Summer 1966

Problems in the Tax-Free Incorporation of a Business

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Section 351 is the provision of the Internal Revenue Code of 1954 that accords nonrecognition treatment to gain or loss realized upon the incorporation of a business.\(^1\) In one form or another, this provision has been a part of our tax laws since the Revenue Act of 1921. Nevertheless, while many areas of its construction are settled, serious interpretative problems remain. This paper will consist of a brief review of those aspects of the application of section 351 which have become clear and an examination of some of the issues still to be resolved.

**INTRODUCTION**

Technically speaking, the transfer of assets to a corporation upon its formation constitutes an exchange of one class of property (the transferred assets) for another (the stock or securities issued by the transferee), a transaction which normally is taxable. Yet, even prior to the Revenue Act of 1921, the Treasury Department concluded that incorporation exchanges were mere formalities and should not be subject to tax.\(^2\) There was doubt, however, whether the Treasury's approach would be accepted by the courts.\(^3\) Consequently, in 1921, Congress decided to deal with the matter by statute.\(^4\)

Section 202(c)(3) of the Revenue Act of 1921, the earliest counterpart of section 351 of present law, provided, in pertinent part, that no gain or loss shall be recognized—

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The opinions expressed herein are those of the author and do not necessarily represent the views of the Treasury Department or any agency thereof.

\(^2\) Section 351 also may apply to the transfer of property to an existing company controlled by the transferor. For the sake of convenience, however, the discussion herein will focus principally upon the formation of a corporation. Unless otherwise indicated, all references to the Code or to the Internal Revenue Code are to the *Internal Revenue Code of 1954*, as amended, and all sectional references are to provisions thereof.

\(^3\) See Article 1566 of Regulations No. 45, promulgated under the Revenue Act of 1918. The Treasury subsequently decided that its view was not warranted in law and Article 1566, first authorized on April 17, 1919, was modified on September 26, 1919 to hold such exchanges taxable.

\(^4\) Indeed, the courts ultimately concluded that exchanges of this kind were taxable. See *e.g.*, Jefferson Livingston, 18 B.T.A. 1184 (1930) and the cases cited therein.

\(^4\) The House Ways and Means Committee recommended that nonrecognition treatment be granted for incorporation, reorganization and certain other types of exchanges to "permit business to go forward with the readjustments required by existing conditions" and to prevent "taxpayers from taking colorable losses in wash sales and other fictitious exchanges." See H.R. Rep. 350, 67th Cong., 1st Sess. 10 (1921). The Senate Finance Committee added that such treatment would eliminate "many technical constructions which are economically unsound." See S. Rep. 275, 67th Cong., 1st Sess. 12 (1921).
Where (A) a person transfers any property, real, personal or mixed, to a corporation, and immediately after the transfer is in control of such corporation, or (B) two or more persons transfer any such property to a corporation, and immediately after the transfer are in control of such corporation, and the amounts of stock, securities, or both, received by such persons are in substantially the same proportion as their interests in the property before such transfer.\(^5\)

This provision has been modified in some respects since 1921. The "proportionate interest" requirement has been dropped from the statute and Congress has codified the judicial rule that stock or securities issued for services do not qualify for tax-free treatment.\(^6\) But the basic pattern has remained largely the same.

Section 351, as it has finally evolved, requires that property be transferred in exchange for stock or securities and that the transferor (or transferors) be in control of the corporation immediately after the transfer. If these requirements are met, no gain or loss is recognized on the exchange and the tax basis of the transferred assets in the hands of the transferor carries over in the hands of the corporation and becomes the tax basis of any stock or securities issued therefor.\(^7\) On the other hand, if the statute is not satisfied, gain or loss is recognized but both the transferred assets and any consideration received in return acquire a tax basis equal to their fair market value at the time of the transfer.\(^8\)

In the discussion which follows we will consider first the construction given to the major statutory elements of section 351: the requirement that property be transferred, that there be an exchange for stock or securities, and that the transferors be in control immediately after the transfer. Thereafter, we will turn to the question whether section 351

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5. Control was defined by this provision as the ownership of at least 80 percent of the voting stock and at least 80 percent of the total number of shares of all other classes of stock of the corporation. The definition of control under present law differs slightly. See text accompanying note 32 infra.

6. Both of these changes were made in 1954. With regard to the proportionate interest test, see Hoffman, *The Substantial Proportionate Requirement of Section 112(b)(5)*, 5 Tax L. Rev. 235 (1950) and compare Mather & Co. v. Commissioner, 171 F.2d 864 (3d Cir.), *cert. denied*, 337 U.S. 907 (1949) with Bodell v. Commissioner, 154 F.2d 407 (1st Cir. 1946).

