introduced section 351's predecessor in 1921 was to promote the organization of business enterprises by not recognizing a gain or loss on the incorporation of an existing enterprise,[7] since these gains or losses were technical or paper gains or losses[8] produced by the separate entity concept.[9] But the "shield" which Congress had given the depression burdened taxpayer of the '20s was soon turned into a flaming sword by the enterprising taxpayer of the late '30s. The taxpayer who wished to realize the appreciation in value of his business property at low capital gains rates would incorporate his business outside the nonrecognition features of section 351. The corporation would acquire a "stepped-up" cost basis for depreciation purposes while the taxpayer paid only a capital gains tax on the transfer and remained in control of the property as the majority or sole stockholder of the corporation.[10] The Treasury Department counter-attacked with regulations, rulings, suggested code amendments and new sections resulting in a maze of court decisions.

Section 351 is applied most frequently when a new corporation is organized or an existing partnership is incorporated. The section also applies to transfers of property to existing corporations wherein the controlling stockholder[11] may be an individual, trust, estate, partnership, association, company or corporation.[12] When the requirements of the section under discussion are satisfied, whether intentionally or unintentionally, it is mandatory that no gain or loss be recognized on the transaction.[13]

The tax-free transfer of property to a controlled corporation is not always desirable. For example, if the transfer consists of substantially appreciated capital assets which will be treated as inventory after the transfer,

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7. S. REP. No. 275, 67th Cong., 1st Sess. 9 (1921); 1939-2 CUM. BULL. 518-19.
8. "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." Portland Oil Co. v. Commissioner, 109 F.2d 479, 488 (1st Cir.), *cert. denied*, 310 U.S. 650 (1940).
9. Jack L. Easson, 33 T.C. 963 (1960).
10. A transfer outside of § 351 would take its basis under § 1012 of the Internal Revenue Code of 1954, which is cost; therefore, depreciation deductions would be increased resulting in lower income to the corporation.
11. INT. REV. CODE OF 1954, § 7701(a)(1).
12. In the preparation of § 351 for the 1954 Code, the original proposal by the Ways and Means Committee declared that it did not extend to transfers of property to a corporation in a nontaxable corporate reorganization, or to transfers constituting corporate separations. Other sections of the Code are concerned with these transactions. But these express exclusions were deleted from the section as finally enacted. The result is that these transactions may apply for nonrecognition of gain or loss under multiple provisions. Section 351(a) of H.R. 8300, 83d Cong., 2d Sess. (1954) as introduced by the Ways and Means Committee. See Darrell, *Corporate Organizations and Reorganizations*, 32 TAXES 1007, 1009 (1954).
13. Houck v. Hinds, 215 F.2d 673 (10th Cir. 1954); Chafee v. United States, 139 F. Supp. 916 (D. Idaho 1956); Pocatello Coca-Cola Bottling Co. v. United States, 139 F. Supp. 912 (D. Idaho 1956).

it is more advantageous to effect a taxable transfer so as to increase the basis of the property. The transferor would be taxed on the gains at low capital gains rates, but certain corporate assets would have a higher basis in computing annual depreciation, thereby reducing the income taxable at the higher corporate rates. The first part of this comment will discuss those transactions subject to section 351. The second part will discuss successful and unsuccessful attempts to escape the effect of section 351 on transfers to controlled corporations.

I. SURVEY OF SECTION 351

If cash is the only asset to be transferred to the corporation, it is of no consequence whether the plan is of the taxable or the tax-free variety. Or if the assets to be transferred have a fair market value equal to their adjusted basis in the hands of the incorporators, there is no tax problem. In all other cases, the incorporators must choose between a taxable or a nontaxable transfer of property to the corporation, or a combination of both methods. Regardless of the method selected, the corporation will not realize any income upon receipt of the property.[14] Only the basis and holding period of the property received by the corporation is affected by the choice of methods.[15] The immediate tax effects, if any, are felt by the transferors in their tax returns for the current year.

The components of section 351 will first be examined, and then its interaction with other provisions will be considered. In general, section 351 provides that no gain or loss is to be recognized if:

1. Property is transferred to a corporation;
2. By one or more persons;
3. Solely in exchange for stock or securities of that corporation; and
4. Immediately after the exchange the person or persons are in control of the corporation.[16]

A. *Transfer of Property*

The key to section 351 is the transfer of "property" in exchange solely for stock or securities. The Code does not define the term "property" as used in section 351.[17] Treasury rulings and court decisions have held that

14. INT. REV. CODE OF 1954, § 118(a).

15. In a nontaxable transaction, the corporation must use the basis and holding period of the transferor. INT. REV. CODE OF 1954, §§ 362(a), 1223(2).

16. A simple purchase of stock in a newly formed corporation solely for cash is not the type of transaction covered by the tax-free exchange provisions of the Code. Davey Co., 32 T.C. 743 (1959).

17. The definition of "property" in § 317(a) applies only to Part I of Subchapter C of the Internal Revenue Code of 1954, which excludes § 351.

it includes cash[18] and generally every kind of property interest, including an equitable interest.[19]

Section 351(a) expressly provides that stock or securities issued for services are not considered as issued in return for property. The stock or securities issued solely in exchange for services performed for the corporation cannot be counted with other stock or securities issued for "property" to determine if the transferors have control[20] of the transferee corporation. A transfer may still qualify under section 351, even if stock or securities are issued for services as long as the other persons who have transferred "property" are in control.[21] If the contributor of services *also* transfers other property for stock or securities, then all of his stock is to be counted for purposes of control.[22] But if the stock or securities issued for property are of relatively small value in comparison to the value of the stock or securities already owned, or to be received for services, and the primary purpose of the transfer is to bring within section 351 the exchanges of property by other persons transferring property, then section 351 shall not apply.[23] The Regulations exclude the services from section 351 whether they have been rendered in the past or are to be rendered in the future.[24] However, if the stock or securities are distributed to a third person who has performed services for one of the transferors, rather than for the transferee corporation, the transaction should be treated as if the stock had first been distributed to the transferor who benefited by the services, and the transferor had used the stock to pay his debts.[25]

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18. The earlier Treasury rulings excluded cash from the definition of "property" for § 351, but the current and sounder rule is that cash is included since a new corporation requires cash for working capital. G.C.M. 2862, VII-1 CUM. BULL. 161 (1928), revoked by G.C.M. 24415, 1944 CUM. BULL. 219. This also allows several transferors to equalize the proposed investment with transfers of cash.

19. Roberts Co., 5 T.C. 1 (1945); F.L.G. Straubel, 29 B.T.A. 516 (1933).

20. Control as required by § 351 is defined in INT. REV. CODE OF 1954, § 368(c) and "means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation." See discussion in text *infra* at note 37.

21. The contributor of services cannot receive more than 20% of any class of stock. Treas. Reg. § 1.351-1(a) (1955).

22. Illustration: *A* receives 75% of the stock of the corporation for property and *B* receives 25% for a combination of property and services in an arm's length transaction. The transfer of the property as to *A* and *B* would be tax free with *B* realizing ordinary income to the extent of the stock received for services. Treas. Reg. § 1.351-1(a)(2) (1955).

23. Treas. Reg. § 1.351-1(a)(1)(ii) (1955).

24. Treas. Reg. § 1.351-1(a)(1) (1955). If the transferors wish to make the exchange a taxable transaction, they might create a preferred stock and issue it exclusively for services rendered by persons who do not contribute any property, for example accountants, lawyers and engineers.

25. A contract to render services is not property. Treas. Reg. § 1.351-1(a)(1)(i) (1955).

B. *Stock or Securities*

Section 351 provides that the transfer of property must be "solely in exchange for stock or securities" in the transferee corporation. The terms "stock" and "securities" are not defined in the Code. The courts have incurred little difficulty in defining "stock,"[26] except that stock rights and stock warrants are not regarded as stock or securities.[27] But the term "securities" has caused considerable difficulty in the courts.

The source of the litigation is whether the term includes short-term notes which indicate a sale rather than a continuing interest in the business. "Securities," with reference to section 351, has been interpreted to have the same meaning and effect as in the reorganization sections.[28] The Supreme Court attempted to put the matter at rest when it said:

> Certainly, we think that to 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.[29]

This gave rise to the question of for how long the obligations must be issued before they will be classified as "securities." Several cases have attempted to set standards other than time.[30] But the predominant test appears to be time to maturity. The cases in this area are used at times as a sword and at other times as a shield by both the taxpayer and the Commissioner.[31] At times the taxpayer desires the obligations to resemble short-term notes so as to create a taxable transaction,[32] but at other times he wishes to qualify under section 351 for a nontaxable exchange.[33]

