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COMPARISON OF MAJOR TAX AND LEGAL ADVANTAGES AND DISADVANTAGES OF OPERATING IN AN UNINCORPORATED FORM

PROFESSOR KAHN:

As an introduction to the subject of this conference, several topics will be discussed. First, the tax and non-tax consequences of conducting business in a partnership form will be examined and compared with the consequences of doing business in a corporate form. The principle concern of this paper, however, is to examine the tax consequences of transferring property to a corporation, whether such transfer is made at the time the corporation is organized or at some subsequent date.

1. Non-tax Attributes of Partnerships

The relationship of a partner to his fellow partners and to the partnership depends upon the status afforded the partnership as an entity. A corporation normally is treated as a separate entity. It can hold property in its own name; can sue and be sued in its own right; its stock is normally freely transferrable; and it is treated as a person having an identity separate from its shareholders. The shareholders of a corporation are not deemed to own the assets of the corporation, but rather only an interest in the corporate entity. The relationship among partners and their partnership is substantially different, however.

As defined in the Uniform Partnership Act (U. P. A.), adopted by a substantial majority of the states and the District of Columbia, a partnership is: "an association of two or more persons to carry on as co-owners a business for profit."\(^1\) A few jurisdictions, however, have no partnership statutes and rely on the common law rules. Since partnership law, whether codified or not, defines a general partnership in broad terms, there is considerable flexibility as to the permissible form a partnership may take.

The law has been ambivalent in its treatment of partnerships; for some purposes, a partnership is treated as a separate entity, and for others it is not. The common law tended to favor non-entity classification of partnerships, but it was not wholly consistent. At common law, a partnership could not hold property in its own name\(^2\) nor could it sue or be sued.\(^3\) Suits by the partnership were brought in the name of the individual partners, and conversely, suits against the partnership were brought against partners in their individual capacity. Generally, at common law, the rights and obligations arising out of partnership activities were attributed to the partners rather than to the partnership as an entity.\(^4\) The familiar "mutual agency" relationship of partners is discussed below. However, for certain limited purposes, such as the keeping of partnership accounts, the common law treated the partnership as an entity. In contrast to the common law, the Uniform Partnership Act establishes entity treatment for a partnership, but the U.P.A.

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1 U.P.A. § 6(1).
2 Riddle v. Whitchill, 135 U.S. 621, 34 L. Ed. 282, 10 S. Ct. 924 (1890).
is less consistent in its treatment of a partnership than was the common law.\(^5\)
Indeed, several courts have stated that the U.P.A. has not changed the aggregate nature of a partnership as established by the common law.\(^6\) Under the U.P.A., a partnership can hold property in its own name, and such property is treated as belonging to the partnership itself.\(^7\) Nevertheless, it is unlikely that the U.P.A. permits a partnership to sue or be sued in its own name,\(^8\) but many states permit that by separate statute.\(^9\)

The question of whether a partnership can hold property in its own name is not merely a question of title; it may also determine the nature of a partner's interest. For example, where a partner dies who was domiciled in the state of Virginia and who was a member of a partnership which owns real estate in the state of North Carolina, is he treated as owning a percentage of the real estate located in the state of North Carolina so that there must be an ancillary administration there, or is he treated as owning an interest in a partnership—an entity which itself owns property in North Carolina? Under the U.P.A., a partnership will be treated as an entity for these purposes so that no ancillary administration will be needed.

One of the more important differences between a corporation and a partnership is the availability of limited liability to the investors. The shareholders of a corporation normally incur no personal liability for the activities of the corporation, and the amount of their risk is limited to their investment in the company. Of course, there are unusual cases where a shareholder has personal liability, but those are atypical. With a general partnership, the situation is quite different. The partners are jointly and severally liable for the tort obligations of the partnership and jointly liable for its contractual obligations.\(^10\) Moreover, each of the partners is regarded as an agent of the partnership and of the other partners—the concept of "mutual agency." Consequently, if in performing a function of the partnership, a partner commits a tort or executes a contract, the other partners are obligated for any liabilities arising therefrom. Furthermore, under normal agency rules which apply both at common law and under the U.P.A., the partners are liable for


\(^{7}\)U.P.A. § 8 and § 10.


\(^{10}\)U.P.A. § 15. Where the partners are only jointly liable, they must be sued jointly, but where the partners are jointly and severally liable, the plaintiff may choose whether to sue them jointly or to sue a partner separately. See Crane and Bromberg, Law of Partnership (1968), pp. 334-35. By separate statute, some states have joint liability of parties to joint and several liability; and modern pleading practices have substantially reduced the significance of the distinction.
obligations incurred by a contracting partner acting under his apparent authority as a partner, even though the partnership agreement expressly denied the partner the authority to conduct business of that nature. Of course, the partnership and other partners are not liable if the third parties with whom the contracting partner dealt actually knew that he was not authorized to act. The partnership and other partners are not bound by the acts of a partner who had neither apparent nor express authority so to act. The U.P.A. excludes the following from a partner's apparent authority:

a. Assignment of partnership property to a trust for creditors or on the assignee's promise to pay creditors;
b. Disposal of the good will of the business;
c. Action which makes the conduct of partnership business impossible;
d. Confession of a judgment; and
e. Submission of a partnership claim or liability to arbitration or reference.

Thus, a partner's conduct in those matters will not bind his fellow partners or the partnership unless he has express authority.

Finally, some common law restrictions on a partner's apparent authority include a prohibition against assuming the debt of another and a partner's application of partnership property to the payment of his own debt.

The exposure to liability of a partner is a sufficient reason in itself for some organizations to incorporate, although with many closely held organizations, it is only a minor factor. Where it is important to provide limited liability to some investors, a partnership form can be employed if one or more investors are willing to accept general liability, accomplishable through the vehicle of a limited partnership. This is a statutory partnership in which one or more of the partners manage the business and have the personal liability of general partners, while other partners (so-called "limited partners") share in the profits but assume no liability beyond their contributed capital.

Most states have now adopted the Uniform Limited Partnership Act (U.L.P.A.), which defines a limited partnership as:

...a partnership formed by two or more persons under the provisions of Section 2, having as members one or more general partners and one or more limited partners. The limited partners shall not be bound by the obligations of the partnership.

The necessity of having at least one general partner assures that someone will have personal liability.

12 U.P.A. § 9(3).
16 U.L.P.A. § 1.
Limited partners are exempt from personal liability on the condition that they do not participate in management.\textsuperscript{17} However, neither the U.L.P.A. nor the decisions under it are very helpful in indicating how much of an actual role a limited partner may take before he is regarded as taking part in management.\textsuperscript{18} The U.L.P.A. specifically provides, however, that a limited partner may become liable as a general partner if:

\begin{itemize}
  \item[a.] his name appears in the firm name;\textsuperscript{19}
  \item[b.] he knows of a falsity in the certificate of limited partnership;\textsuperscript{20}
  \item[c.] he holds himself out as a general partner;\textsuperscript{21}
  \item[d.] he knows the firm is defectively organized and fails to make a renunciation on discovery;\textsuperscript{22} to the extent of any unpaid contributions promised in the certificate to be made to the firm;\textsuperscript{23} or to creditors as to any part of his contribution which he has withdrawn subsequent to the extending of such credit.\textsuperscript{24}
\end{itemize}

Since the limited partnership form does not provide the general partners with limited liability, and since it lacks some of the flexibility available in the corporate form (i.e., different types of interests in a corporation can be reflected by different classes of stock more readily than such differentiation can be made among partners, albeit the partnership agreement can grant different rights to separate groups of partners), why should a business utilize the limited partnership form rather than incorporate? A major reason for operating a business as a limited partnership is the difference in tax consequences of the two forms. The limited partnership form is used for investment in many real estate operations, mineral extraction operations, and theatrical productions.