7. With respect to the basis of the transferred assets, see § 362(a). With respect to the basis of the stock or securities issued to the transferor, see § 358(a). If property other than stock or securities is received in the exchange, gain is recognized to the extent of the fair market value of such other property and the basis of the assets transferred to the corporation is adjusted accordingly. See § 351(b) and the last clause of § 362(a). On the question whether an assumption of liabilities by the corporation constitutes the receipt of "other property" by the transferor, see § 357.

8. See §§ 1001-02, 1012.
applies where its requirements literally are met but the transaction is con-
trived to avoid taxes. Finally, we will consider the interrelation of sec-
tion 351 and a number of other provisions and judicial doctrines which,
if applied upon incorporation, would result in the recognition of gain or
loss.

THE STATUTORY REQUIREMENTS

A. The Requirement That Property Be Transferred

To qualify for tax-free treatment, the item or items transferred to
the controlled corporation must constitute property. In the usual
situation, this term is accorded its commonly accepted meaning and no
interpretative problems are presented. However, as already indicated,
stock or securities issued for services are not considered to be issued in
return for property. Instances may arise in which this distinction be-
tween property and services will prove troublesome.

The most difficult case conceptually is presented where stock or se-
curities of a controlled corporation are issued in return for technical
know-how, such as processes, formulae, designs, drawings, technical
records and manuals, the details of work procedures, training material,
etc. Recently, after a study of the question, the Internal Revenue Service
published Rev. Rul. 64-56 setting forth its views on the extent to which
such items were to be regarded as property for purposes of section
351.

Under this revenue ruling, an item will be classified as property
rather than services if it constitutes a secret process or device within the
meaning of sections 861(a)(4) and 862(a)(4) of the Code or other se-
cret information as to a device, process, etc., in the general nature of a
patentable invention, without regard to whether a patent has been applied

9. Cf. Pillar Rock Packing Co. v. Commissioner, 90 F.2d 949 (9th Cir. 1937) which,
in holding accounts receivable to be property for purposes of the reorganization provi-
sions, commented that "the word [properties] must be taken in its ordinary sense, and
as it is a comprehensive word, it includes accounts receivable. If Congress had intended
to restrict the meaning of the word, it would have done so." It has sometimes been sug-
gested that the accounts receivable of a cash basis taxpayer should not be considered
property for purposes of § 351. However, the problems presented by cash basis receiv-
able may better be explored in the light of other tax doctrines. See text accompanying
notes 60-69 infra. On the question whether money constitutes property, see G.C.M. 24415,
1944, Cum. Bull. 219, revoking G.C.M. 2862, VII-1 Cum. Bull. 161, and e.g., Halli-
burton v. Commissioner, 78 F.2d 265 (9th Cir. 1935).

10. This rule is set forth in the last sentence of § 351(a). Although a contract for
the rendition of services ordinarily might be regarded as property, the regulations under
this provision provide that both services rendered and services to be rendered to or for

11. 1964-1 (Part I) Cum. Bull. 133. Since transfers of know-how most often are
made to a foreign corporation the revenue ruling is framed in those terms, although it
would seem to be equally apt where the transferee is a United States company.
for or whether it is patentable in the patent law sense.\textsuperscript{12} Other information which is secret will be given consideration as "property" on a case-by-case basis. Apparently, the know-how need not be embodied in a writing in order to constitute property, but on the other hand, the mere recording of information on paper or some other physical material is not in itself to be regarded as an indication that the information is property.\textsuperscript{13} For purposes of the revenue ruling it is assumed that the country in which the transferee is to operate affords substantial legal protection against the unauthorized disclosure and use of the secret information involved.

Once it is established that property has been transferred, the transfer will be tax-free even though services were used to produce the property. The revenue ruling considers this to be the case where the transferor developed the property primarily for use in its own manufacturing business. On the other hand, it is pointed out that where information has been developed specially for the transferee, the stock or securities received in exchange for it may be treated as payment for services rendered. Where services are to be performed in connection with the transfer of property, a reasonable allocation will have to be made between services and property unless the services are merely ancillary and subsidiary to the property transfer such as, for example, assistance in the "starting up" of the property transferred.\textsuperscript{14}

Rev. Rul. 64-56 and the criteria which it announces have been criticized on a number of grounds. The question has been raised whether a distinction can validly be drawn between secret information in the general nature of a patentable invention and other secret information\textsuperscript{15} and, indeed, doubt has been expressed whether secrecy should be regarded as an essential element of property in any event.\textsuperscript{16} Conditioning the ruling on the adequacy of legal protection against disclosure in the country of operation and, hence, requiring that the taxpayer prove that such protection exists, also has been subject to attack.\textsuperscript{17} Moreover, criticism has