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26. The stock may be common or preferred, voting or nonvoting, or a combination.
27. Treas. Reg. § 1.351-1(a)(1)(ii) (1955). The issuance of scrip for fractional shares possessing no rights until assembled into full shares does not disqualify an otherwise tax-free acquisition. Rev. Rul. 59, 1955-1 CUM. BULL. 35. See also Helvering v. Southwest Consol. Corp., 315 U.S. 194 (1942).
28. The term "stock or securities" in § 351 has the same meaning as in INT. REV. CODE OF 1954, §§ 354(a)(1) and 361(a), which provide for nonrecognition of gain or loss in an exchange during a corporate reorganization. Lloyd-Smith v. Commissioner, 116 F.2d 642, 644 (2d Cir. 1941).
29. Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462, 470 (1933).
30. These cases are discussed in the text *infra* at note 86.
31. In the case of Harry F. Shannon, 29 T.C. 702 (1958) the taxpayer recorded a transfer to a controlled corporation as a sale. Later the Commissioner assessed a deficiency on the sale and the taxpayer attempted to escape the consequences of a "sale" by arguing that the transaction was "really" a transfer under § 351. The tax court refused to allow the taxpayer to reverse his position. See also Ralph E. Cotter, Jr., 30 P-H Tax Ct. Mem. 1121 (1961).
32. Cortland Specialty Co. v. Commissioner, 60 F.2d 937 (2d Cir. 1932), *cert. denied*, 288 U.S. 599 (1933) (unsecured notes due in fourteen months); Lloyd-Smith v. Commissioner, 116 F.2d 642 (2d Cir. 1941) (unsecured note due in two years); Warren H. Brown, 27 T.C. 27 (1956) (installment sales contract not a security); John W. Harrison, 24 T.C. 46 (1955), *aff'd*, 235 F.2d 587 (8th Cir. 1956) (shareholder's drawing accounts not securities); Neville Coke & Chemical Co., 3 T.C. 113, *aff'd*, 148 F.2d 599 (3d Cir. 1945).
33. The following have been held to be securities: (1) installment notes due after five years—Camp Wolters Enterprises, Inc., 22 T.C. 737 (1954), *aff'd*, 230 F.2d 555 (5th

The obligations may be classified as "stock or securities" as used in section 351(a), yet the transfer may be a taxable event. If the transferor receives a combination of stock and short-term notes, the notes may result in taxable income under section 351(b). This provision recognizes a realized[34] gain to the extent of the money received plus the fair market value of property other than stock or securities received.[35] No loss may be recognized.[36]

C. *Control - Eighty Per Cent*

The transferors of property must be "in control" of the corporation immediately after the exchange to qualify under section 351. Control is defined in section 368(c) to mean the ownership of: (1) at least eighty per cent of the total combined voting power of all 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.[37] The cases do not indicate the reason for the selection of this particular figure as the required percentage for control.[38]

The requisite stock includes only issued stock and not the authorized capital stock.[39] Equitable ownership of stock is sufficient to meet the eighty per cent requirement.[40] The term "stock entitled to vote" is not defined in the Code,[41] nor has it been judicially interpreted. But it would seem to refer only to stock possessing no substantial restrictions upon the right to vote.[42] If there are "other classes of stock," the transferors must possess at least eighty per cent of the total number of shares. A recent

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Cir.), *cert. denied,* 352 U.S. 826 (1956); (2) debenture notes—Karl B. Segall, 38 B.T.A. 43 (1938), *rev'd on other grounds,* 114 F.2d 706 (6th Cir. 1940), *cert. denied,* 313 U.S. 562 (1941); (3) bonds—Commissioner v. Freund, 98 F.2d 201 (3d Cir. 1938); Pan-Am. Trust Co., 14 P-H Tax Ct. Mem. 609 (1945).

34. INT. REV. CODE OF 1954, § 1001(a); Treas. Reg. § 1.351-2 (1955).

35. Illustration: *M* transfers property with an adjusted basis of $5,000 and a fair market value of $10,000 to a corporation for all its stock, worth $6,000, plus $4,000 of short-term notes. *M's* gain is $5,000 but it is recognized only to the extent of $4,000, the fair market value of the notes. If the adjusted basis of the property transferred had been $15,000, *M* would have realized a loss of $5,000 under INT. REV. CODE OF 1954, § 1001(a), but it would not have been recognized because of § 351(b)(2).

36. INT. REV. CODE OF 1954, § 351(b)(2); Treas. Reg. § 1.351-2(a) (1955).

37. INT. REV. CODE OF 1954, § 368(c). Receipt of less than 80% of the stock does not necessarily make a loss deductible. Section 267(b)(2) denies the deduction of a loss between either party from a sale or exchange between a corporation and an individual who owns more than 50% in value of its outstanding stock. INT. REV. CODE OF 1954, § 267(b)(2).

38. 3 MERTENS, LAW OF FEDERAL INCOME TAXATION 105 (1957).

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

40. These shares of stock were deposited in a voting trust. National Bellas Hess, Inc., 20 T.C. 636 (1953); Peabody Hotel Co., 7 T.C. 600 (1946); Federal Grain Corp., 18 B.T.A. 242 (1929).

41. Generally § 368(c) presents no problems of interpretation. In most cases the corporation issues only one class of stock or the transferors receive all stock of all classes.

42. See generally BITTKER, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 89 (student ed. 1959).

Treasury Ruling[43] requires eighty per cent of each "class" of nonvoting stock, but section 368(c) would appear to aggregate all the nonvoting classes and require only eighty per cent of the total.

D. *Control "Immediately After"*

A number of interesting cases have considered the requirement that the transferors be in control "immediately after the exchange."[44] The principal issue has been the length of time the original transferors must possess the stock[45] and the effect of pre-existing commitments.[46] The key to this section is that the shares of stock of two or more transferors may be aggregated to determine control provided their transfers are part of a single transaction.[47]

In determining what is a single transaction, the courts have developed the so-called "step transaction doctrine."[48] Under this theory integral steps in a chain of corporate action are not considered individually, but are lumped together as a single transaction. One line of cases maintains that this doctrine is applicable only when the parties to a given transaction are under a legal commitment to take each of the succeeding steps.[49] Another view is to the effect that the doctrine applies if each of the steps was within the clear contemplation of the parties, even in the absence of a legal duty to complete all of them.[50] Individual courts have not been consistent in following either view. The following factors have been considered

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43. Rev. Rul. 259, 1959-2 CUM. BULL. 115.

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

45. ACF-Brill Motors Co. v. Commissioner, 189 F.2d 704 (3d Cir. 1951); Wilgard Realty Co. v. Commissioner, 127 F.2d 514 (2d Cir. 1942); Portland Oil Co. v. Commissioner, 109 F.2d 479 (1st Cir. 1940); Robert J. Harder, 27 P-H Tax Ct. Mem. 425 (1958).

46. May Broadcasting Co. v. United States, 200 F.2d 852 (8th Cir. 1953); Barker v. United States, 200 F.2d 223 (9th Cir. 1953); S. Klein on the Square, Inc. v. Commissioner, 188 F.2d 127 (2d Cir.), *cert. denied*, 342 U.S. 824 (1951); Manhattan Building Co., 27 T.C. 1032 (1957); American Bantam Car Co., 11 T.C. 397 (1948), *aff'd per curiam*, 177 F.2d 513 (3d Cir. 1949), *cert. denied*, 339 U.S. 920 (1950).

47. The question of control is to be determined by the situation existing at the time of the completion of the plan rather than the fulfillment of one of the intermediate steps. Charles Hull, 31 B.T.A. 125 (1934).

48. "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." Manhattan Building Co., 27 T.C. 1032, 1042 (1957).

49. Wilgard Realty Co. v. Commissioner, 127 F.2d 514 (2d Cir. 1942); Manhattan Building Co., 27 T.C. 1032 (1957); American Bantam Car Co., 11 T.C. 397 (1948).

50. Fahs v. Florida Mach. & Foundry Co., 168 F.2d 957 (5th Cir. 1948); West Texas Ref. & Dev. Co., 25 B.T.A. 1254 (1932), *aff'd*, 68 F.2d 77 (10th Cir. 1933). "Even though there was no unifying contract, the unity of the plan brings the case within the rule applied in Starr v. Commissioner, 4 Cir., 82 F.2d 964." Helvering v. Elkhorn Coal Co., 95 F.2d 732, 738 (4th Cir. 1938). An informal family understanding between husband and wife transferors was sufficient in Royal Marcher, 32 B.T.A. 76 (1935).

by past decisions:[51] (1) intent of the parties; (2) time elements; (3) ultimate result; and (4) mutual interdependence.

The courts generally hold a transaction is outside the scope of section 351 if the transferors retain only momentary control and subsequently transfer enough stock to lose "control" under a pre-arranged agreement.[52] The transferors of property are deemed not to own this stock.[53] If there are no pre-existing commitments the transfer will qualify under section 351.[54]

E. *Two or More Transferors: Allocation of Stock and Securities*

Section 351 expressly includes transfers of property by two or more persons. The transferors must act in concert according to a preconceived plan.[55] In some cases, the total value of the stock and securities received from the corporation by each transferor differs from the total value of the assets contributed. Before 1954, this disproportionate distribution would destroy the tax-free character of the exchange. But the requirement was vague and uncertain in its method of application, resulting in extensive litigation.[56] The 1954 Code eliminated the requirement, much to the relief of most tax practitioners. But the regulations[57] still recognize certain

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51. The cases are collected in a useful analysis of the overall problem in Mint & Plumb, *Step Transactions in Corporate Reorganizations*, N.Y.U. 12TH INST. ON FED. TAX. 247 (1954).