An important consideration in deciding whether to form a partnership is the ability of a partner to transfer or sell his interest in the partnership to third parties. Unless the partnership agreement provides otherwise, under the U.P.A., a partner's assignment of his share of partnership profits or his right to distributions in liquidation does not in and of itself dissolve the partnership.\textsuperscript{25}

The assignee does not become a partner without the consent of the other partners, and he has no right to participate in management, to require an accounting, or to inspect the partnership books.\textsuperscript{26} The assignment itself does

\begin{footnotes}
\item[19]U.L.P.A. § 5(2).
\item[21]U.L.P.A. § 16.
\item[22]U.L.P.A. § 11.
\item[23]U.L.P.A. § 17(1).
\item[24]U.L.P.A. § 17(4).
\item[25]U.P.A. § 27.
\item[26]Ibid.
\end{footnotes}
not causes a dissolution of the partnership, but in certain circumstances, the assignee may cause a dissolution by making application therefor to the appropriate court.27

A partner who sells his interest in a partnership may have a continuing liability for all partnership debts incurred prior to the sale.28 The partners may agree to discharge a selling partner from this liability, and such a discharge may be included in the partnership agreement to protect subsequent sales of partnership interests. The effect of such an agreement is to relieve a selling partner of any liability to co-partners on account of the firm's indebtedness, but the agreement will not relieve the selling partner of his liability to prior creditors of the partnership.29

Generally, a selling partner is not liable for partnership debts arising subsequent to sale of his partnership interest if he has given appropriate notice of the sale of this interest.30 On the other hand, he will be liable if he does not give the appropriate notice to those entitled to it.31 "Appropriate notice" requires that actual notice be given to all those who formerly did business with the partnership, and notice by publication is usually sufficient as to others.32

In making a rational choice as to what form of business organizations to use, it is important to compare the legal aspects of partnerships, discussed above, with the corresponding aspects of corporations. In this respect, the limited liability of participants and the ease with which corporate ownership, including voting rights, may be transferred are major non-tax attractions of the corporate form over the partnership form. In many cases, however, the tax considerations (rather than the non-tax attributes of the two forms) will determine which of the two forms is most desirable. The tax treatment of partners and partnerships is discussed below.

2. The Tax Consequences of Doing Business as a Partnership

Before discussing the partnership, it may be helpful to sketch briefly the basic tax treatment of a corporation so that the contrast with the partnership tax laws can be noted. The corporation, of course, is a separate entity for tax purposes (even special corporations such as Subchapter S corporations are separate entities). If a corporation distributes its earnings to its shareholders in the form of dividends, the dividend constitutes ordinary income to the shareholder, but the corporation receives no deduction. This is the double or dual tax system, and it is one of the disadvantages of the corporate form. In most small corporations, the double tax is not a disadvantage, because the

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27U.P.A. § 32(2).
32Towend v. Patterson, 136 Cal. App. 120, 28 P.2d 413 (1933).
 corporation can distribute what funds are needed in the form of salaries or other deductible payments and thus avoid the double tax. The corporate income that is not needed by the shareholders may be accumulated in the corporation at a tax rate of no more than 48 percent. If the shareholder's marginal tax bracket is greater than 48 percent, the corporation provides tax insulation for the shareholders.33

A partnership is taxed quite differently. The tax law has avoided the entity-aggregate controversy that plagues the characterization of partnerships for non-tax purposes, and instead has treated the partnership as an entity when such treatment best suited tax policy and as a mere aggregate of interests when that was best suited to tax policy.34 In one very important respect, the partnership is not treated as an entity—while the partnership files an income tax return, it does so purely for informational purposes as the partnership pays no federal income tax whatsoever.35 All tax attributes of a partnership (e.g., income, deductions, losses, credits) are allocated among the partners and the portion allocated to each partner is treated as if it had been incurred by that partner individually.36 State income taxes may be imposed on the partnership, however, but that is a matter of local tax law.

The allocation of tax attributes among the partners is one area in which the tax law treats the partnership as a mere conduit rather than an entity. It would be misleading, however, to regard the partnership as a conduit for all tax purposes. In fact, the partnership is treated as an entity for many tax purposes and, on balance, it may well have more attributes of an entity than of a conduit. Nevertheless, the conduit treatment of allocating tax attributes among the partners frequently is the crucial factor in determining whether to employ the partnership or corporate form. If the investors are in high marginal tax brackets, and if the business produces a substantial net income, the investors might prefer to employ a corporate form so that the income from the business will be taxed at no higher rate than 48 percent. On the other hand, if the investors are commencing a new business and if they contemplate sustaining losses in the early years of its operation—e.g., the exploitation of a new invention may create expenses far in excess of income for several years until the public accepts it—it may be desirable to operate the business as a partnership in the early years so that the partners can deduct the operating losses

33 Where a corporation is used to insulate shareholders from a larger tax rate, the parties should be made aware of the possibility that a surtax may be imposed on the corporation under the accumulated earnings tax provision (IRC § 533) or the personal holding company tax provision (IRC § 543).

34 See Dunroy, Ltd. v. United States, 301 F.2d 200, 207, n. 7 (CA 9, 1962).

35 IRC § 701.

36 IRC §§ 702 and 704. Partnership tax items are allocated among the partners according to ratios established in the partnership agreement, provided that the allocation can be justified on non-tax grounds. If the agreement does not provide for an allocation, the partnership's tax items are allocated according to the partners' respective shares of income and loss. IRC § 704.
from their income earned from other sources. When the operation becomes profitable, the business can then be incorporated. Similarly, a business may have investment credits and other types of favorable tax attributes that the investors would prefer to use themselves. These benefits can be passed through to partners but not shareholders.

It should be noted that a partner's share of partnership losses can be deducted only to the extent that the partner has basis in his partnership interest at the end of the partnership year. Also, in some cases, the subsequent incorporation of the business may result in tax liability or may even be impossible. For example, if the business is operated in a foreign country and the partners wish to form a foreign corporation to operate the business, the Service may refuse to grant permission (under section 367) to make a tax-free exchange of the business for the stock of the corporation, since the losses of the business were enjoyed by the investors individually and the income of the foreign corporation may not be subject to United States taxation.

An alternative means of permitting the investors to enjoy the tax benefits of the losses suffered by the business is to conduct it in a corporate form but to cause the corporation to make an election under Subchapter S. Subchapter S elections are discussed later in this work, and at this point, it is sufficient merely to point out that although this election is sometimes useful, it is not desirable in all circumstances. For example, the election is not available if there are more than ten shareholders nor if the corporation has rental income in excess of 20 percent of its gross receipts. Moreover, the Subchapter S corporation is a conduit of only certain tax attributes—ordinary income, capital gains, and net operating losses; capital losses and tax credits of a Subchapter S corporation are not passed through to the shareholders. Also, a shareholder's portion of a Subchapter S corporation's net operating loss is deductible only to the extent of the total of the basis in his stock and his basis in any debts the corporation owes him. A partner is also precluded from deducting his share of partnership losses to the extent that his share of losses exceeds his basis in his partnership interest, but the excess loss can be deducted at such time as the partner acquires sufficient basis in his interest, which includes his proportionate share of partnership liabilities.

\[37\text{IRC § 704(d).}\]
\[38\text{If the liabilities of the business exceed the basis of its assets, the transfer of the assets and liabilities of the business to a corporation will cause the partners to recognize income. IRC § 357(c).}\]
\[39\text{IRC § 1371 et seq.}\]
\[40\text{IRC § 1371(a)(1); and § 1372(c).}\]
\[41\text{IRC § 1372(c)(5).}\]
\[42\text{IRC § 1374(c)(2).}\]
\[43\text{IRC § 704(d).}\]
\[44\text{Ibid.}\]
\[45\text{IRC § 752.}\]
This latter provision is of special importance to real estate partnerships where each partner's share of the mortgage on partnership realty increases his basis in his partnership interest so that the partner can deduct fully any partnership losses incurred as a consequence of accelerated depreciation allowances and interest on construction loans and the permanent mortgage.

A contribution of property to a partnership in exchange for a partnership interest does not cause recognition of income either to the partnership or the contributing partner. In contrast to the treatment of transfers to a corporation for stock, nonrecognition is granted to exchanges of property for partnership interests without regard to whether the transferors are in control of the partnership. The receipt of a partnership interest in exchange for services (past or future) will be included in the partner's income unless the partner obtains no interest in partnership property but acquires only the right to share in profits and losses. It is arguable that the right to share in partnership profits is property within the meaning of IRC, section 83 (added to the Code by the Tax Reform Act of 1969) and, therefore, that the receipt of such a right in exchange for services is a taxable transaction under section 83. It is unlikely, however, that the interpretative regulation (§1.721-1) was vitiated by that section.