\textsuperscript{12} Cf. E.I. duPont deNemours v. United States, 288 F.2d 904 (Ct. Cl. 1961).
\textsuperscript{13} The ruling cites as authority for this proposition, Harold L. Regenstein, 35 T.C. 183 (1960), a case said by one commentator to provide it with dubious support. See Cohen, \textit{Long- awaited Ruling on Transfer of Know-how Sets Guidelines in Important Areas}, 21 J. Taxation 38 (1964).
\textsuperscript{14} Rev. Rul. 64-56, 1964-1 CUM. BULL. 133, also contains a discussion of the circumstances under which the transfer of know-how constituting property will be regarded as a mere licensing arrangement rather than an exchange under § 351.
\textsuperscript{15} See Cohen, \textit{supra} note 13.
\textsuperscript{17} See McClure, \textit{Reorganizations and Distributions Involved in U.S. Taxation of
been leveled at the manner in which the Service has administered its rulings program in this area. Whether the Service will change its policy remains to be seen.

B. The Requirement That There Be an Exchange of Stock or Securities for the Property

A transfer of assets to a controlled corporation may be tax-free under section 351 only if the consideration received in exchange constitutes stock or securities. In the past, this requirement that there be an exchange of stock or securities for the transferred assets was applied in a relatively mechanical fashion. The principal interpretative problem was the meaning of the term "securities" and, while the courts were somewhat elusive about laying down a test based on the time period of the note, it generally was thought that a note with a term of five years or more probably would qualify as a security and that a note with a shorter term probably would not. Beginning with the Sun Properties case, however, the law has become decidedly less clear.

Where property is transferred to a controlled corporation in return for long-term debt obligations of the transferee, it is possible, in construing section 351, either to apply the statute on an objective basis and hold that it governs in all such cases or to look to the intent of the transferor to determine whether such a transfer is to be regarded as a nontaxable capital contribution or a taxable sale. At least one commentator has suggested that section 351 should be construed literally and that any examination into the intention of the parties is unnecessary and improper. Nevertheless, recent cases indicate that the courts have adopted the sale-capital contribution distinction.

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Foreign Activities and Income, Tax Executive, July 1963, written prior to the issuance of Rev. Rul. 64-56, supra note 14.
19. See e.g., Camp Wolters Enterprises, Inc. v. Commissioner, 22 T.C. 737, 751 (1954), aff'd, 230 F.2d 555 (5th Cir.), cert. denied, 352 U.S. 826 (1956), where the Tax Court commented that "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.". In Camp Wolters, notes maturing in from five to nine years were held to be securities. Cf. Neville Coke & Chemical Co. v. Commissioner, 148 F.2d 599 (3d Cir. 1945), cert. denied, 326 U.S. 726 (1945) (three-, four-, and five-year notes not securities).
20. 220 F.2d 171 (5th Cir. 1955).
Having drawn this distinction, however, it becomes necessary to lay down criteria for determining whether a particular transfer falls into one category or the other. The decisions in this area refer to a variety of factors to be taken into account in making this determination. But little indication is given of the weight to be assigned to these elements and, consequently, it is difficult to predict what the result in a particular case might be. Nevertheless, some pertinent observations can be made.

Typically, the case with which we are concerned involves the formation of a corporation with a relatively nominal amount of capital and the transfer of business property to it in return for installment notes. In deciding whether a sale or a capital contribution is involved, the courts have considered whether the corporation would have been undercapitalized without the transferred assets, whether these assets generated sufficient income to cover payment of the notes or whether payment was dependent upon the future success of the business, whether title to the assets was reserved to the seller as security, and whether the transferor intended to collect the notes regardless of the effect on the corporation's financial position. However, even though an evaluation of these factors might indicate that a capital contribution had been made, the courts have found a sale whenever a valid business purpose has been deemed to exist for engaging in such a transaction. Similarly, the transfer has been held to be a sale where such was determined to have been intended notwithstanding the presence of signs to the contrary.

To the extent that it is possible to extrapolate from these decisions rules for disposing of future cases, the stress placed by the courts on the presence or absence of a valid business purpose and on the intention of the parties suggests that where property is transferred in return for debt

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23. The sale-capital contribution distinction generally is put in issue by a dispute over the basis of the transferred property, the corporation claiming a stepped-up basis and the Commissioner maintaining that § 351 applies and the basis of the transferor is carried over. See e.g., Charles E. Curry, supra note 22. However, the question also may be raised in determining the proper treatment to be given to amounts paid to the transferor on the installment notes, with the Commissioner contending not only that § 351 is applicable but that the corporation is so thinly capitalized that the notes actually represent equity and the payments dividends. See e.g., Burr Oaks Corp., 43 T.C. 635 (1965). For another context in which this issue may arise, see Harry F. Shannon, 29 T.C. 702 (1958).


27. See e.g., Marsan Realty Corp., T.C. Memo 1963-297.

28. See e.g., Warren H. Brown, supra note 22; Est. of Miller v. Commissioner, 239 F.2d 729 (9th Cir. 1956), rev'd, 24 T.C. 923 (1955).