52. No control existed when the transferors were bound by an agreement to transfer a large portion of their stock to third persons as payment for services. Columbia Oil & Gas Co., 41 B.T.A. 38 (1940), *aff'd*, 118 F.2d 459 (5th Cir. 1941). See also Heberlein Patent Corp. v. United States, 105 F.2d 965 (2d Cir. 1939); Bassick v. Commissioner, 85 F.2d 8 (2d Cir. 1936). The sole transferor of property ordered the corporation to transfer 20% of the stock to the transferor's donee. The transfer was taxable. Fahs v. Florida Mach. & Foundry Co., 168 F.2d 957 (5th Cir. 1948). *But cf.*, a gift of stock immediately upon its receipt by the transferors does not negate the required control. Wilgard Realty Co. v. Commissioner, 127 F.2d 514 (2d Cir. 1942). See the collection of cases in 3 CCH 1961 STAND. FED. TAX REP. ¶ 2503.175.

53. S. Klein on the Square, Inc., 14 T.C. 786 (1950), *aff'd*, 188 F.2d 127 (2d Cir.), *cert. denied*, 342 U.S. 824 (1951); Mojonnier & Sons, Inc., 12 T.C. 837 (1949); Independent Oil Co., 6 T.C. 194 (1946).

54. If one of the persons transferring is also a corporation, the fact that it distributes to its shareholders the stock or securities received is not material. Since it has been one of the persons in control immediately after the exchange, the subsequent distribution does not affect the tax-free character of the exchange. Rev. Rul. 57-464, 1957-2 CUM. BULL. 244.

55. Separately owned property may be transferred and it is not even necessary that the transfers be made simultaneously provided that all of them are made pursuant to a pre-existing agreement. Portland Oil Co. v. Commissioner, 109 F.2d 479 (1st Cir.), *cert. denied*, 310 U.S. 650 (1940).

56. The old proportionate interest rule of § 112(b)(5) of the 1939 Code caused considerable uncertainty in its application. S. REP. No. 1622, 83d Cong., 2d Sess. 264 (1954). The uncertainty was based upon divergent results reached in United Carbon Co. v. Commissioner, 90 F.2d 43 (4th Cir. 1937) and Bodell v. Commissioner, 154 F.2d 407 (1st Cir. 1946) on the one hand and Mather & Co. v. Commissioner, 171 F.2d 864 (3d Cir.), *cert. denied*, 337 U.S. 907 (1949) on the other. The uncertainty must still be faced on *basis* problems involving corporations incorporated under the 1939 Code and prior law. *E.g.*, Ernest W. Brown, 28 T.C. 682 (1957), *aff'd*, 258 F.2d 829 (2d Cir. 1958).

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

tax consequences.[58] The transaction may be treated as if the stock or securities first had been received in proportion to the value of the property transferred and then some of the stock and securities had been used to make gifts, to pay compensation, or to satisfy the obligations of the transferor to his co-transferor.[59] Thus, the parties to a transaction that is tax-free under section 351 may be subject to the income tax on a part of their gain or to the gift tax on the fair market value of a portion of the property.

F. *Assumption of Liability*

Section 357(a) permits the taxpayer to transfer encumbered property to the corporation and still qualify under section 351.[60] The corporation's assumption of the liability or its acquisition of property subject to a liability is not treated as a distribution of money or other property to the transferor.[61] The liabilities will affect the basis of the stock or securities.[62] There are two broad exceptions to section 357(a). First, if it appears the transferor's principal purpose was to avoid federal income taxes on the transfer, or that there was not a bona fide business purpose, then the total amount of the liability will be treated as money distributed by the corporation.[63] Secondly, if the sum of all the liabilities exceeds the adjusted basis of all the property transferred to the corporation, the excess will be taxed as gain to the transferor.[64]

G. *Basis*

1. BASIS TO TRANSFEROR STOCKHOLDERS

"Tax-free" may be a dangerous phrase to use in describing a section 351 transfer. At best the tax is deferred in that the stock or securities assume the basis of the property transferred. Upon a subsequent sale of the stock or securities any deferred gain or loss will be recognized. Section 358 provides that stock and securities received will take the basis of the property exchanged, decreased in the amount of any "boot" (money or property) received, and increased in the amount of any gain recognized to the trans-

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58. H.R. REP. No. 1337, 83d Cong., 2d Sess. 39, A116-18 (1954); S. REP. No. 1622, 83d Cong., 2d Sess. 264 (1954).
59. INT. REV. CODE OF 1954, § 351(d).
60. INT. REV. CODE OF 1954, § 357(a). Treas. Reg. § 1.357-1 (1955).
61. In United States v. Hendler, 303 U.S. 564 (1938) the rule was established that assumption of or the transfer of property subject to an indebtedness is the equivalent to the receipt by the transferor of "money or other property" or in other words "boot." The legislature enacted § 357 to temper the *Hendler* decision when an exchange is under §§ 351, 361, 371 or 374.
62. The basis of the stock or securities is reduced by the amount of liability assumed by the corporation. INT. REV. CODE OF 1954, § 358(d).
63. INT. REV. CODE OF 1954, § 357(b)(1)(A).
64. INT. REV. CODE OF 1954, § 357(b)(1)(B).

feror.[65] If several classes of stock or stock and securities are received, the basis of the property transferred must be allocated among the various classes of stock and securities.[66]

If the corporation acquired the property subject to a liability or assumed a liability attached to the property, the liability is treated as money received.[67] The effect is to reduce the basis of the stock or securities in the hands of the transferor whether or not the liability caused a gain to be recognized under section 351(b).

The issue of basis may arise many years after the stock or securities are sold or exchanged. In such cases it is necessary to determine: (a) the original cost or other basis of the "old" property; (b) whether any money was received, and if so, the amount; (c) whether any "other property" was received, and if so, the amount; and (d) whether the exchange was a taxable transaction under the law in effect at the time of the exchange, and if so, the amount of gain or loss "recognized" under the applicable law.

2. BASIS TO TRANSFEREE CORPORATION

Section 362(a) requires the basis of the property transferred to be the same as the transferor's basis, increased in the amount of any gain recognized to the transferor.[68]

II. SALE OR SECTION 351 TRANSFER?

The organization of a corporation presents many subtle tax problems to the lawyer. Tax planning at the "birth" of the corporation will have substantial beneficial effects upon the corporation during its entire tax life. The advantages of a simplified tax-free incorporation under section 351 may be outweighed by several other tax factors. A taxable transfer may be preferable to obtain a new basis for depreciable property which has a low basis in comparison to a high market value.[69] If the transfer is taxable,[70] the transferor will be taxed at low capital gains rates and the corporation will obtain a larger depreciation allowance to offset against ordinary income.[71]

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65. INT. REV. CODE OF 1954, § 358. Treas. Reg. § 1.358-1 (1955).

66. INT. REV. CODE OF 1954, § 358(b)(1). Treas. Reg. § 1.358-2(b) (1955) requires the allocation to be in proportion to the market values of the stock and securities received.

67. INT. REV. CODE OF 1954, § 358(d).

68. Neither the Code nor the regulations state how the corporation is to allocate the carried-over basis among a group of assets. For an excellent discussion of the problem see BITTKER, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 101 (student ed. 1959).

69. In all cases, the sales price must be fair or the transaction will be subject to possible readjustments by the Commissioner. INT. REV. CODE OF 1954, § 482.

70. A loss will be denied if the seller owns more than 50%, directly or indirectly, of the acquiring corporation. INT. REV. CODE OF 1954, § 267.

71. The boot provisions of § 351(b) are operative only if the transferor receives stock

The stepped-up basis for depreciation is most attractive to incorporators who have a substantial investment in physical plant equipment of an unincorporated going concern. If the assets have been used in the business for any period of time, they have already benefited from depreciation at ordinary income rates. By transferring the assets in a taxable transaction, the corporation acquires a higher basis to utilize in computing the depreciation deduction.[72]

Another situation in which it is advantageous to effect a taxable transfer is when the assets are to constitute the stock in trade of the corporation. The most frequent example of such a transfer is in the case of real estate which is to be subdivided and developed by the corporation.[73] The theory is for the incorporators to realize part of their gain upon the transfer at low capital gains rates. The corporation, of course, acquires a "stepped-up" basis to be matched against the sales price of the individual lots.

In the past many attorneys when confronted with one of the above situations advised their clients to purchase all the stock for cash and later "sell" the assets to the corporation at their fair market value for the newly transferred cash. Today the courts will not base their decisions upon the formality of the transfer, but rather they will look to the substance and practical effect of the transfer.[74] In this and similar situations the courts generally rule that the two acts were steps of a single transaction resulting in a transfer of the property for stock or securities under section 351.[75] If the transfer comes within the ambit of section 351, it is mandatory that the transfer be tax-free.[76] Hence, if only stock or traditional-type securities are issued, the "sale" will be defeated. However, some cases have recognized the "sale" within the supposed confines of section 351 if certain factors were present.[77] These cases have depended upon the type of credit instruments issued and the capitalization of the corporation.

A. *Type of Credit Instruments*

The issuance of credit instruments as consideration for the purported sale has been the true "thorn in the side" for the Commissioner of Internal

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or securities as interpreted under § 351(a). If no stock or securities are received, the transaction is not subject to § 351.

72. For an interesting discussion see Pennell, *Tax Planning At the Time of Incorporation*, 35 TAXES 927 (1957).

73. *E.g.*, Aqualane Shores, Inc. v. Commissioner, 269 F.2d 116 (5th Cir. 1959); Sun Properties, Inc. v. United States, 220 F.2d 171 (5th Cir. 1955).

74. *E.g.*, Larbot v. Burnet, 57 F.2d 413 (D.C. Cir. 1932).

