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THE CONVERSION OF ORDINARY INCOME TO CAPITAL GAIN BY INTENTIONALLY AVOIDING SECTION 351 OF THE INTERNAL REVENUE CODE OF 1954

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I. INTRODUCTION

The emphasis has long been on how to transfer property to a controlled corporation without causing recognition of income to the transferor. The effort is usually to urge careful compliance with the terms of section 351¹ of the *Internal Revenue Code of 1954*² to insure the tax-free status of the transfer. It may be that all too little emphasis has been placed on the tax benefits that can arise from having the transfer either partially or fully taxable.

The tax benefits that may flow from a taxable rather than a non-taxable transaction depend to a large extent on the particular facts and the nature

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1. INT. REV. CODE OF 1954, § 351 provides as follows:

TRANSFER TO CORPORATION CONTROLLED BY TRANSFEROR.

(a) General Rule.—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property.

(b) Receipt of Property.—If subsection (a) would apply to an exchange but for the fact that there is received, in addition to the stock or securities permitted to be received under subsection (a), other property or money, then—

(1) gain (if any) to such recipient shall be recognized, but not in excess of—

(A) the amount of money received, plus

(B) the fair market value of such other property received; and

(2) no loss to such recipient shall be recognized.

(c) Special Rule.—In determining control, for purposes of this section, the fact that any corporate transferor distributes part of all of the stock which it receives in the exchange to its shareholders shall not be taken into account.

2. All references to the "Code" (or to "sections" thereof) shall mean the INTERNAL REVENUE CODE OF 1954, as amended and effective as of the date of this publication.

of the taxpayer's business. One of the most popular situations is the taxable transfer of low-basis real property (non-depreciable) to a controlled corporation organized for the purpose of improving, subdividing, and selling lots. The objective is to step up the basis of the real property at the cost of a capital gains tax, and thus isolate a portion of the appreciation in value as capital gain in the hands of the shareholder rather than ordinary income in the hands of the corporation.

Example:

The typical transaction may look as follows: Subdividers, Inc., is in the business of buying property, subdividing it, and selling house lots to individual builders. All the stock is owned by Mr. Investor. Mr. Investor is not a dealer for federal income tax purposes. Some time ago Mr. Investor acquired as an investment a parcel of realty now ripe for subdivision. He originally paid \$100,000 for the parcel, and he has had offers to sell it for \$200,000. He feels that with a well-conceived subdivision plan he could sell the individual lots for a gross amount of approximately \$400,000 and projects his cost of subdividing and improving at about \$100,000.

(1) If Mr. Investor *contributes* the property to the corporation under section 351, the tax results will be as follows. Mr. Investor realizes no tax. Subdivider's, Inc., will hold the property at a basis of \$100,000. Its tax profits upon the sale of all the lots would be \$200,000 (\$400,000 minus \$100,000 basis in land plus \$100,000 cost of improving). Taxed at present corporate rates (in one year), the total tax would be \$89,500.

2) If Mr. Investor *sells* the property to Subdivider's, Inc., for \$200,000 cash, he will recognize an immediate capital gain of \$25,000. Subdividers, Inc., will then hold the property at a basis of \$200,000. The corporation upon selling all lots will show a tax profit of \$100,000 (\$400,000 less \$200,000 basis in land plus \$100,000 cost of improving). The tax to the corporation would be \$41,500, and the total tax to both the corporation and Mr. Investor would then be \$66,500 (or \$33,000 less than under section 351).

Of course, in numerous other fact situations the tax benefits could be weighty.³ The benefits of transferring depreciable property in a taxable transaction have been rendered sufficiently less attractive by the enactment

3. The tax benefits that flow from a taxable transaction basically result from stepping up the basis of the assets transferred, *i.e.*, more depreciation and less gain on future sales. If the taxable transaction is achieved via the sale technique rather than certain of the other alternatives available, the tax benefits include those provided by the presence of a sizeable amount of debt in the capital structure of the corporation.

of section 1239⁴ and sections 1245⁵ and 1250.⁶ A taxable transaction is normally beneficial only when the transferor is seeking recognition of a potential gain rather than a potential loss on the transaction. The loss may be unallowable in many of these transactions either because of section 351⁷ or section 267.⁸

The opportunities for achieving a taxable event on the transfer of property to a corporation can generally be categorized as follows: (1) Sales of property to a controlled corporation; (2) Boot transactions; (3) Transfers of properties with liabilities in excess of basis; (4) Intentional failure to meet "control" requirements. Some of these transactions are less useful than others. Each will be considered herein.

II. SALES TO A CONTROLLED CORPORATION

By far the most common device employed to avoid intentionally section 351 upon the transfer of property to a controlled corporation is a "sale" (as opposed to an equity contribution). In light of its frequent use and the benefits it offers if employed successfully, the bulk of this effort will be devoted to a consideration of this technique of avoiding the tax-free provisions of section 351.