A partnership has a basis in its assets, and the partners have a basis in their interests in the partnership. The entity treatment of the partnership is similar to the treatment of corporations where the corporation has a basis in its assets and the shareholders have a basis in their corporate stock. A partnership's basis in an asset transferred to it in exchange for a partnership interest is equal to the basis the transferor had in the asset. A partnership's basis in assets not acquired as a contribution from a partner is determined under the normal rules for determining basis. A partner's original basis in his partnership interest is equal to the cash contributed by him to the partnership, plus the adjusted basis of assets contributed by him.

A partner's basis in his partnership interest is continually subjected to adjustment as follows:

A partner's basis is increased by his share of:

a. taxable income of the partnership;
b. income of the partnership which is exempt from tax; and
c. the excess of the partnership's total depletion deductions over the partnership's basis in the depletable property.

46IRC § 721.
47IRC § 351.
49IRC §§ 722 and 723.
50IRC § 723.
51IRC § 722.
52IRC § 705.
A partner's basis in his partnership interest is decreased (but not below zero) by distributions he received from the partnership during the tax year and is further reduced (but not below zero) by the partner's share of:

a. partnership losses; and
b. non-deductible partnership expenditures not chargeable to capital account.

These adjustments to basis are required to prevent double taxation to the partners. The reason the adjustments are needed becomes clear upon an examination of the tax treatment of partnership distributions to a partner.

A distribution of property in kind from a partnership to a partner will not cause the partner to recognize any gain, and a distribution of cash to a partner will cause gain to the partner only to the extent that the cash distributed to the partner exceeds the partner's basis in his partnership interest. A partner will not usually recognize a loss on partnership distributions to him, but he can recognize a loss on a liquidating distribution in certain circumstances. A partnership recognizes no gain or loss on partnership distributions.

It must be noted that in certain circumstances, a distribution of property to a partner in exchange for all or part of his interest in other partnership property will be treated as a sale between the partnership and the partner and may cause the partner to recognize ordinary income on the transaction.

Thus, a partner's share of the partnership's taxable income is taxed directly to the partner, but the income allocated to the partner increases his basis in his partnership interest; and when a like amount is actually distributed to the partner, the partner recognizes no gain from the distribution but merely reduces his basis in his partnership interest. The net effect is that the partner is taxed on partnership income when earned by the partnership, and the resulting increase in his basis in his interest permits him to draw the income out of the partnership at no additional tax cost. For example, X has a 50 percent interest in the X-Y partnership, and X has a basis of $1,000 in his 50 percent interest. In the year 1970, the partnership had taxable income of $800. X's share of the income was $400; thus, X must include the $400 in his gross income, and X's basis in his 50 percent interest is increased to $1,400. On February 10, 1971, the partnership distributes $400 to X, and this reduces X's basis in his interest to $1,000. Thus, X was taxed on $400; he received that amount from the partnership, and he retains the same basis he had before the partnership recognized the income.

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53A partner's basis is reduced (but not below zero) by the amount of cash distributed to him, plus the amount of basis the partner acquires in non-cash distributions. IRC § 733.
54IRC § 731(a).
55Ibid.
56IRC § 731(b).
57IRC § 751(b) and Reg. § 1.751-1(b).
A partnership is treated as an entity that can conduct transactions with a partner in a capacity other than that of a member of the partnership—i.e., it can purchase or sell assets to a partner. Where a partnership is obligated to pay a specified amount to a partner for his services or for the use of capital, and where such payments are to be made regardless of the amount of income earned by the partnership, such payments are treated as a “guaranteed payment” to the partner.58 A guaranteed payment constitutes ordinary income to the partner and is deductible by the partnership.59

No loss deduction is allowed for a loss realized on a sale of property between a partnership and a partner owning more than a 50 percent interest in the partnership or on a sale between two partnerships in which the same persons own more than a 50 percent interest, and any gain recognized on the sale of an asset which is not a capital asset in the hands of the transferee will constitute ordinary income if the sale is between a partnership and a partner owning more than an 80 percent interest in the partnership or between two partnerships in which the same persons own more than an 80 percent interest.60 For these purposes, a partner’s percentage interest in the partnership includes the percentage interests of certain related parties whose interests are attributed to the partner under IRC section 267(c).61

Where a distribution is made in kind to a partner, the determination of the partner’s basis in the distributed property turns upon whether the distribution was made in liquidation of the partner’s interest in the partnership. In general, if the distribution was not made in liquidation of the partner’s partnership interest, the partner’s basis in the distributed property is equal to the basis the partnership had therein, but the partner’s basis in the distributed property cannot exceed the partner’s basis in his partnership interest immediately prior to the distribution reduced by any cash received by the partner as part of the same transaction.62 Since a partner will not include a distribution in kind in his gross income, the net effect of the distribution to the partner is to transfer some or all of his basis in his partnership interest to the property distributed to him from the partnership. If the distribution in kind is made in liquidation of the partner’s partnership interest, the partner’s basis in the distributed property is equal to his basis in his partnership interest reduced by any cash distributed to him as part of the same transaction.63 The

58IRC § 707(c).
59Reg. § 1.707-1(c).
60IRC § 707(b). Where a deduction is disallowed under section 707(b) for a loss realized on a sale of property between a partner and a partnership or between two partnerships, a gain realized by the transferee on the subsequent disposition of the property will not be recognized, but the amount of such realized gain that will not be recognized is limited to the amount of loss realized by the transferor that was disallowed as a deduction. IRC §§ 707(b)(1) and 267(d).
61IRC § 707(b)(3).
62IRC § 732(a).
63IRC § 732(b).
partner’s basis in the distributed assets may be determined differently (at the partner’s election) if the partner acquired his interest in the partnership from a predecessor partner within two years of the date the distribution was made,\textsuperscript{64} and the basis will be determined differently if the distribution is treated as a sale or exchange under IRC section 751.\textsuperscript{65}

Where a partner sells his partnership interest to a third party, the question is whether the partner will be treated as having sold an interest in an entity (a capital asset) or whether he will be treated as having sold a percentage interest in each of the partnership’s assets. The tax laws are ambivalent on this issue, and such sales are treated partly as a sale of the partner’s interests in certain partnership assets and partly (the balance of the purchase price) as a sale of an interest in the partnership as an entity. Under IRC section 741, the gain or loss recognized by a partner on the sale of a partnership interest is treated as capital gain or loss, except to the extent provided otherwise in IRC section 751. That section, sometimes referred to as the “collapsible partnership” provision, provides that the amount realized on the sale of a partnership interest which is attributable to “unrealized receivables” of the partnership and “inventory items of the partnership which have appreciated substantially in value”\textsuperscript{66} shall be treated as an amount realized from an asset other than a capital asset; thus, the partner is treated as having sold his percentage share of the section 751 items, and any gain recognized thereon will be treated as ordinary income.\textsuperscript{67} The regulations (Reg. § 1.751-1(a)(2)) state that the gain realized on section 751 items is determined by allocating thereto a portion of the purchase price paid for the partnership interest and a portion of the selling partner’s basis in his partnership interest. If the contracting parties (the purchaser and the seller) allocate a portion of the purchase price to the section 751 items in their agreement of sale, their allocation will usually be accepted. The amount of basis allocated to the section 751 items is the amount of basis the selling partner would acquire in such items under section 732 if the items had been distributed to the partner as a current distribution in kind immediately prior to the sale.

For partnership tax purposes, the terms “unrealized receivables” and “inventory” are defined far more broadly than is typical.\textsuperscript{68} For example, “unrealized receivables” includes the potential recapture of depreciation that

\textsuperscript{64}IRC § 732(d).

\textsuperscript{65}IRC § 732(e).