75. See discussion in text at note 48 *supra*.

76. Rev. Rul. 56-303, 1956-2 CUM. BULL. 193. See, *e.g.*, Houck v. Hinds, 215 F.2d 673 (10th Cir. 1954).

77. A transfer of property to a corporation for cash or property is outside the scope of section 351 since no stock or securities are issued as part of the consideration. But other sections of the Code may destroy the taxable nature of such a transfer. See discussion in text at note 107 *infra*.

Revenue.[78] The "thorn" was planted by the Supreme Court in the *Pinellas Ice & Cold Storage Co. v. Commissioner*[79] decision wherein the Court stated that short-term notes "were not securities within the intendment of the act."[80] This statement was startling to the business world as notes were generally regarded as securities. Noting that in this case the notes were of the short-term variety, subsequent cases attempted to use the test of time as the dividing line in deciding whether the obligations were securities.[81] Notes with a maturity of ten or more years appeared to be classified as securities[82] while notes with a maturity of five years or less tended to fall outside of section 351(a).[83] Hence, a "sale" for short-term notes would constitute a taxable event.

The theory supporting these decisions is that if only cash or property was received from the corporation the transaction would not be subject to section 351. Hence, if certain credit instruments analogous to cash are received, as opposed to securities of the types used for investment purposes, the transaction is still not subject to section 351.[84] The Code fails to provide a definition of the type of credit instruments within the classification of securities. The Commissioner has acknowledged the exclusion of short-term obligations from the security classification, but he has refused to define "short-term" and has litigated the issue many times.[85]

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78. The term "securities" as used in § 351 has been held to have the same meaning as in §§ 354(a)(1) and 361(a), which provide for the non-recognition of gain or loss on an exchange during a corporate reorganization. INT. REV. CODE OF 1954, §§ 354(a)(1), 361(a). Formerly Int. Rev. Code of 1939, ch. 1, §§ 112(b)(3), (4), 53 Stat. 37.

79. 287 U.S. 462 (1933).

80. *Id.* at 468-69. The decision was primarily based upon the lack of continuity of interest by the taxpayer in the new corporation. For critical comment, see Griswold, *"Securities" and "Continuity of Interest,"* 58 HARV. L. REV. 705 (1945).

81. Cases defining securities: Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462 (1933); Lloyd-Smith v. Commissioner, 116 F.2d 642 (2d Cir. 1941); Cortland Specialty Co. v. Commissioner, 60 F.2d 937 (2d Cir. 1932), *cert. denied*, 288 U.S. 599 (1933); Camp Wolters Enterprises, Inc., 22 T.C. 737 (1954), *aff'd*, 230 F.2d 555 (5th Cir.), *cert. denied*, 352 U.S. 826 (1956); Neville Coke & Chem. Co., 3 T.C. 113 (1944), *aff'd*, 148 F.2d 599 (3d Cir.), *cert. denied*, 326 U.S. 726 (1945).

82. Helvering v. Watts, 296 U.S. 387 (1935) (mortgage bonds); Camp Wolters Enterprises, Inc. v. Commissioner, 230 F.2d 555 (5th Cir. 1956) (notes with five to ten-year maturity); Commissioner v. Freund, 98 F.2d 201 (3d Cir. 1938) (six-year bonds); Burnham v. Commissioner, 86 F.2d 776 (7th Cir. 1936) (ten-year unsecured notes); Globe-News Publishing Co., 3 T.C. 1199 (1944) (twenty-five-year scrip); E.S. Dillard, 30 P-H Tax Ct. Mem. 145 (1961) (twenty-year subordinated debentures).

83. Neville Coke & Chem. Co. v. Commissioner, 148 F.2d 599 (3d Cir. 1945) (three, four and five-year notes); Commissioner v. Sisto Financial Corp., 139 F.2d 253 (2d Cir. 1943) (demand notes); Lloyd-Smith v. Commissioner, 116 F.2d 642 (2d Cir. 1941) (two-year unsecured notes); Cortland Specialty Co. v. Commissioner, 60 F.2d 937 (2d Cir. 1932) (unsecured notes due in fourteen months); Warren H. Brown, 27 T.C. 27 (1956) (installment sales contract not a security); Wellington Fund, Inc., 4 T.C. 185 (1944) (twelve-month notes).

84. "Accordingly under the Code, a short-term purchase money note is not a security of a party to a reorganization . . . ." Treas. Reg. § 1.368-1(b) (1955). "Securities" under § 351 has been interpreted to have the same meaning as that term is used in the reorganization sections. See note 78 *supra*.

85. The Commissioner has refused to issue rulings on classifications of credit instruments. Announcement 61-31, 1961 INT. REV. BULL. No. 13, at 21.

1. OVERALL EVALUATION

The test of time to maturity has been modified by recent decisions. A leading case interpreting "securities" under section 351 is *Camp Wolters Enterprises, Inc. v. Commissioner.*[86] In this case the Fifth Circuit was confronted with a corporation which had issued promissory notes amounting to some 411,000 dollars on its organization. These notes, payable in five to nine years, had been issued in exchange for assignments from its eighty-nine incorporators of claims against the United States for buildings standing on Camp Wolters. The issue was whether the notes were securities within the intendment of section 351. If this were the case, the incorporators' basis would carry over to the corporation.

The court noted that the time period was a major factor in determining whether the notes were securities, but it was not the only factor. These notes, although redeemed within two years, were neither of the short-term variety nor were they for "current corporate needs," but were a "participation" and "an integral part of the pot luck no pay no cure plan, formed before incorporation . . . ."[87] The court adopted the test applied by the Tax Court:

> The test as to whether notes are securities is not a mechanical determination of the time period of the note. Though time is an important factor, the controlling consideration is an overall evaluation of the nature of the debt, degree of participation and continuing interest in the business, the extent of proprietary interest compared with the similarity of the note to a cash payment, the purpose of the advances, etc.[88]

Applying this test, the notes were held to be securities under section 351.

The Tax Court in a subsequent case had another opportunity to reject the test of time to maturity for classifying credit obligations as securities. In *Harry F. Shannon*[89] the overall evaluation test when applied to the facts resulted in the characterization of the transaction as a sale. In this case the shareholders transferred their ranch to a newly organized corporation. The consideration was 2,500,000 dollars of which 50,000 dollars was paid in cash and the balance of the 2,450,000 dollars was to be paid in equal annual installments over a fifty year period. At the time of the transfer, the shareholders treated the transaction as a sale and reported it as long-term capital gains in their tax returns. Later, certain additional tax assessments were made and the shareholders sought to reverse

86. 230 F.2d 555 (5th Cir.), *cert. denied,* 352 U.S. 826 (1956).
87. *Id.* at 559.
88. *Id.* at 560, citing Camp Wolters Enterprises, Inc., 22 T.C. 737, 751 (1954).
89. 29 T.C. 702 (1958).

their position and report the transfer as a nontaxable exchange under section [351(a)].[90] The Tax Court refused to allow a change of position and confirmed the "sale."

The Tax Court distinguished *Camp Wolters Enterprises* on the grounds that in the instant case a vendor's lien was retained, but in *Camp Wolters* no lien was reserved. Next, in the instant case the payments were not subordinated to creditors of the corporation, but in *Camp Wolters* they were subordinated. Finally, the burden was upon the taxpayer to prove a section [351] transfer in the instant case, but in *Camp Wolters* the burden was upon the taxpayer to prove a sale.

The Tax Court ruled the transaction was a sale because a valid debtor-creditor relationship was established. The installment agreement had been strictly adhered to and all payments had been made on time. The transfer was for a valid business purpose since the ranch could be better operated by a corporation than as a partnership because of the many owners who had an interest in the ranch.

The decision is difficult to square with the older test of the maturity of the obligations. In the instant case, the debt was to be paid off over a fifty-year period. The Tax Court completely subordinated the test of time to maturity and stated that when the facts demonstrate a sale, it is not mandatory to transpose the transfer into a section 351 exchange because long-term obligations are received.

The opinion may be explained upon the basis that the Tax Court does not seem to believe that an installment sales contract represents a "security" as that term is used within section 351(a). The Tax Court in the instant case cited *Warren H. Brown*[91] for this proposition. In that case the Tax Court was attempting to distinguish 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."[92]

2. CONTINUING INTEREST

The Court in *Camp Wolters*, as part of the "overall" test, referred to the transferors' "continuing interest in the business." Primary emphasis was placed upon this aspect of the transfer in the *Brown* case:

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90. In this paper the predecessors to § 351 will be referred to as [351] or [§ 351]. See note 5 *supra*.

91. 27 T.C. 27 (1956), *acq.*, 1957-2 CUM. BULL. 4.

92. "The installment contract in question was not intended to insure the partners a continued participation in the business of the transferee corporation, but was intended rather to effect a termination of such a continuing interest. We are aware of no decision in which an installment sales contract reserving title in the seller has been held to qualify as a security within the meaning of section 112(b)(5) of the Code, and respondent has cited none." Warren H. Brown, 27 T.C. 27, 36 (1956).

> The question . . . depends rather upon an over-all evaluation of the nature of the debt so as to ascertain whether or not the instrument issued evidences a continuing interest in the affairs of the corporation.[93]

The reasoning behind these cases is to classify an instrument as a security if it is in the nature of an investment, as opposed to an instrument used to facilitate a sale on credit because the corporation cannot make immediate payment in cash.[94] This reasoning caused the Tax Court to hold an installment contract payable in ten equal annual installments not to be a "security" as that term is used in section 351.[95]

The continuing interest doctrine seems to have developed from cases in which the transferors intended payment as soon as possible by the corporation.