29. See e.g., Harry F. Shannon, supra note 23; Evwalt Development Corp., T.C. Memo 1963-251.
obligations of the controlled corporation, section 351 ultimately could become in effect an elective provision. If a transferor wanted this section to apply, he could cause the corporation to issue bonds for his property and document the transfer as a capital contribution. On the other hand, if he wished to avoid the application of this section, he might take back installment notes and frame the transaction as a sale. Since there is nothing in the legislative history of section 351 to indicate that it was intended to be optional, there would seem to be some merit to the suggestion that the statute should be construed on an objective basis and applied whenever property is transferred to a controlled corporation for long-term debt indebtedness. But such an approach presents problems of its own.

The principal difficulty with the objective test is that it would seem to treat as a transferor any person transferring property to the corporation at the time of its formation in return for long-term indebtedness, whether or not such person intended to become an investor in the enterprise. For example, if at the time the corporation was organized, it went into the market and purchased machinery on the installment basis or real estate subject to a purchase money mortgage, the seller might be regarded as one of the principals of the company and the purchase deemed a capital contribution. The purpose of the transaction and the intent of the parties must be taken into account if such an untoward result is to be avoided. Hence, the Revenue Service, taxpayers, and ultimately the courts seem destined to continue their struggle with the sale-capital contribution distinction.

C. The Requirement That the Transferors Be in Control Immediately after the Transfer

The transfer of property to a corporation in exchange for its stock or securities can come within section 351 only if the corporation is controlled by the transferor or transferors immediately after the exchange. For this purpose, control is defined as the ownership of stock representing 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 each class of nonvoting stock of the corporation. The aspect of this "control" requirement most often brought into issue is whether the requisite control existed immediately after the exchange. The law in this area is far from clear and for every principle that can be derived

30. In fact, the comment in the Committee Reports with respect to preventing taxpayers from taking colorable losses on fictitious exchanges suggests quite the contrary.
31. See the discussion of this point in Charles E. Curry, supra note 22, at 697.
from the cases, there seems to be at least one contrary holding. Subject to this reservation, however, it is possible to set forth some guidelines of general application.

Where the transferors dispose of sufficient stock after the exchange to bring their interest below the 80 percent level, it is more or less certain that the requisite control will be deemed to be present if the stock is disposed of by means of a gift but not if the shares are sold pursuant to an unconditional obligation to do so entered into before the transfer. Apparently, control will not be lost where the transferors had a prior intention to sell shares but were under no commitment to do so, where there was an agreement to sell which was subject to contingencies or which represented merely an undertaking by underwriters to use their best efforts to dispose of the transferors’ shares, or even, it would seem, where there was a pre-existing obligation to sell but not until a date occurring a substantial period of time in the future. But section 351 will not apply where the shares are sold pursuant to a firm underwriting commitment entered into before the transfer.

Recently, the question has arisen whether “control” means something more than 80 percent ownership; whether in the light of the legislative history of section 351, it also presupposes a group identity and concerted activity by the transferors. The question principally is presented by the creation of so-called Centennial-type funds organized to secure tax-free greater diversification of investments. Under a Centennial-type arrangement, holders of appreciated securities convey their stock to an escrow agent who holds the shares until a specified date, at which time the escrow agent transfers the securities it has received to a newly formed corporation and distributes the shares of the new corporation issued in exchange to the investors. The new corporation then qualifies as a mutual fund. As a result of this transaction, the investors

34. E.g., Bassick v. Commissioner, 85 F.2d 8 (2d Cir. 1936), cert. denied, 299 U.S. 592 (1936).
35. E.g., Scientific Instrument Co., 17 T.C. 1253 (1952), aff’d per curiam, 202 F.2d 155 (6th Cir. 1953).
38. E.g., Overland Corporation, 42 T.C. 26 (1964), vacated and remanded on another issue, 316 F.2d 777 (6th Cir. 1965).
39. For a description of the mechanics of creating such a fund, see Chirelstein, Tax Pooling and Tax Postponement—The Capital Exchange Funds, 75 Yale L.J. 183 (1965) [hereinafter referred to as Chirelstein].
40. More specifically, the corporation is operated so as to come within the definition of a regulated investment company set forth in § 851. A corporation which meets these tests is not taxed on income which it distributes currently, provided that the bulk
will have converted their direct interest in a single block of securities into an undivided interest in a diversified investment portfolio.