\textsuperscript{66}Inventory items have “appreciated substantially in value” if their fair market value exceeds both: (1) 120 percent of the partnership’s basis in such property, and (2) 10 percent of the fair market value of all partnership property other than money. IRC § 751(d).

\textsuperscript{67}As previously noted, a distribution of partnership property to a partner in exchange for the partner’s interest in other partnership property will be treated as a sale or exchange under IRC § 751(b) and if the property deemed sold by the partner is a Section 751 item, he will recognize ordinary gain thereon.

\textsuperscript{68}IRC § 751(c) and (d)(2).
would be recognized under IRC sections 1245 or 1250 on the disposition of depreciable property.\textsuperscript{69}

Payments made by a partnership in liquidation of the interests of a retiring or deceased partner are subject to special tax treatment under IRC section 736, an examination of which is beyond the scope of this paper.

The interplay of entity and conduit characterizations of a partnership under the tax law is best illustrated by the election granted to a partnership in IRC section 754. If the election under that section is made, the partnership’s basis in its assets must be adjusted in the following two circumstances:

1. In the case of a distribution to a partner from a partnership which has made an election under section 754, the partnership’s basis in its remaining assets will be\textsuperscript{70} increased:
   a. for cash distributions, by the amount of gain (if any) recognized by the distributee partner under section 731(a)(1); and
   b. for distributions in kind, by the excess (if any) of the partnership’s basis in the distributed property immediately prior to distribution over the distributee partner’s basis in such property; and the partnership’s basis will be decreased
   a. by the amount of loss recognized by a partner from a distribution in liquidation of his interest; and
   b. by the excess (if any) of a partner’s basis under section 732(b) in property distributed to him in liquidation of his interest over the partnership’s basis in such properties immediately prior to distribution.

2. Where an interest in a partnership is transferred either by sale, exchange, or the death of a partner, no adjustment will be made in the partnership’s basis in its assets unless an election under section 754 is effective; but if an election under section 754 is applicable, then the partnership’s basis in its assets will be either:
   a. increased by the excess (if any) of the transferee partner’s basis in his partnership interest over his proportionate share of the partnership’s basis in its assets, or
   b. decreased by the excess (if any) of the transferee partner’s proportionate share of the partnership’s basis in its assets over his basis in his partnership interest.\textsuperscript{71} The partnership’s basis in its assets will be adjusted only as to the proportionate share of tax attributes which are allocated to the transferee partner.\textsuperscript{72} This provision is illustrated by the following example:

\textsuperscript{69}IRC § 751(c).
\textsuperscript{70}IRC § 754 and § 734.
\textsuperscript{71}IRC § 754 and § 743.
\textsuperscript{72}Ibid.
In 1968, Able, Baker and Carr were equal partners in the ABC partnership. The only asset of ABC was a machine which the partnership had bought in 1963 for $10,000, and for which $6,000 depreciation deductions had been allowed. The machine had a fair market value of $9,000 in 1968. In that year, Able sold his one-third interest in the partnership to Evans for $3,000. Evans will have a basis of $3,000 in his partnership interest, but in the absence of a section 754 election, Evans will receive a depreciation allowance equal to one-third of that claimed by the partnership; since the partnership’s adjusted basis in the machine is only $4,000, Evans’ proportionate share of depreciation will be computed on a basis of only $1,333 even though he paid $3,000 for his share of that asset. Moreover, if the partnership immediately sold the machine for its value of $9,000, the partnership would recognize ordinary income of $5,000 under section 1245, of which one-third will be allocated to Evans. However, if a section 754 election were in effect for the year in which Evans purchased the machine, the partnership will compute Evans’ one-third share of depreciation or gain separately, and it will have a $3,000 basis in the one-third of the machine from which Evans’ share of depreciation or gain is computed. Thus, Evans will have a greater depreciation allowance than the other partners; and if the machine were sold for value immediately after Evans acquired his interest, Evans would recognize no gain or loss on the partnership’s sale.

An election under section 753 is made by a partnership by filing a written statement to that effect with the partnership’s tax return. A valid election applies to all transactions taking place in the partnership’s taxable year for which the election is made and to all subsequent taxable years until revoked.

The election under section 754 applies to the “transfer of an interest in a partnership by sale or exchange.” As previously noted, under the U.P.A., a transferee of an interest in a partnership does not necessarily become a partner. The Code and regulations do not state whether an election under section 754 applies to transfers by or to a person having an interest in the partnership who does not qualify as a partner. A prominent commentator on partnership tax law contends that section 754 applies irrespective of whether either the transferor or the transferee is a partner.

An interesting question under section 754 is the effect of the death of a partner on the partnership’s basis in unrealized receivables where an election is made under section 754. In George Edward Quick Trust v. Commissioner, the Eighth Circuit and the Tax Court both held that the partnership’s basis in

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73 Reg. § 1.754-1(b).
74 Reg. § 1.754-1(a).
75 IRC § 743(a).
76 U.P.A. § 27.
its receivables, which basis was zero at the date of death of a 50 percent partner, was not increased by the partner's death even though a valid election was made under section 754. The courts reasoned that the receivables constituted income in respect of a decedent and consequently, the underlying policy of IRC section 1014(c) precluded the use of a section 754 election to increase the transferee partner's basis in his share of the receivables where the increase is attributable to a basis the transferee acquired in his partnership interest under section 1014. The decision in the *Quick Trust* case is a sensible one, but it is mildly out of phase with the statutory language and has been criticized by two commentators in a jointly written article. In any event, it would appear that section 754 will cause a change in a partnership's basis in its receivables where the partnership interest was acquired by the transferee in a sale or exchange, and the *Quick Trust* problem is limited to circumstances where the transferee acquired his partnership interest through the death of a partner.

A comparison of partnership and corporate tax treatment would be incomplete if no mention were made of several tax benefits available to employees that cannot be enjoyed by partners but can be enjoyed by shareholders who are employed by their own corporation. Where an employer pays the medical expenses of an employee and his spouse and dependents, or where the employer provides them with medical insurance coverage, the employee does not recognize any income because of the receipt of medical benefits or insurance coverage. Nevertheless, the employer's payment of such expenses or such insurance premiums are deductible business expenses under IRC section 162. Also, an employer can provide an employee with a wage continuation plan in the event of the employee's illness or disability, and some portion, or possibly all, of such payments may be excluded from the employee's income. An employer can provide group life insurance coverage for its employees, and an employee will be taxed on the cost of his group life insurance coverage only to the extent that the amount paid by the employer for his coverage exceeds the cost of $50,000 face value coverage. A shareholder can be employed by his corporation and, therefore, can qualify for the above-mentioned employee tax benefits (and for other employee benefits), but a partner cannot qualify as an employee of his partnership for purposes of the above-mentioned provisions and thus cannot enjoy those special tax benefits.

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80 IRC §§ 105 and 106.
81 IRC § 105(d).
82 IRC § 79.
83 See Rev. Rul. 56-326, 1956-2C.B. 100; and IRC § 105(g). But cf. Armstrong v. Phinney, 394 F.2d 1260 (CA5, 1968) holding that a partner could qualify as an employee as that term is used in IRC § 119 and consequently, a partner may be allowed to exclude from his income the value of meals and lodging furnished to him for the convenience of his employer if the partner otherwise qualifies under § 119.
A word of caution is appropriate here. While a shareholder may serve as an employee of his corporation, the Commissioner will scrutinize transactions between a corporation and its shareholder-employee to determine if the latter was dealing with the corporation in his capacity as a shareholder rather than in his capacity as an employee. Where a closely held corporation establishes a medical plan only for its shareholder-employee(s) there is a risk that the plan will be deemed to be for the benefit of the shareholder as a shareholder rather than in his employee capacity; in that event, the shareholder-employee will not receive the special tax treatment which is available only for employees.

Perhaps the most important employee benefit available to shareholder-employees and not to partners is the tax consequences of participating in a qualified deferred compensation plan, i.e.—a qualified pension or profit-sharing plan. Partners may participate in a so-called HR 10 plan (or Keogh plan), but the benefits of such participation are far more limited than those enjoyed by participants in a corporate employer's plan. The availability of qualified deferred compensation plans has been an extremely important consideration favoring incorporation, especially for professional firms. It should be noted that a shareholder-employee of Subchapter S corporation who owns more than 5 percent of the corporation's stock is subject to restrictions on his participation in a qualified deferred compensation plan that are similar to those restrictions imposed on partners in HR 10 plans.