In one such case, *Herff & Dittmar Land Co.*,[96] land was "sold" to a controlled corporation which promised to pay the transferor as soon as the land was sold. No written contract of sale was signed by the parties, but both parties reported the transaction as a sale on their tax returns. The land was later sold on an installment basis and payments were made by the corporation as it received the cash. The court held it was a valid "sale" and not a contribution to capital or a gift to the corporation. The court stressed the fact that the parties intended "immediate payment" and the adequate capitalization of the corporation.

Another similar case was *Hollywood, Inc.*,[97] wherein property was "sold" to a controlled corporation under a written agreement to make payment as soon as the property was resold. The Commissioner contended the transaction was a nontaxable exchange under section [351(a)]. The Tax Court held it was a "sale" because the parties intended payment as soon as possible and the corporation was adequately capitalized.

The "continuing interest" theory is still new and is difficult to apply. However, if accepted, as it seems to have been by the Tax Court, it may facilitate sales to corporations under installment contracts covering ten to twenty years when there is a lack of an overall investment intent. But if the taxpayer desires a taxable exchange by a sale on credit to the corporation, it would be wise to utilize short-term credit instruments and to main-

93. *Ibid.*

94. "[Security] denotes an obligation of a character giving the creditor some assured participation in the business of the debtor, or, in other words, an investment in the business, and . . . the term does not include evidences of indebtedness for short-term loans representing temporary advances for current corporate needs." Wellington Fund, Inc., 4 T.C. 185, 189 (1944).

95. Warren H. Brown, 27 T.C. 27 (1956).

96. 32 B.T.A. 349 (1935), *acq.*, XIV-2 CUM. BULL. 10 (1935).

97. 10 T.C. 175 (1948), *acq.*, 1948-1 CUM. BULL. 2.

tain a strict creditor attitude towards the corporation. The instruments should have a maturity date of less than five years and should be formally drawn.

3. CONTINUITY OF PROPRIETARY INTEREST

Common stock, preferred stock and evidences of indebtedness that qualify as securities may be allocated among the transferors in any ratio desired in a section 351 transfer.[98] But the participants may utilize the "continuity of proprietary interest" rule to effectuate a sale if one of the parties receives almost all securities and only a nominal amount of stock. This is a nonstatutory rule first enunciated by the courts at a time when the statute was quite vague on the subject, and the courts were compelled to distinguish for themselves between tax-free reorganizations and sales.[99] The theory was developed in the cases under the reorganization sections of the Code[100] which provide for tax-free exchanges. The equity owners of the corporate enterprise undergoing tax-free reorganization must retain a substantial proprietary interest in the continuing corporation immediately after the event.[101] The proportion must be evidenced by equity capital substantial in relation to the total consideration received by the old equity owners upon the exchange.[102] At present, the extent to which the courts might apply the "continuity of interest" doctrine as developed under the reorganization sections to section 351 exchanges is not known.[103] If strictly applied, the transferors of property would be required to receive a substantial amount of stock in relation to the securities received to prevent a taxable transaction. But if one of the transferors was to receive only securities and no stock, the transaction might fail to be nontaxable under section 351. Hence, it is arguable that a "sale" may be generated upon the

98. Disproportionate allocations may result in gifts, compensation, or satisfaction of obligations of the transferors. Treas. Reg. § 1.351-1(b)(1) (1961).

99. The doctrine was formally recognized in Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462 (1933), but more fully developed in subsequent cases. In one case, the transferor of property in a reorganization received only bonds and cash but no stock. The Supreme Court ruled that the transfer was a taxable transaction. Le Tulle v. Scofield, 308 U.S. 415 (1940). The Court's opinion makes it plain that a continuity of stock interest is necessary to prevent the recognition of gain or loss in a reorganization or nontaxable transfer.

100. INT. REV. CODE OF 1954, §§ 354-95. This theory is not derived from any specific language in the reorganization sections but rather it is 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." BITTKER, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 83 (student ed. 1959). See, *e.g.*, Le Tulle v. Scofield, 308 U.S. 415 (1940).

101. Helvering v. Minnesota Tea Co., 296 U.S. 378 (1935); L. & E. Stirn, Inc. v. Commissioner, 107 F.2d 390 (2d Cir. 1939). Subsequent Treasury Regulations required a substantial proprietary interest. Treas. Reg. § 1.368-1(b) (1955).

102. One writer has suggested a percentage of not less than 40%. MOLLOY, FEDERAL INCOME TAXATION OF CORPORATIONS 144 (1957).

103. BITTKER, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 123 (student ed. 1959).

transfer of property to a newly organized corporation if one person receives all stock and the other receives only securities.

The objectives of increasing the basis of property for depreciation and inventory purposes may also be obtained to some extent by a provision within the Code. Section 351(b),[104] known as the "boot" provision, allows a partially taxable transfer if property other than stock or securities is distributed by the corporation. This section provides that a gain shall be recognized but not in excess of "(A) the amount of money received, plus (B) the fair market value of such other property received." The gain recognized regulates the increase in the basis of the assets received by the corporation.[105]

If the property is being transferred to a going concern, the boot provision will accomplish essentially the same result as a completely taxable exchange. However, if the transfers are to a new corporation, the other property will generally be short-term notes and the same problems as discussed earlier arise.[106]

B. *Capitalization of the Corporation*

Many tax planners have utilized short-term obligations to effectuate a sale and the future tax-free withdrawal of funds from the corporation in the form of repayments of the debt.[107] Some incorporators have modified the sale by eliminating the issuance of any formal instruments and accepting the corporation's open-account promise to pay at a future time. But not all of these transactions have reached the haven of "sale" status. In appropriate cases, the Commissioner has successfully argued that the short-term obligations, although not securities, represent a contribution to capital, hence the obligations are actually stock under section 351(a).[108] Even if no formal instruments[109] are issued or if money or property is disbursed by the corporation to the incorporators, the Commissioner may utilize section 362(a)[110] to characterize the transaction as a contribution to capital and defeat the sale.[111]

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104. INT. REV. CODE OF 1954, § 351(b).
105. INT. REV. CODE OF 1954, § 362.
106. See discussion in text at note 79 *supra*.
107. In certain of the cases in the contribution to capital area, the credit instruments would appear to have the attributes of a security as that term is used in § 351(a). However the courts fail to discuss the security aspect. See, *e.g.*, Sun Properties, Inc. v. United States, 220 F.2d 171 (5th Cir. 1955), discussed in the text at note 143 *infra*.
108. See, *e.g.*, Houck v. Hinds, 215 F.2d 673 (10th Cir. 1954).
109. One court ruled it was not necessary for a stock certificate to be actually issued in order to constitute a person the owner of stock in a corporation. John C. O'Connor, 26 P-H Tax Ct. Mem. 182 (1957), *aff'd per curiam*, 260 F.2d 358 (6th Cir. 1958).
110. INT. REV. CODE OF 1954, § 362(a)(2).
111. See, *e.g.*, Herff & Dittmar Land Co., 32 B.T.A. 349 (1935), *acq.*, XIV-2 CUM. BULL. 10 (1935).

The "contribution to capital" contention may also present a serious stumbling block to incorporators who are willing to forego the benefits of a direct sale and accept "securities" as part or all of the consideration under section 351.[112] The Commissioner has successfully contended in numerous cases, to be discussed below, that the securities are not a true debt, but represent capital investment. The Commissioner's objective is twofold:

1. To prevent the tax-free withdrawal of funds from the corporation in the form of interest payments and repayments of loans.
2. To prevent the deduction of interest charges by the corporation.

All such withdrawals would be taxable as dividends to the incorporators and would be nondeductible by the corporation for income tax purposes.

The bulk of the cases which have considered the debt obligations to be equity capital have involved corporations having a high debt to capital investment ratio, commonly referred to as a thin capitalization. When the debt is held in proportion to stock holdings and the need for a greater amount of capital than was paid in for stock alone may reasonably have been anticipated, the debt paper may be classified as an equity investment.

1. RATIO TEST

The thin incorporation doctrine had its origin in the dictum of a Supreme Court opinion in which the Court referred to "extreme situations such as nominal stock investments and an obviously excessive debt structure."[113] Taking this dictum as a starting point, the courts began to strike down distorted ratios of debt to equity between the years 1946 to 1956.[114] Prior to this period the courts had concentrated upon the intent of the parties.[115] But the judiciary reasoned that a rule of construction, such as the ratio test, was necessary to bridge the gap between the incorporators' manifested intent and their unknown "true intent." Realistically, the courts were substituting an objective ratio guide to establish a set standard by which to determine whether the transferor has received an equity or a debt interest, irrespective of the parties' evidenced intent.[116]

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112. If the debt obligations are classified as "securities," the interest and installment payments will not be taxable as dividends and the interest payments will be deductible by the corporation.

113. John Kelley Co. v. Commissioner, 326 U.S. 521, 526 (1946).

114. The courts generally consider only debt held by stockholders. J. A. Maurer, Inc., 30 T.C. 1273 (1958); *but cf.* Lockwood Realty Corp., 27 P-H Tax Ct. Mem. 212 (1958); Isidor Dobkin, 15 T.C. 31 (1950), *aff'd per curiam*, 192 F.2d 392 (2d Cir. 1951). In the last two cases, the court did consider outside loans.