Although such a transaction can be tailored to meet the specific requirements of section 351, a number of arguments have been advanced for holding the transfer to the fund taxable. One of the major contentions along these lines is, as has been suggested, that the statute presupposes that the transferors are acting together in furtherance of a common enterprise and that such unity of purpose is lacking in a Centennial fund situation. In a recent article in the Yale Law Review, Professor Chirelstein of Rutgers University expressed strong doubts as to the merits of this position. He suggested that to require a group identity among the transferors in the sense of a prior acquaintanceship or association would be to limit section 351, contrary to the history of that provision, to the formation of closely-held corporations. He also pointed out that concerted behavior is present in the Centennial-type arrangement, although as a result of promoter activity rather than investment initiative, because under the agreement with the escrow agent each investor is afforded an opportunity prior to formation of the fund to review the fund's portfolio and either to continue to participate or withdraw. Nevertheless, despite Professor Chirelstein's analysis, the thought persists that section 351 should apply only where a group of persons bands together to pursue a common venture and not where each is acting in furtherance of his own aims albeit under a single roof.

BUSINESS PURPOSE AND RELATED CONCEPTS

To be tax-free, a corporate merger or other corporate reorganization must not only comply with the governing statute but must have a valid business purpose in the sense that there must be a reason for the transac-

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of its income for the year is so distributed. In addition, capital gains distributed by such a corporation may retain their character as such in the hands of the shareholders. See § 852.

41. See generally, Chirelstein supra note 39. On July 14, 1966, the Internal Revenue Service announced publication of a proposed amendment to the regulations under section 351, holding that provision inapplicable to the formation of Centennial-type funds. See Technical Information Release, No. 832, July 14, 1966. See also Technical Information Release, No. 843, August 16, 1966, relating to the effective date of this change. Previously, the Internal Revenue Service had announced, without comment on the substantive issues involved, that it would not rule in advance on the question whether the formation of a Centennial-type fund is tax-free. See Technical Information Release, No. 311, March 3, 1961, modifying Technical Information Release, No. 303, February 9, 1961. See also Technical Information Release, No. 312, March 13, 1961.

42. Chirelstein, supra note 39, at 193-94.
43. Ibid.
44. Ibid.
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tion other than tax avoidance. However, it has never been entirely clear to what extent this “business purpose” test is applicable under section 351. For example, assume that an existing company wishes to acquire appreciated property from an individual in exchange for stock representing less than 80 percent of its shares. If the transaction were carried out in this fashion, the transferor would not be in control immediately after the transfer, section 351 would not apply, and any gain on the exchange would be taxable.

Assume, instead, that a new corporation was organized, that the individual conveyed his property to it in return for some of its stock, and that at the same time, the existing company transferred all of its assets to the new entity for the remainder of its shares, the stock received in the exchange being distributed by the former in liquidation. Now, both the individual and the existing company would be regarded as transferors for purposes of section 351, the requisite control would be present, and the literal requirements of this provision would be met. But should this transaction be regarded as nontaxable?

This issue was raised in a somewhat unusual fashion in Gus Russell, Inc. There Gus, an individual engaged in a typesetting and composition business, granted an option to purchase the business to Composition, a newly formed corporation organized by some of his employees. Under the terms of the option, which was exercisable for a 30-day period beginning five years after the date it was granted, Gus was to be paid for his assets in preferred stock. Had the transaction been carried out as an exchange of assets for preferred stock, Gus would have been subject to tax on the exchange. However, after notification by Composition that it intended to exercise the option, Gus consulted a tax lawyer and was advised that the transaction should be framed as a tax-free exchange. Accordingly, a second company was organized, the outstanding stock of Composition being transferred to this new entity for common stock and Gus’ assets being transferred to it for preferred.

The Commissioner did not question Gus’ treatment of the transaction as tax-free. Quite the contrary, he disallowed a stepped-up basis in the transferred assets for depreciation purposes, rejecting the corpora-

47. Insofar as the existing company and its shareholders are concerned, the transaction would constitute a tax-free reorganization under § 368(a)(1)(C) and §§ 361 and 354. See Bard-Parker Co. v. Commissioner, 218 F.2d 52 (2d Cir. 1955).
tion's contention that section 351 did not apply. The corporation argued that compliance with section 351 was merely "pro forma" and the product of a "fraud" practiced upon Composition by Gus in representing to his former employees that there would be no adverse tax consequences to them. However, the Tax Court dismissed the fraud argument out of hand and then went on to conclude that section 351 was applicable, even though the transaction as originally conceived would have been taxable, because the new corporation was a "real functioning entity" and the literal requirements of the statute were met.