Having considered the basic legal and tax attributes of partnerships and having compared some of those attributes with the legal and tax status of corporations, a more detailed examination of the tax treatment of corporations and shareholders is in order. The tax consequences of transferring property to a corporation in exchange for the corporation's stock and securities and other properties will be examined.

3. Transfers to a Corporation in Exchange for the Corporation's Stock, Securities, and Other Property

A taxpayer's exchange of one item of property for another will constitute a taxable transaction in which the taxpayer may recognize gain or loss unless there is a specific statutory provision for nonrecognition. The Internal Revenue Code permits or requires nonrecognition of gain or loss in many specified circumstances. A taxpayer's transfer of property to a corporation in exchange for the corporation's stock is an exchange of property; consequently, the exchange will be treated as a taxable transaction unless excluded by some statutory provision. The statute most likely to grant nonrecognition for such
exchanges is section 351, and the operation and scope of that provision is the subject of this paper.\footnote{87} However, in such exchanges, the corporation which distributed its own stock and securities does not recognize any gain or loss thereby, regardless of whether section 351 is applicable, because section 1032 precludes nonrecognition of gain or loss by a corporation in such cases.

The basic requisites of section 351 are that property be transferred to a corporation in exchange solely for stock or securities of the corporation, and that immediately after the exchange the transferors of such property are in control of the corporation. If section 351 applies to an exchange, neither gain nor loss is recognized by the transferors, and this nonrecognition of gain or loss is mandatory. If the transfer of property to a corporation is made for stock and securities of the corporation and for other property, part or all of any gain realized by the transferors on the exchange may be recognized, but no loss will be recognized.\footnote{88}

The nonrecognition treatment accorded by section 351 to exchanges with controlled corporations is not limited to exchanges with newly organized corporations; it is equally applicable to such exchanges with a corporation which has existed for many years. The key requisite is that the transferors control the corporation immediately after the exchange, and the age of the corporation is not relevant.

The requirements for qualifying a transaction under section 351 often will turn on one or more of the following questions:

a. whether property was transferred;

b. whether the transferors were in control of the corporation immediately after the exchange; and

c. whether the property received in exchange from the corporation qualified as "stocks or securities."

Control

Section 351 grants nonrecognition treatment only if the persons who transferred property to the corporation are in control of the corporation immediately after the exchange is completed. Control is defined as ownership of stock possessing at least 80 percent of the total combined voting power of all classes of outstanding voting stock plus ownership of at least 80 percent of all other classes of stock.\footnote{89}

\footnote{87}Other code sections granting nonrecognition for gain or loss realized on such exchanges relate to transfers connected with a corporate reorganization or division (e.g., IRC §§ 354 to 356, and 1036), and the discussion of those areas is beyond the scope of this paper.

\footnote{88}IRC § 351(b).

\footnote{89}IRC §§ 351(a) and 368(c). The Commissioner has ruled that the requirement of control is not satisfied unless the transferors own 80 percent of each separate class of nonvoting stock. Rev. Rul. 59-259, 1959-2 CUM. BULL. 115.
Control of the corporation need not be held by one person; it is sufficient if the aggregate stock interests of a group of persons who transferred property to the corporation pursuant to a plan constitute control.\textsuperscript{90} The exchanges of the transferors need not be made simultaneously to have their stock interests aggregated; it is sufficient if they were acting pursuant to a pre-existing plan. It is noteworthy that the statute does not require that the transferors acquire control of the corporation as a consequence of the exchange; the requirement of control is satisfied if the transferors are in control immediately after the exchange, regardless of how long before the exchange they had control.\textsuperscript{91} Moreover, section 351 does not require that the transferors receive the corporation's stock and securities in proportion to their contributions,\textsuperscript{92} depending upon the facts, however, the receipt of a disproportionate amount of stock may be treated as a gift from the other shareholders for gift tax purposes, or as compensation from the corporation or from the other shareholders.\textsuperscript{93}

The literal language of section 351 requires only that the transferors control the corporation immediately after the exchange. The statute does not state that the transferors must retain control for any specified period of time. A corporate transferor is authorized by section 351 to distribute stock or securities it received to its shareholders, and this will not disturb the control requirement.\textsuperscript{94} However, in other circumstances, if the stock or securities received by a party to the exchange is promptly distributed to a purchaser or to a donee, the party may not qualify as a "transferor"; and if his shares of stock are needed to establish control, the transaction may not qualify under section 351. There has been considerable litigation in this area, but the results are inconclusive.\textsuperscript{95}

**Property**

Section 351 grants nonrecognition for transfers of property in exchange for the controlled corporation's stock or securities. Stock or securities received in exchange for services rendered or to be rendered constitute income to the recipient.\textsuperscript{96} In most circumstances, it is not difficult to distinguish property from services, but it is sometimes difficult to determine whether a transferor is contributing past services or a property interest which was created by his services;\textsuperscript{97} for example, are the following items services or property interests when contributed to a corporation:

\textsuperscript{90}Reg. $\S$ 1.351-1(a)(1) and (2), Ex. (2).
\textsuperscript{91}Reg. $\S$ 1.351-1(a)(2), Ex. (3).
\textsuperscript{92}Reg. $\S$ 1.351-1(b).
\textsuperscript{93}\textit{Id}.
\textsuperscript{94}IRC $\S$ 351(c).
\textsuperscript{95}For a thorough discussion of this issue, see Bittker and Eustice, \textit{Federal Income Taxation of Corporations and Shareholders} (3rd ed., 1971) No. 3.10.
\textsuperscript{96}Reg. $\S$ 1.351-1(a)(1)(i) and 1(a)(2), Ex. (3).
\textsuperscript{97}See United States v. Frazell, 335 F.2d 487 (5th Cir. 1964).
a. A legal document (such as a contract) drafted by an attorney and contributed to a corporation for its stock?

b. Blueprints and architectural plans drawn by an architect who contributed them to a corporation for stock?

c. A patent on an invention of the taxpayer who transferred the patent to a corporation in exchange for its stock?

Since section 351 requires that the persons who transferred property to a corporation must control the corporation immediately afterwards, it is necessary to separate those persons who received stock in exchange for property from those who did not. For these purposes, cash is treated as property,\textsuperscript{98} consequently, a person who purchased stock for cash will be treated as a transferor and his stock may be aggregated with that of other transferors in determining whether the control requirement is satisfied. A person who receives stock or securities solely for services is not a transferor; therefore, his stock is not aggregated with transferors of property. Thus, if X, Y, and Z formed a corporation to which X and Y transferred property and Z contributed services in exchange for which X, Y, and Z received an equal number of shares of the corporation's common stock, section 351 will not apply since the only persons who transferred property (X and Y) own less than 80 percent of the corporation's stock after the exchange. However, if Z had contributed both property and services in exchange for the stock he received, Z would thus be a transferor of property, and all of Z's stock (including stock given him for his services even though Z is taxed on the receipt of that stock) could be aggregated with the stock of X and Y in determining whether the transferors had control.\textsuperscript{99} If, however, the value of the property contributed by Z was relatively small in comparison to the value of stock or securities distributed to him as compensation for his services, and if Z's primary purpose in transferring that property to the corporation was to qualify the transfers made by X and Y for nonrecognition under section 351, then Z is not treated as a transferor, and section 351 is inapplicable.\textsuperscript{100}

4. "Assignment of Income" and Related Doctrines

The "assignment of income" doctrine was created by the courts to prevent a taxpayer from shifting income to a person who will be taxed at a lower rate. The assigned income may be a payment for services rendered by the assignor,\textsuperscript{101} or it may be the right to income from property owned by him.\textsuperscript{102} In such cases, the income received by the assignee is nevertheless


\textsuperscript{99}Reg. § 1.351-1(a)(2), Ex. (3).