115. The corporations were being financed by security devices which were neither stock nor bonds, but a hybrid combination of both. The purpose was to obtain debt status for tax purposes but to retain sufficient characteristics of equity for business and corporate financing purposes. Commissioner v. H.P. Hood & Sons, 141 F.2d 467, 469 (1st Cir. 1944). See also Caplin, *The Caloric Count of a Thin Incorporation*, N.Y.U. 17TH INST. ON FED. TAX. 771 (1959).

116. Bittker, *Thin Capitalization: Some Current Questions*, 34 TAXES 830 (1956); Comment, 5 U.C.L.A.L. REV. 275 (1958).

Heavy reliance was placed upon the debt-equity ratio after 1946. It was objective and easy to use. Courts tended to use the fair market value of the net assets rather than par or book value of the stock.[117] If there was a high ratio of debt to equity the courts would conclude that *all* stockholder-held debt must be treated as part of the equity investment. Only a few cases recognized the validity of part of the debt.[118]

The Commissioner refused to articulate any criteria of an "excessive debt structure," but he did tend to acquiesce in cases involving a debt to equity ratio of four to one or less.[119] Relying upon this ratio, many practitioners advised their clients *deliberately* to use debt for tax minimization, so long as it was within these limits.[120] The former test of intent of the parties to create a valid debtor-creditor relationship was overwhelmingly subordinated to the ratio test and in many decisions was ignored.[121]

The use of a fixed ratio to segregate contributions to capital from corporate debt is subject to obvious criticisms. Corporations could pursue a purposeful tax avoidance scheme by utilizing a capitalization structure consistent with a fixed ratio. At the other extreme, no stockholder could safely advance money to his financially embarrassed corporation without the danger of having the Commissioner say, "he had no right to launch a corporate business without investing in it all the money it needed, and investing it in the way that is most disadvantageous to himself, both as relates to taxation and as to other creditors."[122]

2. TRUE INTENT TEST

In 1956, the courts began to evolve a new test in which the ratio test was one of many other factors which could cause debt obligations to be treated as stock. The foundation of the new test was the intent of the parties. In many respects this seemed to be a return to the test of the pre-ratio days. However, the courts were searching for something more than compliance with technical or clerical formalities to classify a hybrid security as a stock or as a security. Professor Caplin has referred to this "something more" as a search for the "substance" of the transaction.[123] The courts

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117. Miller's Estate v. Commissioner, 239 F.2d 729 (9th Cir. 1956); Kraft Foods Co. v. Commissioner, 232 F.2d 118 (2d Cir. 1956); Ainslie Perrault, 25 T.C. 439 (1955), *aff'd per curiam*, 244 F.2d 408 (10th Cir.), *cert. denied*, 355 U.S. 830 (1957); Gooding Amusement Co., 23 T.C. 408 (1954), *aff'd*, 236 F.2d 159 (6th Cir. 1956).

118. George J. Schaefer, 24 T.C. 638 (1955); J. Terry Huffstutler, 23 P-H Tax Ct. Mem. 1 (1953).

119. Ruspyn Corp., 18 T.C. 769 (1952), *acq.*, Rev. Rul. 303, 1956-2 CUM. BULL. 193.

120. See Warren H. Brown, 27 T.C. 27 (1956); Ainslie Perrault, 25 T.C. 439 (1955), *aff'd per curiam*, 244 F.2d 408 (10th Cir.), *cert. denied*, 355 U.S. 830 (1956).

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

122. Rowan v. United States, 219 F.2d 51, 55 (5th Cir. 1955).

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

now began to search for the "true intent" of the incorporators and ask such questions as: Need the shareholder have the mind of an outside creditor, ready to put the corporation in bankruptcy in the event of business difficulties? To what use will the funds contributed be put? What will be the source of repayment?

The case which marked the turning point from the ratio test was *Gooding Amusement Co.*,[124] in which the Tax Court examined the bona fides, genuineness and substance of the transfer rather than relying upon the ratio test. In this case a family partnership was incorporated and the former partners received stock and notes for their interests. The debt-equity ratio was about one to one.[125] The notes were held to be equity although they were normal both in form and amount because the taxpayer had no:

> intention at the time of issuance of the notes ever to enforce payment of his notes, especially if to do so would either impair the credit rating of the corporation, cause it to borrow from other sources the funds necessary to meet the payments, or bring about its dissolution.[126]

The factors relied upon by the Tax Court were:

1. Close family partnership
2. Partial payment almost entirely to the father alone
3. Subjection of the wife and daughter to control of the father
4. Heavy indebtedness due outside creditors
5. Default in payment of most stockholder notes
6. No obvious tax reason for creating the debt.

The decision was affirmed on appeal by the Court of Appeals for the Sixth Circuit which stated that the test was the real intention of the parties as based upon the findings of fact of the Tax Court.[127]

The conclusion is that extreme ratios may be harmful, but reasonable ratios may not be of much help. The substance and genuineness of the transfer will govern over a form based upon a reasonable ratio.[128]

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124. 23 T.C. 408 (1954), *aff'd*, 236 F.2d 159 (6th Cir. 1956), *cert. denied*, 352 U.S. 1031 (1957).

125. The stock had a stated value of $49,000 while the notes had a face value of $232,000. The ratio would appear to be 4.7 to 1. But the Tax Court required a reasonable value be attributed to goodwill which resulted in an adequate capitalization ratio of 1 to 1. Gooding Amusement Co., 23 T.C. 408, 419 (1954). See also Manly, *What To Do About the New Intent Test for Thin Incorporations; More on Gooding*, 5 J. TAXATION 379 (1956).

126. Gooding Amusement Co., 23 T.C. 408, 418 (1954).

127. Gooding Amusement Co. v. Commissioner, 236 F.2d 159, 166 (6th Cir. 1956).

128. Bittker believes the "finding of fact" referred to by the Sixth Circuit is based upon an irrebuttable presumption or inference drawn from the shareholder-corporation rela-

Another major case at this same period, which not only subordinated the ratio test but completely refused to follow it, was *Rowan v. United States*.[129] The test set out by the Fifth Circuit depended upon the intent of the parties, based upon all the relevant facts and circumstances.[130] An inference of capital investment may be drawn when the facts show:

> that the initial payments, both capital and advances, were all made for acquisition of capital assets . . . or the issuance of certificates of stock . . . ; or subordination [of the transferors' securities] to other indebtedness; or inordinately postponed due date; or agreement not to enforce collection; or provision for payment of "interest" only out of earnings; or payment of advances as initial funds to start the corporate life.[131]

The "true intent test" conforms more with the economic problems of financing a close or family corporation. Under the new test, it has become possible once more to engage the Commissioner in an open court battle to sustain the validity of a sale, even when there is a high debt-equity ratio.

In *Miller's Estate v. Commissioner*[132] three brothers organized a corporation with 1,030 dollars capital stock. The corporation subsequently purchased the assets of their partnership and gave an installment note for 86,000 dollars. The debt-equity ratio was approximately eighty-three to one. The Ninth Circuit upheld the transaction as a sale because of a purported business purpose to provide for the widow of a dying partner and allow continuity of the business. In regard to the thin capitalization the court stated:

> We know of no rule which permits the Commissioner to dictate what portion of a corporation's operations shall be provided for by equity financing rather than by debt. It is common knowledge that the choice of procedures in this regard will vary from corporation to corporation.[133]

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tionship, rather than a conclusion based on evidence. BITTKER, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 116 (student ed. 1959).

129. 219 F.2d 51 (5th Cir. 1955). In this case a husband and wife organized a corporation with $9,000 of capital stock. Subsequently they loaned the corporation $125,000 on open account. The ratio of debt to equity was 14 to 1. The Fifth Circuit held the open accounts to be a valid debt.

130. "Under Rowan's teachings, stockholders are free to invest capital in their corporation's obligations and to lend additional amounts to it in its operations, if that is their true intent, always reserving the right to share with other creditors in the distribution of assets if the corporate venture fails." Atlantic Acceptance Corp. v. Tomlinson, 58-2 U.S. Tax Cas. 69620 (S.D. Fla. 1958). *Cf.* Gounares Bros. & Co. v. United States, 185 F. Supp. 794 (S.D. Ala. 1960).

131. Rowan v. United States, 210 F.2d 51, 55 (5th Cir. 1955).

132. 239 F.2d 729 (9th Cir. 1956), *reversing* 24 T.C. 923 (1955).

133. *Id.* at 734.

The trend away from the objective ratio guide was also evident in *J. I. Morgan, Inc.*[134] In this case property was transferred to a corporation in exchange for stock and an installment note of 629,682.55 dollars. The transferor and son possessed an eighty per cent interest in the corporation. The debt-equity ratio was fifty to one. The Commissioner claimed the installment obligations represented stock, therefore payments on the notes were dividends as to both parties. The Tax Court held the transaction to be a *sale* and not a transfer under section [351(a)]. The court stated that a high debt-equity ratio is insufficient to justify treating the installment sales contract as evidence of equity capital. The court emphasized:

1. Title remained in the seller-shareholder which made his claim superior to the other creditors of the corporation.
2. The transferor insisted upon payments under the contract.
3. The note was given to equalize the transfer of assets in relation to the stock received by the transferor.