Although the Russell case would seem to suggest that tax-free treatment can be secured for an exchange of property for stock by coupling it with reincorporation of the existing company, the fact that it was the taxpayer rather than the Service that attacked the bona fides of the transaction tends to undermine the value of this decision as precedent. Indeed, the recent William F. Wolf, Jr.,49 case indicates that the Commissioner might well have been upheld had he sought to tax Gus on the exchange. In the Wolf case, a partnership and two individuals, each of whom owned one-third of the stock of X Corporation, transferred their shares to the newly organized Y Corporation, the individuals receiving in exchange cash and notes, with the partnership receiving stock of Y and the latter assuming a personal liability of the partnership. X Corporation was then liquidated, Y adopting its name and continuing its business. The Tax Court held that Y Corporation, the new company, was merely a temporary depository for stock of X Corporation, the old company, and that viewing the transaction as involving only a single corporate entity, the assumption of the partnership's liability and its payment by the new company amounted to a dividend to the partnership. It will be observed that, under the same kind of analysis, section 351 would not have applied in the Russell case.

INTERRELATION WITH OTHER PROVISIONS AND DOCTRINES

Sometimes, section 351 will come into conflict with some other provision or judicial doctrine and it will be necessary to determine which of the two should prevail. Thus, in the recent case of Henry McK. Haserot,50 where the controlling shareholder of two sister corporations transferred stock of one to the other for securities of the latter and cash, the transaction might have been regarded either as a transfer of property under section 351 or, through the application of section 304, as a redemption

49. 43 T.C. 652 (1965), aff'd, 66-1 USTC ¶ 9316 (9th Cir. 1966).
50. 41 T.C. 510 (1964), rev'd and rem'd, 66-1 USTC ¶ 9168 (6th Cir. 1966).
of stock under section 302. However, if the transaction were treated as a redemption, the shareholder would be taxable on the cash and securities received at ordinary income rates unless their distribution to him was not essentially equivalent to a dividend. On the other hand, if section 351 were deemed to govern, gain would be recognized only to the extent of the cash received by the shareholder and would be taxable only as capital gains.

The Tax Court assumed that dividend income would result if section 304 were considered applicable and, on the basis of statutory language of somewhat questionable relevancy, found that dividend treatment had been subordinated by the Code to the more favorable treatment granted by provisions such as section 351. The court of appeals has now reversed this decision and remanded the case to the lower court for consideration of the correctness of its assumption that a dividend would be realized if section 304 applied. Reversal on this ground suggests that the circuit court would hold section 351 to be inapplicable if the alternative were dividend treatment. However, whether it ultimately will adopt this view is a matter for speculation.

A major shortcoming of at least the Tax Court's decision in Haserot is its failure to come to grips with the underlying question in that case, to wit, whether the congressional policy of facilitating incorporation requires that section 351 be regarded as paramount under these circumstances. It is difficult to conclude that this policy is served by permitting taxpayers to avoid dividend treatment upon a bail-out of earnings through redemption of a sister corporation's stock by the simple expedient of causing the redeeming corporation to make a part of the distribution in its own securities. However, the rather mechanical approach of the Tax Court in Haserot leads to just that conclusion.

Another area of confrontation between section 351 and competing tax rules is in the treatment of the bad debt reserve of a business under-

51. See §§ 302(d) and 301(a) (1).
52. See § 351(b). The cash received by the shareholder would constitute "other property" for purposes of this provision and the gain on the transfer would be taxable up to that amount. At least where the property transferred constitutes a capital asset, such gain generally is treated as capital gain. But cf. Treas. Rgs. § 1.351-2(d) (1955).
53. Sections 302(d) and 301(a), the provisions prescribing dividend treatment for certain distributions in redemption, state that such treatment is applicable "except as otherwise provided in this subchapter" or, in the case of § 301(a), "except as otherwise provided in this chapter." Since § 351 is contained in the same chapter and subchapter as these provisions, the Tax Court concluded that the quoted language meant that Congress intended section 351 to govern. The difficulty with this view is that both §§ 302(d) and 301(a) specifically apply only to distributions in redemption and, from the standpoint of § 351, the transaction in Haserot must be regarded as a transfer of assets to a controlled corporation in return for securities and other property. Hence, it is arguable that there is no overlap and that the language in question does not come into play.
going incorporation. It is a tax doctrine of longstanding that reserves must be restored to income when the necessity for them ceases. Upon the transfer of accounts receivable to a controlled corporation, the risks of noncollection are shifted to the transferee and a reserve for bad debts no longer is needed by the transferor. It would seem, therefore, that the amount of the reserve should be included in the latter's income in the year of the transfer. Yet, to require the restoration of this amount would mean that taxpayers using this method of writing off bad debts could never incorporate entirely tax-free.

In Rev. Rul. 62-128, the Service followed the restoration of income approach and concluded that the transferor must take the amount of his bad debt reserve into income in the year in which the accounts receivable are transferred. The issue was subsequently litigated and, in Estate of Henry Schmidt, the Tax Court upheld, somewhat reluctantly, the position adopted by Internal Revenue. On appeal, however, the Ninth Circuit determined that the transferor was not taxable on that amount.