\textsuperscript{100}Reg. § 1.351-1(a)(1)(ii). The same rule applies where property contributed by a shareholder is of relatively small value to the stock held by the shareholder prior to the exchange, and the primary purpose of the transfer of that property was to qualify the exchanges of other persons under section 351. See Kamborian v. Commissioner, 30 Am. Fed. Tax R.2d 72-5744 (1st Cir. 1972), 56 T.C. aff'd g. 66.

\textsuperscript{101}Lucas v. Earl, 281 U.S. 111 (1930).

\textsuperscript{102}Helvering v. Horst, 311 U.S. 112 (1940).
taxed to the assignor—i.e., the assignment is ignored for income tax purposes. Of course, virtually all property has income-producing potential, and a taxpayer's assignment of his entire interest in an item of property will not cause him to be taxed on income subsequently produced by that property. The distinction between an assignment of property with its attendant income rights and an assignment of the income rights alone frequently is difficult to determine.\textsuperscript{103} The "assignment of income" doctrine can apply to transfers made to a controlled corporation,\textsuperscript{104} and in such event, the transferor will be taxed on the income when received by the transferee corporation.

A major purpose of section 351 is to remove tax costs that might deter taxpayers from adopting a corporate form for the conduct of a business activity so that the decision whether to incorporate will not be unduly influenced by tax considerations. Consequently, the transfer of the assets of an existing business to a controlled corporation should not constitute an "assignment of income" as to any item that is an element of the business and which normally would be transferred with the business.\textsuperscript{105} Thus, where the assets of an existing business, including the accounts receivable, are transferred to a controlled corporation in an exchange under section 351, the transferor should not be taxed on the corporation's collection of the receivables, even though the transferor had not included the receivables in gross income prior to the exchange because the transferor was on the cash receipts and disbursements method of accounting.\textsuperscript{106} While the tax treatment of an assignment of unrealized receivables to a controlled corporation has not been resolved, K. Martin Worthy, former Chief Counsel of the Internal Revenue Service, wrote in a 1970 article that it is the practice of the Service to rule that the collection of such receivables will not be taxed to the transferors provided that certain requirements are met, such as:

a. that the accounts payable of the business must be taken over by the corporation; and

b. that the transferee corporation agrees in a closing agreement with the Service to recognize payments on the receivables as ordinary income when collected.\textsuperscript{107}

Thus, if the transferor is on the cash method and the amount of the business' receivables are large, the parties should consider seeking a closing agreement with the Service.

\textsuperscript{103} \textit{Compare} Strauss v. Commissioner, 168 F.2d 441 (2d Cir. 1941), \textit{cert. denied}, 335 U.S. 858 with Heim v. Fitzpatrick, 262 F.2d 887 (2d Cir. 1959).

\textsuperscript{104} See Clinton Davidson, 43 B.T.A. 576 (1941).

\textsuperscript{105} See \textit{Arent, Reallocation of Income and Expenses in Connection with Formation and Liquidation of Corporations, 40 Taxes} 995 (1962).


A question related to the treatment of collections on receivables is whether the transferee corporation will be allowed an income tax deduction for the payment of obligations incurred by the transferor in the operation of the business prior to its incorporation if such payments would have been deductible by the transferor had he made the payment. For example, can the transferee corporation deduct retirement payments it made to an employee of the business who retired before the business was transferred to the corporation? It would appear that such payments by the transferee corporation should be treated as part of the cost of acquiring the business, and thus would constitute a nondeductible capital expense. However, in the 1970 article mentioned above, Mr. Worthy stated that it was the practice of the Commissioner to permit the transferee corporation to deduct such payments where the parties had executed a closing agreement with the Service in connection with the transfer of the business to the corporation. If a business has substantial payables which would otherwise qualify for a deduction, that may be a sufficient reason to seek a closing agreement with the Service. In this regard, it is noteworthy that in a recent decision, the Tax Court denied a deduction for a transferee corporation’s payment of a pre-existing obligation.

Where the income from a taxpayer’s business is reported on the accrual method of accounting and where the taxpayer had established a bad debt reserve for his receivables and had deducted the reserve from his gross income, the Commissioner contended that the transfer of that business, including the receivables, to a controlled corporation will cause the taxpayer to recognize a gain in the amount of the bad debt reserve, irrespective of whether the exchange qualifies under section 351. The Supreme Court rejected the Commissioner’s contention and held that where receivables are transferred in an exchange covered by section 351 and where the market value of the accounts receivable do not exceed their net book value (i.e., the excess of the face amount of the receivables over the total bad debt reserve), the transferor will not recognize any income on the transfer. The consequences of transferring receivables, the market value of which is greater than the net book value, is unresolved, but it appears likely that the excess will be treated as income to the transferor.

The transfer of an installment obligation, the gain from which is being reported on the installment method, will not constitute a taxable disposition if the transfer is made in an exchange which qualifies for nonrecognition treatment under section 351. Similarly, the statutory provisions for recapture

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108Id.
112Reg. § 1.455-9(c)(2).
of depreciation (or losses) do not apply to a transfer to a controlled corporation if section 351 is applicable. However, if the transferor is required to recognize part of his realized gain under section 351(b), then the recapture provisions will cause the transferor to characterize part or all of his recognized gain as ordinary income, but they will not cause the recognition of gain that is protected by section 351. A transfer to a controlled corporation of property, for which an investment credit previously had been allowed the transferor, usually will not trigger the recapture of the investment credit since such transfers typically will constitute a mere change in the form of conducting a trade or business in which the transferor retains a substantial interest.

Stock and securities

One of the requirements for qualifying an exchange under section 351 is that property be transferred to the corporation "solely in exchange for stock or securities" of the corporation. If the requisites of section 351 are satisfied, except that in addition to receiving stock or securities of the corporation a transferor also receives other property from the corporation, the transferor will recognize the gain realized by him on the exchange but only to the extent of the value of the "other property" (the "other property" received in a section 351 exchange—property received from the distributee corporation other than the corporation's stock and securities—is often called "boot"). If a transferor realizes a loss on an exchange which qualifies under section 351 except that the transferor receives boot in addition to the corporation's stock or securities, the loss will not be recognized.

Since nonrecognition is granted only for transfers to a corporation in exchange for its stock or securities, the definition of stock and securities is of critical importance. However, neither of those terms is defined in the Code. The word "stock" refers to an equity interest in the corporation. It includes common and preferred stock, whether voting or nonvoting. It also included hybrid stock—i.e., a purported debt of the corporation which is deemed to have more characteristics of an equity interest than of a debt and so is treated as stock. The regulations state that stock rights and stock warrants do not qualify as stock, and thus the receipt of those items in an exchange under section 351 constitutes boot. The Service's position on stock rights and stock

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113IRC §§ 1245(b)(3), 1250(d)(3), and 1251(d)(3).
114Id.
115IRC § 47(b).
116IRC § 351(a).
117IRC § 351(b). The term "other property" refers to cash and any property other than the transferee corporation's stock and securities.
118IRC § 351(b)(2).
119See IRC § 385.
120Reg. § 1.351-1(a)(1).
warrants has also been applied to corporate divisions, and although at first litigation on that issue was inconclusive, it now appears reasonably well settled that the courts will uphold the Service’s position.\textsuperscript{121}

The meaning of the word “securities” has been the subject of considerable litigation. It should be emphasized that the word “securities” does not have the same meaning in the tax law that it has in the SEC laws. For tax purposes, a security is an instrument representing a corporate obligation, but not all such instruments are classified as a security. The standards for distinguishing between a security and ordinary debt were described in the \textit{Camp Walters Enterprises}\textsuperscript{122} case, where the Fifth Circuit stated that the test of whether a note should be classified as a security is not determined solely by the time period of the note, although that is an important factor, but instead by “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.” Despite the Fifth Circuit’s statement that the duration of the obligation is only one factor in distinguishing debt from a security, it is virtually certain that a note or bond which matures in ten years or more will constitute a security, since an obligation which is not payable for at least ten years bears little similarity to a cash payment. Notes or bonds which mature in less than five years typically will not be treated as a security,\textsuperscript{123} since in most cases, an obligation of such short duration is more similar to a cash payment than to a proprietary interest which is subject to the risks of the business; however, in unusual circumstances, a short-term obligation could be a security. In one relatively recent case, the Fifth Circuit sustained a jury verdict that a one-year promissory note of a corporation qualified as a security,\textsuperscript{124} but it is unlikely that many notes of that duration will be so classified. The characterization of notes or bonds which mature between five and ten years of issuance is unresolved. It should be emphasized that while the time periods described above are useful guidelines, they should not be treated as absolute, and considerable caution should be exercised in relying on them.