The *Gooding*[135] case was distinguished on the grounds that in *Gooding:*

1. Title was transferred to the corporation.
2. Stockholder claims were subordinated to the claims of other creditors of the corporation.
3. A majority of the notes remained unpaid long after maturity.
4. No valid business reason was given for the transferors taking short-term notes except to avoid taxes.

3. RISK OF THE BUSINESS

The tax court decisions since *Gooding* and *Rowan* have used a number of factors to evaluate the true intent of the incorporators.[136] The most important factor appears to be whether the transferred property has been placed at the "risk of the business." This minor test was developed primarily in the cases of *Sun Properties, Inc. v. United States*[137] and *Aqualane Shores, Inc. v. Commissioner.*[138] It rests upon the theory that if the incorporator knowingly transfers property to the corporation when the hope

134. 30 T.C. 881 (1958), *rev'd on other grounds,* 272 F.2d 936 (9th Cir. 1959).
135. Gooding Amusement Co., 23 T.C. 408 (1954).
136. Caplin, *The Caloric Count of a Thin Incorporation,* N.Y.U. 17TH INST. ON FED. TAX. 771, 807 (1959) sets forth the major factors as: risk of the business; permanent capital structure; acquisition of permanent assets; commencement of new business; expectation of repayment regardless of earnings or success; normal creditor safeguards; presence or absence of security; outside investor standard; use of formal debt instruments; intention to assert rights of creditor; intention or actions to enforce; pro rata advances; practical subordination; ratio; substantial economic reality; business purpose; real or true intent; substance v. form; sham. *Cf.* J. A. Maurer, Inc., 30 T.C. 1273 (1958); J. I. Morgan, Inc., 30 T.C. 881 (1958); Houguet Real Estate Corp., 30 T.C. 580 (1958); Leach Corp., 30 T.C. 563 (1958); Aqualane Shores, Inc., 30 T.C. 519 (1958), *aff'd,* 269 F.2d 116 (5th Cir. 1959); Harry F. Shannon, 29 T.C. 702 (1958); W. H. Truschel, 29 T.C. 433 (1957).
137. 220 F.2d 171 (5th Cir. 1955).
138. 269 F.2d 116 (5th Cir. 1959).

of repayment is substantially dependent upon the successful conversion of the property into income, then the transfer is in fact a contribution to capital and not a true debt. The cases require a reasonable expectation of repayment plus normal creditor safeguards before the debt will be recognized.

The *Sun Properties* case was a most unusual decision rendered by the Fifth Circuit involving a ratio of approximately 310 to 1. In this case, the corporation was organized with about 400 dollars stock outstanding. Subsequently, a warehouse was "sold" to the corporation by the sole shareholder. The sales price was 125,000 dollars which was to be paid off at 4,000 dollars semi-annually with no interest or down payment.[139] The district court[140] ruled the "sale" was actually a contribution to capital and denied the corporation the stepped-up basis of 125,000 dollars. The court reasoned that the transaction had no legitimate purpose except to reduce taxes. The decision was reversed on appeal in what may be termed "a real break" for the taxpayer.

The appellate court first held a "transaction must not be disregarded simply because it was not at arm's length."[141] The tax avoidance motive of the transferor should not have been considered evidence that a transaction is something different than what it purports to be nor did the lack of a business purpose invalidate the sale.[142] "No cases require that a *sale* have any business purpose beyond that of realizing a capital gain."[143]

The court reasoned that the installment sales contract represented a valid debt and not a contribution to capital. It is significant that the court refused to apply or discuss the "thin" capitalization. This case once again demonstrates that the "thin capitalization" doctrine is not applicable in the Fifth Circuit.[144] A more significant point is that the decision appears to discard "business purpose" and other tests of tax avoidance[145] in favor of saying a "sale" is always a "sale" for tax purposes.[146] Was the

139. No mortgage was required and the installments were to be made out of rentals. Sun Properties, Inc. v. United States, 220 F.2d 171, 172 (5th Cir. 1955).

140. Sun Properties, Inc. v. United States, 54-2 U.S. Tax Cas. 46373 (S.D. Fla. 1954).

141. George J. Staab, 20 T.C. 834 (1953), as cited in Sun Properties, Inc. v. United States, 220 F.2d 171, 174 (5th Cir. 1955).

142. The court cited Gregory v. Helvering, 293 U.S. 465 (1935) for the proposition that "a motive of tax avoidance will not establish liability if the transaction does not do so without it." Sun Properties, Inc. v. United States, 220 F.2d 171, 174 (5th Cir. 1955).

143. *Id.* at 175.

144. The court cited its decision in Rowan v. United States, 219 F.2d 51 (5th Cir. 1955) which rejects the ratio test in thin capitalization cases.

145. " 'The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted.' " Knetsch v. United States, 364 U.S. 361, 365 (1960), quoting Gregory v. Helvering, 293 U.S. 465, 469 (1935). Other cases permitting taxpayers to minimize their taxes: Montgomery v. Thomas, 146 F.2d 76 (5th Cir. 1944); Johnson v. Commissioner, 86 F.2d 710 (2d Cir. 1936); W.P. Hobby, 2 T.C. 980 (1943).

146. The Fifth Circuit seems to favor the *Sun Properties* decision. In Cowden v. Commissioner, 289 F.2d 20, 23 (5th Cir. 1961) this same court stated: "As a general

Fifth Circuit to allow form to govern substance in "sales" to controlled corporations?

The issues involved in *Sun Properties* soon arose again in the Fifth Circuit in *Aqualane Shores, Inc. v. Commissioner.*[147] In this case landowners organized a corporation for the purpose of subdividing and selling Florida realty. The shareholders subsequently "sold" to their corporation for 250,000 dollars the land which they had purchased the year before for 69,000 dollars. The corporation paid 9,000 dollars in cash, assumed an unpaid mortgage of 49,129 dollars and agreed to pay the balance of 191,871 dollars in five equal annual installments.

The Tax Court concluded that the transaction did not create a bona fide debt, but was in substance a transfer of land solely in exchange for stock under section [351(a)].[148]

The Fifth Circuit Court of Appeals affirmed, reasoning that the evidence tended to prove the transaction was a contribution to capital and not a sale. The court relied heavily upon the factor that payment of the obligations "was dependent upon and at the risk of the success of the venture. The obligations were a participation in the pot luck of the enterprise."[149]

The taxpayer argued vigorously that his case was on "all fours" with the *Sun Properties* decision and apparently it was. But the Fifth Circuit was not prepared to give the taxpayer another "break." Rather than overrule that case, the court chose to distinguish it on the grounds that in *Sun Properties* the income from the property transferred was sufficient to pay the obligations retained by the transferor without risk to the capital assets. In the instant case the assets transferred were not income producing and the security of the obligation was dependent upon the success or failure of the corporate enterprise. Therefore, "the contract obligations clearly represented risk capital."[150]

This distinction as to the source of payment was followed in *Bruce v. Knox,*[151] wherein a corporation was formed to subdivide and sell land. The sole shareholder "sold" the land to the corporation under an installment sales contract payable over a ten-year period. The Commissioner claimed that interest and installment payments received by the transferor-shareholder constituted dividend income and that the transfer of the property was a contribution to the capital of the corporation. The district court upheld

rule a tax avoidance motive is not to be considered in determining the tax liability resulting from a transaction."

147. 269 F.2d 116 (5th Cir. 1959).

148. Aqualane Shores, Inc., 30 T.C. 519 (1958).

149. Aqualane Shores, Inc. v. Commissioner, 269 F.2d 116, 119 (5th Cir. 1959).

150. *Id.* at 120.

151. 180 F. Supp. 907 (D. Minn. 1960).

the Commissioner stating that one of the controlling factors was the anticipated source of the payments to the stockholder. The court citing *Aqualane Shores* held that payment to the transferor depended upon the success or failure on the sale of the lots by the corporation; hence, the transaction was one of participation in the "risk of the business."

Aqualane Shores was also relied upon in *Harkins Bowling, Inc. v. Knox*,[152] wherein the court stated the issue to be "whether the funds were advanced with reasonable expectations of repayment regardless of the success of the venture or were placed at the risk of the business."[153] The district court ruled that the transfer of property was a contribution to capital rather than a sale since payment was dependent upon the business success of the transferred property. The Tax Court has also sustained the sale in a similar case, stating that "the property was not placed at risk of the business."[154]

Several other cases have relied upon or noted the "risk" doctrine under which the court looks to the underlying source of payment to ascertain if the transaction falls within the contemplation of section 351.[155] The "risk" doctrine is distinguishable from the mechanical "ratio" test of the thin incorporation cases since the "risk" approach is not bound by a debt-equity ratio examination.[156] A strict application of this doctrine would require "boot" in the form of short-term notes in an adequately capitalized corporation to be treated as "risk capital."[157]

Several courts have used this criterion of whether the funds were intended to be at the risk of the business, but it does not seem to be justifiable. Every business loan, whether from a professional lending institution or from one of the stockholders, will be at the risk of the business. Predicating risk of the business upon the source of repayment seems to be an even more unwarranted extension of this theory.