The circuit court's view in Schmidt was presaged, strangely enough, by its decision in West Seattle National Bank v. Commissioner, in which it upheld inclusion of the amount of the reserve in income. There, accounts receivable were sold at their face value incident to the liquidation of the selling corporation. The taxpayer contended that his tax basis in the receivables was reduced by additions to the bad debt reserve in much the same way that the tax cost of depreciable property is offset by allowances for depreciation; that as a result, the amount of the reserve represented gain realized upon the sale of the accounts at face value; and that, under section 337, such gain was not recognized. Rejecting this contention, both the Service and the Tax Court employed the restoration of income approach to tax the corporation on the amount of the reserve. The court of appeals, on the other hand, took a somewhat different tack.

Under the so-called "tax benefit" theory, if a taxpayer takes a deduction for a worthless debt and subsequently recovers the amount due, then to the extent of any tax benefit received from the deduction, he must include the recovery in income. The Ninth Circuit followed this theory in West Seattle and treated the proceeds from the sale of the accounts receivable at face value as representing in part the recovery of the bad debt reserve. To that degree, then, the transaction was viewed not

56. 42 T.C. 1130 (1964), rev'd, 66-1 USTC ¶ 9202 (9th Cir. 1966).
57. 288 F.2d 47 (9th Cir. 1961), aff'd, 33 T.C. 341 (1959).
58. See e.g., Dobson v. Commissioner, 320 U.S. 489 (1943). This rule has been partially codified in § 111. See also §§ 1342 and 1346.
as a sale but as collection of a bad debt, section 337 was found not to apply, and the taxpayer was held to be taxable.

Unlike West Seattle, however, the Schmidt case did not involve a sale of receivables at their face value but an exchange for stock. The circuit court concluded that the stock necessarily reflected only the fair market value (i.e., market value net of the bad debt reserve) of these accounts and that, since the consideration received for the accounts receivable represented only what they were worth, nothing was attributable to the reserve. Accordingly, it was held that there had been no recovery of a bad debt previously written off and the transferor was not subject to tax.

In effect, the “tax benefit” approach followed by the Ninth Circuit works an adjustment in the amount of the bad debt reserve. Where the accounts receivable are sold for an amount in excess of their face value less any bad debt reserves, inclusion of the excess in income at the time of the transfer as a bad debt recovery merely serves to reduce the reserve to its proper level. On the other hand, the sale of the receivables for their value net of reserves confirms that the reserve was reasonable in amount, that such an adjustment is not necessary and, it may be argued, that no income should be charged to the transferor.

Whatever the appeal of this approach generally, it is questionable whether it should be employed in the context of a transfer under section 351. In the case of a cash sale of receivable, a duplication of bad debt deductions or allowances as between the buyer and the seller is avoided by a statutory rule requiring that the bad debt deduction be computed on the basis of the tax cost of the underlying accounts, the seller receiving the benefit of any reduction in value of the underlying accounts occurring prior to sale and the buyer securing the benefit of any reduction occurring thereafter. However, this result is achieved only because the tax basis of the receivables in the hands of the transferee-purchaser reflects their fair market value at the time of the transfer. Where the accounts are transferred in a nontaxable exchange under section 351, if the bad debt reserve is not equated to a depreciation reserve, the tax basis of the receivables in the hands of the transferee generally will be their face value. It would seem, therefore, that in such an instance, the Ninth Circuit’s approach would allow the transferee to duplicate the bad debt allowance of the transferor with respect to the transferred accounts.  

59. See § 166(b). The discussion here is based on the assumption that the transferor’s bad debt reserve is reasonable in amount.

59A. To illustrate this distinction, assume that accounts receivable with a face value of $100 are transferred to another person when their market value is $90, the latter ultimately collecting $70 on the accounts. Where the transfer takes the form of a
Section 351 and the policy which it reflects come into even sharper conflict with other tax rules where accounts receivable are transferred incident to the incorporation of a business using the cash rather than the accrual method of accounting. If such a transfer were regarded as tax-free, the unrealized income reflected in the transferred accounts would no longer be chargeable to the transferor upon collection but would be taxable to the corporation. Hence, if the corporation were subject to a lesser rate of tax than the transferor, a tax savings would result.

There are, however, a number of Code provisions and judicial doctrines designed to assure that, as a general matter, income will be taxed to the one who earns it. Under the so-called assignment of income doctrine developed by the courts, income is taxable to the one whose activities give rise to that income notwithstanding that the right to payment may have been assigned to another. Section 482 authorizes the Commissioner to reallocate income or expenses among related entities to more clearly reflect income or prevent the avoidance of taxes. And, under section 446(e), the Internal Revenue Service is empowered to change the taxpayer's method of accounting, as from the cash to the accrual method, to achieve a clearer reflection of income.