\textsuperscript{121}On appeal to two different circuit courts from a consolidated case in the Tax Court, the circuit courts split over the issue whether stock rights and warrants constitute stock for purposes of Section 355. \textit{Compare} Commissioner v. Gordon, 382 F.2d 499 (2d Cir. 1967) \textit{with} Commissioner v. Baan, 382 F.2d 485 (9th Cir. 1967). The cases subsequently were remanded to the Tax Court by the Supreme Court which did not pass on this issue. On remand, the Tax Court held that stock rights do not constitute stock or securities within the meaning of section 355, and on appeal, both circuits affirmed—the Second Circuit thus abandoned its initial position that stock rights did constitute stock. Oscar E. Baan, 51 T.C. 1032 (1969), \textit{aff'd. sub nom.} Gordon v. Commissioner, 424 F.2d 378 (2d Cir. 1970), \textit{aff'd. sub nom.} Baan v. Commissioner, 29 \textit{AM. FED. TAX R.} 2d 72-331 (9th Cir. 1971).

\textsuperscript{122}Camp Walters Enterprises, Inc. v. Commissioner, 230 F.2d 555 (5th Cir. 1956), \textit{aff'd.} 302 U.S. 554 (5th Cir. 1956). \textit{See also} United States v. Mills, 399 F.2d 944 (5th Cir. 1968).

\textsuperscript{123}E.g., \textit{L & E Stirn, Inc. v. Commissioner}, 107 F.2d 390 (2d Cir. 1939) held that corporate bonds having an average maturity date of two and one-half years were not securities.

\textsuperscript{124}United States v. Mills, 399 F.2d 944 (5th Cir. 1968).
Consequences of receiving boot

If a transferor receives boot in an exchange covered by section 351, the tax consequences are clear where only one item of property was transferred to the corporation by the transferor. In that event, the transferor recognizes any gain realized on the exchange to the extent of the boot he received, and if he realized a loss on the exchange, none of it will be recognized. However, if the transferor assigned several items of property to the corporation in exchange for stock, securities, and boot, are his gains and losses on each item to be aggregated, and the net gain, if any, to be recognized to the extent of the boot; or alternatively, is the boot to be allocated among all the assets transferred to the corporation by the transferor pro rata according to the fair market values of those assets, so that the gain realized on each appreciated asset will be recognized to the extent of the boot allocated to that asset and the loss realized on each depreciated asset will not be recognized? The Commissioner has ruled that the gain recognized from boot must be determined by the latter method—viz., to allocate the boot pro rata among the various assets transferred by the transferor according to their respective market values. The Service's position has not yet been litigated, but it has much to recommend it and is likely to be sustained, since the rule is well established that on the sale of a business each asset of the business is deemed to be sold separately and the gain or loss on each asset is characterized according to its nature. Thus, the approach to the sale of a business is consistent with the Service's ruling on boot in section 351 exchanges.

The gain recognized by a transferor on a section 351 exchange will be characterized according to the nature of the asset transferred to the corporation on which gain was recognized. Thus, under the Service's position, after the boot has been allocated to each transferred asset, the gain recognized on an asset will be characterized accordingly, i.e., the gain on a capital asset will be capital gain and the gain on a noncapital, nondepreciable asset will be ordinary income. Gain recognized on depreciable property will be characterized as ordinary income to the extent that section 1245 or section 1250 are applicable, and the balance of such gain will be characterized under section 1231 unless section 1239 applies.

Under section 1239, where an individual sells to a corporation property which is depreciable in the hands of the corporation, the transferor's entire recognized gain from the sale or exchange of such property is treated as ordinary income if more than 80 percent of the value of the corporation's

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126 The aggregate approach to the sale of a business was established in the landmark decision of the Second Circuit in Williams v. McGowan, 150 F.2d 570 (1945). For a thorough discussion of the Service's position on gain recognized because of boot and of alternative methods of computation which the Service rejected, see Rabinovitz, Allocating Boot in Section 351 Exchanges, 24 TAX L. REV. 337 (1969).
outstanding stock is owned by the transferor, his spouse, his minor children, and his minor grandchildren. While the Regulations state that the more than 80 percent ownership test includes beneficial ownership, two Courts of Appeals have excluded stock which is only beneficially owned by persons named in the statute.

The "more than 80 percent" requirement in section 1239 refers to the value of outstanding shares. Thus, even if a corporation has only one class of stock, it is possible for a transferor to own 80 percent or less of the number of shares of its outstanding stock but, nevertheless, own more than 80 percent of the value of the outstanding stock because of restrictions on the minority shares or possibly because the possession of control adds a premium to the value of the majority stockholder's shares.

Section 1239 is not limited to actual sales between an individual and a corporation; it applies also to gain recognized on section 351 exchanges because of the receipt of boot or because transferred liabilities exceed basis (discussed below) if the transferor is an individual and if the more than 80 percent test is satisfied.

Section 1239 applies to sales or exchange "directly or indirectly" of covered property between an individual and a corporation where the 80 percent test is satisfied. Relying on the reference to indirect sales, the Commissioner has ruled that a sale of depreciable property from one corporation to another, both of which had more than 80 percent in value of their stock owned by the same individual, was an indirect sale from the individual to the transferee corporation and, therefore, was covered by section 1239. The Tax Court subsequently rejected this contention and held that the section was not applicable to such sales. The Court expressed its belief that the result urged by the Commissioner was desirable but held that the legislative history of section 1239 precluded its application to transfers made between two corporations. The Tax Court relegated the term "indirectly" in section 1239 to transfers involving strawmen.

Transferor's basis

The basis of a transferor in boot (other than money) received from the transferee corporation in a section 351 exchange is equal to the fair market

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128 Reg. § 1.1239-1.
129 United States v. Rothenberg, 350 F.2d 319 (10th Cir. 1965); Mitchell v. Commissioner, 300 F.2d 533 (4th Cir. 1962).
130 E.g., United States v. Parker, 376 F.2d 402 (5th Cir. 1967); Henry Trotz, P.H TAX CT. REP. & MEM. DEC. ¶ 67, 139 remanded from 361 F.2d 927 (10th Cir. 1966); Rev. Rul. 69-339, 1969-1 CUM. BULL. 203.
133 Id. For a broader definition of the word "indirect" as used in a different context in IRC § 162, see Prop. Regs. § 162-18(a)(2).
The transferor’s basis for the stocks and securities received in the exchange is allocated among each class of stock and securities separately. The total basis is allocated among the several classes of stocks and securities according to the proportional value that each separate class bears to the total value of stocks and securities received in the section 351 exchange.

Transfer of liabilities

With two exceptions, a transferor will not recognize income from a section 351 exchange with a corporation merely because pursuant to the exchange the transferee corporation assumed a liability of the transferor or received property in the exchange subject to a liability. In an ordinary exchange between A and B, if B accepts property from A subject to a liability (such as a mortgage), the amount of the liability is treated as consideration paid to A. This type of consideration was treated as boot in United States v. Hendler, but the Hendler decision was vitiated by section 357(a). However, as noted above, the transfer of liabilities to the transferee corporation in a section 351 exchange will reduce the transferor’s basis in the stocks and securities he received for the corporation. The two exceptions to the general rule that the transfer of liabilities to the transferee corporation will not cause the recognition of income to the transferor are discussed below.