Several legal advisory committees have suggested definitions and standards to distinguish indebtedness from equity. However, they are most unsatisfactory since they only seek to reduce federal revenues and guarantee results for various stockholders' maneuvers.[158]

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152. 164 F. Supp. 801 (D. Minn. 1958).
153. *Id.* at 805.
154. J. I. Morgan, Inc., 30 T.C. 881, 891 (1958).
155. Camp Wolters Enterprises, Inc. v. Commissioner, 230 F.2d 555 (5th Cir. 1956); Rufus F. Turner, 30 P-H Tax Ct. Mem. 518 (1961); Truck Terminals, Inc., 33 T.C. 876 (1960); J. I. Morgan, Inc., 30 T.C. 881 (1958).
156. One case seems to require a thin capitalization when applying the "risk" theory. Wilshire & Western Sandwiches, Inc. v. Commissioner, 175 F.2d 718 (9th Cir. 1949).
157. The risk doctrine may also be invoked to classify debt obligations under § 351(a) as securities. The issued obligations may clearly represent a debtor-creditor relationship but still be "an integral part of the pot luck no pay no cure plan, formed before incorporation . . . ." Camp Wolters Enterprises, Inc. v. Commissioner, 230 F.2d 555, 559 (5th Cir. 1956) (discussed in text at note 86 *supra*).
158. For an excellent discussion see Rochler, *Transfers to Controlled Corporations: Consideration of Thinness and Multiplicity*, 39 TAXES 1078, 1092 (1961). In this article

Because of the tax avoidance motives of many incorporators, the Commissioner has refused to issue additional tax rulings on:

1. Thin capitalization questions;[159]
2. The tax-free character of an exchange involving issuance of stock plus substantial amounts of bonds or certificates of indebtedness;[160]
3. Questions involving transfers of "know-how" of a domestic corporation to a foreign corporation for stock;[161]
4. Simultaneous transfers of appreciated stocks or securities into a mutual fund, or transfers of appreciated real properties into a real estate investment trust.[162]

At the present time, it would be hazardous for one to set forth what the standards should be for the conversion of debt into equity. The cases are in a state of flux with the government moving steadily in the direction of obliterating the term "securities" under section 351 and treating it as the equivalent of stock. Perhaps the Supreme Court will grant certiorari on a section 351 transaction and set the standards for the conversion of debt into equity in the near future.

III. Related Tax Considerations

The taxpayer should beware of excess concentration upon any one section of the Internal Revenue Code. Many other tax factors must be taken into consideration in analyzing the related tax effects of a sale and section 351.

A. *Asset Analysis*

The application of section 351 is mandatory if the transfer of property is for stock or securities.[163] The transferor can only avoid the nontaxable

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the author summarizes three proposed definitions. The American Law Institute has suggested the following elements for a definition of indebtedness under thin corporation situations: (1) an unconditional obligation to pay a sum certain in money; (2) maturity on or before a fixed date; (3) issuance for adequate consideration or as a dividend; (4) no subordination to trade creditors generally; (5) no voting rights, except on default; (6) interest payments to be independent of earnings. ALI Fed. Income Tax. Stat. § X500(9) (Feb. 1954 Draft). The American Bar Association has suggested about the same criteria and sets forth a ten to one ratio as a maximum limit of safety. ABA Section of Taxation, Legislative Recommendations in Respect of the Provisions of Subchapter C, proposed § 317(c). The Subchapter C Advisory Group's recommendations differ in the following aspects: (1) maturity dates must not be "unreasonably distant"; (2) interest must not be excessive; (3) obligations must be incurred "under circumstances which do not negative any reasonable expectation of payment"; (4) the debt side of the ratio shall include loans guaranteed by shareholders as well as made by them; (5) the obligations may arise through a dividend; (6) a safe ratio of five to one. Advisory Group on Subchapter C, Revised Report on Corporate Distributions and Adjustments (1950).

159. Rev. Proc. 60-6, §§ 3.01-.15, 1960-1 Cum. Bull. 880.

160. Announcement 61-31, 1961 Int. Rev. Bull. No. 13, at 21.

161. *Ibid.*

162. *Ibid.*

163. Aqualane Shores, Inc. v. Commissioner, 269 F.2d 116 (5th Cir. 1959); Camp

result by showing a valid "sale" as discussed in the preceding cases. If the transferor is unable to come within the rules and principles of these cases, the transaction must fall within section 351. But even under this section, much planning may be utilized to minimize taxes. Before incorporation the transferor should carefully study the tax consequences of transferring each type of asset. Some suggestions are: (1) retain property which would be sold shortly after incorporation (avoids double taxation if proceeds are to be distributed as dividends); (2) withhold installment obligations since the transfer could cause acceleration of the deferred profit;[164] (3) assets with a high basis but with a low market value could be sold and the loss offset on the transferor's personal return (the cash received could be transferred to the corporation); (4) retain bonds because of double taxation (stocks may be transferred because of the corporate eighty-five per cent credit as provided by section 243 of the Internal Revenue Code of 1954); (5) consider using a lease or a licensing agreement for the property.

B. *Section 1239*

Assuming the taxpayer is able to satisfy the requirements for making a "sale" to a controlled corporation either on credit or for cash, part of the tax advantages may be blocked by section 1239.[165] This section was enacted to restrict the practice of selling depreciable property to a controlled corporation in order to step-up the basis of the property at the cost to the transferor of a capital gains tax.[166]

The section applies to a sale between the corporation and an individual owning more than eighty per cent of the outstanding stock. Any stock owned by the transferor's spouse, minor children and minor grandchildren will be attributed to the transferor.[167] This attribution rule is not as broad or inclusive as the attribution rules under other sections of the code.

The section applies only to depreciable property, hence land,[168] intangibles (patents[169] or goodwill[170]), or inventory[171] would still be subject to capital gains treatment.

Wolters Enterprises, Inc. v. Commissioner, 230 F.2d 555 (5th Cir.), *cert. denied*, 352 U.S. 826 (1956); Houck v. Hinds, 215 F.2d 673 (10th Cir. 1954).

164. Section 351 is not listed under the exception to INT. REV. CODE OF 1954, § 453(d). But under the 1939 Code the Commissioner did not require recognition of the deferred gain. It is not known if this practice will be continued under the 1954 Code. Treas. Reg. 118, § 39.44-5 (1953).

165. INT. REV. CODE OF 1954.

166. The abuse that section 1239 was directed against was the technique of converting ordinary income into long-term capital gain. H.R. REP. No. 586, 82d Cong. 1st Sess. 26-27 (1951).

167. The attribution rule applies to both legal and equitable interests. Calvin D. Mitchell, 35 T.C. 550 (1960).

168. Jack L. Easson, 33 T.C. 963 (1960).

169. Royce Kershaw, 34 T.C. 453 (1960).

170. George W. Staab, 20 T.C. 834 (1953).

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

C. *Security Analysis*

The transfer may fail to attain "sale" status, yet the taxpayer may win a major battle by having the instruments classified as securities rather than stock. The advantages of this are that interest is deductible by the corporation whereas dividends are not, and the payments on the debt are not taxable to the stockholder as dividends. The tax orientated stockholder will plan wisely if he foresees that the "sale" cannot be accomplished.

It has been suggested that certain procedures be utilized in maintaining a debtor-creditor relationship between the stockholder and his controlled corporation.[172]

1. Material amounts should be invested in the equity;
2. Utilize a realistic debt structure with a normal business flow;
3. Design the debt instruments to be clear and unambiguous;
4. If possible, the indebtedness should be secured;
5. Maintain business formalities on all corporate records;
6. Identify the consideration on exchange of assets;
7. Avoid pro rata lending;
8. Borrow in stages;
9. Use different types of indebtedness instruments;
10. Maintain a valid business purpose;
11. The creditors should exercise a reasonable expectation of payment;
12. Avoid a high debt-equity ratio.

CONCLUSION

The lure of "Pandora's box" in the form of capital gains has resulted in extensive tax litigation under section 351. Congress has taken away part of the capital gains incentive by section 1239, but this section does not apply to land or inventory assets. The added pressure of strict "dealer"[173] provisions has caused many investors, who must subdivide a large tract to liquidate their investment, to attempt a "sale" of the tract to their controlled corporation, thereby realizing their paper profits at capital gains rates.

Property may be "sold" to a controlled corporation for credit obligations under certain conditions. No stock or traditional type securities may be received. The credit obligations should be of the short-term variety and lack any aspect of an investment purpose. A valid debtor-creditor relation-

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172. Caplin, *The Caloric Count of a Thin Incorporation*, N.Y.U. 17TH INST. FED. TAX. 771 (1959).
173. INT. REV. CODE OF 1954, § 1237.

ship should be maintained at all times. The capitalization of the corporation should be fairly balanced unless a valid business purpose may be given for a high debt-equity ratio. But one is advised to proceed cautiously in this area since the Commissioner is moving in the direction of merging short-term obligations and securities within the scope of section 351 into contributions to capital. The simple yet hazardous nature of section 351 is well illustrated by the following satire.[174]

When one speaks of fine China
it brings to mind Spode.

In like case stands Section
351 to the Revenue Code.

Concise in its brevity, seemingly
clear as a bell,

If it fits your transaction
all will be well.

It's devious, dextrous, spotty
but sporty,

A section young at heart,
though chronologically forty.

Its rolling tax-free phrases
have endeared it to the nation,

While also clogging courts
with perennial litigation.

So here's to 351's controlling
transferors.

As long as they dominate companies,
they cannot (professionally speaking)
be absolute bores.

JOHN B. WHITE

174. Richard Boude as quoted by Rockler, *Transfers to Controlled Corporations: Consideration of Thinness and Multiplicity*, 39 TAXES 1078 (1961).