Conceivably, these rules might be brought into play whenever cash-basis receivables are transferred to a controlled corporation to assure that the income reflected therein will be chargeable to the transferor. In the end, however, whether income is taxable to the one who earns it depends upon whether Congress intended to tax that person or someone else.

sale, the receivables being sold for what they are worth, the transferor-seller will have secured a bad debt allowance of $10 if his reserve is reasonable in amount. The transferee-purchaser, on the other hand, only will be entitled to a bad debt deduction computed on the basis of his tax cost of $90, so assuming that he employs the specific charge-off method, he would be allowed a deduction in the year of collection of only $20, the aggregate bad debt deductions and allowances totalling $30, the actual loss on collection. In the case of a transfer under section 351, the transferee presumably would take a basis in the transferred accounts of $100 and a bad debt deduction of $40, $10 of this amount representing a duplication of the transferor's bad debt allowance.

60. P.A. Birren & Son, Inc. v. Commissioner, 116 F.2d 718 (7th Cir. 1940); Orange Securities Corp., 45 B.T.A. 24 (1941); Ezo Products Company, 37 T.C. 385 (1961).


62. See e.g., Central Cuba Sugar v. Commissioner, 196 F.2d 214 (2d Cir. 1952); Jud Plumbing and Heating Co. v. Commissioner, 153 F.2d 681 (5th Cir. 1946); Standard Paving Co. v. Commissioner, 190 F.2d 330 (9th Cir. 1951). See also Plumb & Kapp, Reallocation of Income and Deductions Under Section 482, 41 Taxes 809 (1963).

63. See e.g., Susan J. Carter, 9 T.C. 364 (1947).

64. See e.g., Holahan v. Commissioner, 222 F.2d 82 (2d Cir. 1955) ("The petitioner's contention on this appeal that it is a fundamental principle of tax law that income is taxable to the man who earns it, citing Lucas v. Earl, cannot override the provisions of [the predecessor to § 71]").
While attributing the income from the receivables to the transferor will not often present a substantial impediment to incorporation, there are instances in which adoption of this course would mean that, practically speaking, the business could never be incorporated.\footnote{For example, assume that the transferor is seeking to incorporate a cash basis personal service business which is not of a seasonal nature but in which the operating expenses are incurred and the income earned in the accounting period preceding that in which the customer's accounts attributable thereto are collected; that as a result of this lag, a substantial portion of the assets of the business at any one time consists of accounts receivable, the balance in recent years totalling about $10X; and that while the business has grown steadily so that its gross income per accounting period is now about $10X, this amount is offset by $8X of expenses relating to the next period's profit, and taxable income is only about $2X. Once the business is incorporated, its expenses will be borne by the new company and the transferor no longer will be entitled to a deduction for such expenses. Consequently, if the transferor continued to be taxable upon the income represented by accounts receivable even after they were transferred, he would be liable for tax on the full $10X. Nor would the result be any different if the accounts receivable were retained by the transferor and only the other assets of the business conveyed to the corporation. In either event, the receivables would give rise to $10X of taxable income, or five times the business' customary level of profits for any one accounting period, and the tax cost of incorporation would be prohibitive.} Such a result would seem inconsistent with Congress' policy, as manifested in section 351, of encouraging such adjustments.

Both the courts and now, apparently, the Service have come to recognize that the general goal of taxing income to the earner may have to give way before Congress' desire to facilitate incorporation. Thus, in \textit{Thomas W. Briggs}\footnote{T.C. Memo 1956-86.} and \textit{Arthur L. Kniffen},\footnote{39 T.C. 353 (1962), acq. 1965-45, I.R.B. 5.} the Tax Court refused to tax the transferor upon the income reflected in unrealized receivables transferred incident to incorporation. And, it would seem, Internal Revenue presently will issue advance rulings holding the transferor not to be taxable on such income.\footnote{Bulletin, Section of Taxation, American Bar Association, Volume XVIII, No. 3, p. 104 (April 1965).} However, the Service's ruling policy apparently is subject to the proviso that the taxpayer enter into a closing agreement assuring that the corporation will report the income reflected in the receivables upon their collection or other disposition. It would also appear that favorable rulings will not be issued where the timing of the transfer will be such as to result in a distortion of income. For example, such a ruling presumably could not be obtained if a seasonable business were to be incorporated during the portion of the year occurring after sizeable operating expenses had been incurred but before the income attributable thereto was collected.\footnote{Cf. Rooney v. Commissioner, 305 F.2d 681 (9th Cir. 1962).}

\textit{CONCLUSION}

As we have seen, there are a number of problem areas in the appli-
cation of section 351 and literal compliance with the statute will not always mean tax-free treatment. Nevertheless, in the usual case, it is fairly simple to assure that the incorporation of a business will not be taxable. So long as the transaction is undertaken for legitimate business motives and the specific requirements of the statute are met, section 351 should not present any difficulties. However, substantial unresolved issues may still be encountered in some instances.
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