1. Where, in a section 351 exchange, the sum of the liabilities assumed by the transferee corporation, plus the amount of liability to which property received by the transferee corporation was subject, exceeds the aggregate basis that the transferor had in the property transferred to the corporation, the excess constitutes gain to the transferor. The gain is determined for each transferor separately—i.e., the excess of liabilities transferred by each transferor over that transferor’s adjusted basis in the properties transferred by him to the corporation constitute a gain to that transferor. The “gain” recognized by a transferor is allocated among the properties transferred by him to

134IRC § 358(a)(2).
135IRC § 358.
136Reg. § 1.358-2(b)(2).
137Id.
138IRC § 357(a).
139Crane v. Commissioner, 331 U.S. 1 (1947).
140303 U.S. 564 (1938).
141IRC § 357(c).
the transferee corporation according to their respective fair market values, and the gain is characterized accordingly, i.e., as long-term or short-term capital gain, or as ordinary income.\textsuperscript{143} For this purpose, it is irrelevant whether the transferor realized a gain or loss on an individual asset; the allocation of \textit{gain} is made solely for purposes of characterizing that gain as capital, ordinary, or the like. If a going business is transferred in an exchange to which section 357(c) is applicable, an appropriate percentage of the gain recognized under section 357(c) must be allocated to the good will of the business and typically, that portion of the gain will be treated as a long-term capital gain.

As noted above, a transferor's basis in stock or securities received in a section 351 exchange in which no boot was received is equal to the transferor's basis in the properties transferred by him, plus any gain recognized by the transferor on the exchange and reduced by any liabilities assumed or accepted by the transferee corporation. Thus, if the liabilities transferred to the corporation are greater than the transferor's basis in the properties transferred to the corporation, the transferor would have a negative basis in the stock or securities he received in the exchange if it were not for the operation of section 357(c), which requires the transferor to recognize a gain in the amount of the excess.\textsuperscript{144} Because of section 357(c), the transferor's basis in stock or securities received in such exchange will be zero, and the incongruity of having a negative basis is avoided.

Section 357(c) treats as gain the excess of transferred liabilities over "the adjusted basis of the property transferred." There is no reason, however, to exclude cash transferred to the corporation from the determination of the transferor's total adjusted basis in the transferred assets, even though basis typically has no application to cash. Accordingly, the Commissioner has applied section 357(c) to cause the recognition of gain in an amount equal to the excess of transferred liabilities over the sum of the transferor's basis in the transferred properties plus the amount of cash paid by the transferor in the exchange.\textsuperscript{145}

Where cash and accounts receivable are among the assets transferred by a transferor in a section 351 exchange to which section 357(c) is applicable, should a portion of the gain recognized under section 357(c) be allocated to the cash or to the receivables, and how would gain allocated to the cash be characterized? The Tax Court has held that an appropriate portion of such gain shall be allocated to receivables (and thereby characterized as ordinary income), but that no part of such gain shall be allocated to cash or to prepaid rent.\textsuperscript{146} The Court reasoned that since cash and prepaid rent typically are

\textsuperscript{143}\textsuperscript{143}See \textit{Reg.} § 1.357-2(b).

\textsuperscript{144}See \textit{Lasson v. Commissioner}, 294 F.2d 653, 656 (9th Cir. 1961).

\textsuperscript{145}See \textit{Peter Raich}, 46 T.C. 604, 607 (1966).

\textsuperscript{146}\textit{Id.} at 611.
disposed of at face value, no gain was recognized by the transferor on those assets. The difficulty with this rationale is that gain under section 357(c) is allocated to the transferred assets solely for purposes of characterization without regard to whether the transferor realized a gain on the exchange of that asset; indeed, section 357(c) gain can be allocated to an asset on which the transferor realized a loss, and such gain will, nevertheless, be taxed to the transferor as capital gain or ordinary income, according to the characteristics of that asset. An alternative rationale for not allocating a section 357(c) gain to cash is that since no gain or loss is realized on domestic currency where it is employed as a medium of exchanges, Congress never contemplated cash being treated either as a capital asset or as a noncapital asset; therefore, it would be inappropriate to include cash as one of the assets which characterize the transferor's gain. The consequences of allocating a section 357(c) gain to cash becomes most troublesome when the exchange is viewed from the vantage point of the transferee corporation in determining its basis in assets received on the exchange; and this question is discussed below.

It should be noted that where a cash method taxpayer transfers accounts receivable to a corporation, the taxpayer usually will have a zero basis in the receivables and this must be considered in determining if section 357(c) applies to the exchange.

2. Where any liability transferred to the transferee corporation was transferred for the primary purpose of avoiding federal income taxes or for some other nonbusiness purpose, section 357(b) characterizes as boot all liabilities transferred by that transferor including liabilities transferred for valid business purposes. If both section 357(c) and section 357(b) are applicable, section 357(b) takes precedence.

Transferee corporation's basis

The corporation's basis in assets received in a section 351 exchange is equal to the basis the transferor had in the assets increased by any gain recognized by the transferor on the exchange. Neither the Code nor the Regulations state how a corporation's basis in transferred assets is to be allocated among the several assets the corporation receives from a transferor in a section 351 exchange where more than one asset is transferred. As a start, the corporation should have the same basis in each asset that the transferor had, but the question remains as to how the increment in basis caused by the transferor's recognized gain is to be allocated. Presumably, where the gain to the transferor was caused by the receipt of boot, the resulting increment in the corporation's basis will be allocated among the assets in the same manner that the transferor's recognized gain is allocated for purposes of characterizing

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147 Of course, coin collectors can have a gain or loss when they buy and sell rare coins; but in that case, the coins are not dealt with as a medium of exchange but rather as a commodity whose value is derived from its rarity.

148 E.g., Peter Raich, 46 T.C. 604 (1966).

149 IRC § 357(c)(2)(A).

150 IRC § 362(a).
that gain. Thus, if the Commissioner’s asset-by-asset method of computing and characterizing the transferor’s gain is sustained,\(^\text{151}\) the gain should be allocated in the same manner for the purposes of computing the corporation’s basis in each asset.

Where the gain to the transferor is caused by section 357(c)—i.e., an excess of transferred liabilities over the transferor’s basis in the transferred assets—it is more difficult to determine a desirable method for allocating the gain to the transferred assets for purposes of computing the corporation’s basis in those assets; but one method (described below) appears to have the sanction of administrative application. As noted above, for purposes of characterizing the gain recognized by a transferor under section 357(c), the gain is allocated among the transferred assets according to their respective market values, regardless of the gain or loss realized on each asset.\(^\text{152}\) Under the current administrative practice, the transferor’s gain is similarly allocated among the assets for the purpose of determining the corporation’s basis, but the relative value of the assets bears no significance to the \textit{amount} of gain recognized by the transferor. An alternative method, which has not been adopted to date, is to allocate the recognized gain among the assets in proportion to the gain \textit{realized} by the transferor thereon. However, since there is no apparent rationale for the Regulations’ characterizing the transferor’s gain by an allocation made according to the assets’ market values, perhaps the irrationality of the practice of similarly allocating the gain in determining the corporation’s basis is inconsequential. The current practice has the virtues of simplicity of administration and consistency with the rule for characterizing gain.

\textit{Advantages of debt}

When incorporating a business, the transferors can exchange assets for stock or securities of the corporation without recognizing a gain if they can qualify under section 351. Bonds, which are a form of security, are representations of debt, and it may be advantageous for the transferors to maximize their “loans” to the corporation (as evidenced by bonds) in contrast to their investment in the corporation (as evidenced by stock). The corporation’s payment of interest on its bonds is deductible, but the corporation’s distribution of dividends on its stock is not. Also, a corporation’s retirement of its bond constitutes a repayment of a debt which usually is not a taxable transaction to the bondholder, but the corporation’s redemption of its stock \textit{may} be treated as a dividend taxable to the shareholder as ordinary income. The transferors, however, should proceed with caution. What purports to be a bond or other debt instrument may be characterized as hybrid stock, and if so, no deduction will be allowed for a distribution thereon, and the retirement of such stock may be treated as a dividend distribution. The determina-
tion of the criteria for distinguishing debt from equity is beyond the scope of this article, but an interested reader might consult the Third Circuit's decision in *Fin Hay Realty* where the Court discussed some sixteen factors to be weighed.153