The normal procedure is formation of the corporation under state law, contributions of some property to it in exchange for stock, and the sale of an additional amount of property to the corporation for cash and notes. The gain (assumed to be capital) on the property sold is taxed under sections 1001 and 1002, and the corporation holds the property at a basis equal to the price (*i.e.*, "cost") it paid.⁹ The "sale" technique also offers

4. Section 1239 generally provides that in a transaction between certain related individuals or between an individual and a controlled corporation gain from the sale or exchange of property, which in the hands of the transferee is of a character that is subject to the allowance for depreciation provided in § 167, will be considered as gain from the sale or exchange of property that is neither a capital asset nor a § 1231 asset.

5. INT. REV. CODE OF 1954, § 1245 pertaining to the recapture of depreciation upon the disposition of certain depreciable personal property.

6. See INT. REV. CODE OF 1954, § 1250 pertaining to the recapture of depreciation upon the disposition of certain depreciable realty.

7. INT. REV. CODE OF 1954, § 351(b)(2) provides that no loss will be recognized in a § 351 transfer, even if boot is distributed.

8. INT. REV. CODE OF 1954, § 267(a)(1) provides that no deduction shall be allowed in respect of losses from sales or exchanges of property between those related individuals and organizations specified in § 267(b). Section 267(b)(2) specifically provides as one such relationship, referred to in subsection (a), an individual and a corporation in which such individual directly or indirectly owns fifty per cent in value of the outstanding stock. Section 267(c) provides its own constructive ownership rules.

9. See INT. REV. CODE OF 1954, § 1012.

the advantage of reporting the gain on the installment method¹⁰ and thereby deferring payment of a portion of the tax to years when cash is available. In other words, the "sale" technique offers the opportunity to isolate as a capital gain a portion of what would have been ordinary income of the corporation if the same property had been transferred under section 351.

There are two caveats to this last general statement. First, this technique has not gone unmolested by either the Internal Revenue Service or the courts. The attack has normally been based on the contention that what purported to be a sale for cash and notes was for tax purposes to be treated as an equity contribution.¹¹ Each decision has for the most part been limited to its particular fact situation, and only a close analysis of the cases in this area will reveal the guidelines to be followed in attempting to plan such a transaction. Second, the taxpayer must be careful when planning a transfer that will purposely avoid section 351 that he is not lured into the pitfalls created by sections 1239, 1245 and 1250.

The courts have developed a number of factors which they consider in determining whether a given fact situation constitutes, as a matter of law, a sale or an equity contribution. It should be noted that the decisions have not provided the taxpayer with a uniform test or list of factors around which he can plan with any degree of certainty. Furthermore, an attempt here to reconcile all of the decisions would be fruitless. Part of the problem is that the courts have failed to a large extent to define precisely either the meaning of or the rationale supporting the various factors they employ in their "balance of factors" approach to this issue. Yet to discuss the sale versus equity contribution question without attempting to provide the planner with some sensible guides or tests would not be meaningful. In discussing the various factors presented by the courts, the attempt will be: (i) to evaluate the factors that are considered by the courts as valid criteria

10. See INT. REV. CODE OF 1954, § 453, and specifically subsection (b)(1) (A).

11. The essential difference between a "stockholder" and a "creditor" was pointed out by the Court of Appeals for the Sixth Circuit in *United States v. Title Guarantee & Trust Co.*, 133 F.2d 990, 993 (6th Cir. 1943) as follows:

The essential difference between a stockholder and a creditor is that the stockholder's intention is to embark upon the corporate adventure, taking the risks of loss attendant upon it, so that he may enjoy the chances of profit. The creditor, on the other hand, does not intend to take such risks so far as they may be avoided, but merely to lend his capital to others who do intend to take them. [Emphasis in original].

See also, *Wilshire & W. Sandwiches, Inc. v. Comm'r*, 175 F.2d 718, 721 (9th Cir. 1949), and *Emanuel N. Kolkey*, 27 T.C. 37 (1956), *aff'd*, 254 F.2d 51 (7th Cir. 1958).

in distinguishing a sale from an equity contribution, and (ii) to suggest a sensible test for future use in resolving this issue.

The courts have been careful to point out that no single test or factor standing alone will generally be decisive.¹² Rather, only when all of the factors are considered together will the scales weigh in favor of a sale or an equity contribution.¹³ The initial inquiry is now usually phrased in terms of determining the "true intention" of the parties,¹⁴ which is but a paraphrase of the well-established tax doctrine that substance will prevail over form.¹⁵ This type of test standing alone, however, is of little value since the controlling intention is neither that found in the testimony of the shareholders nor that reflected on the face of the transfer documents; but, rather, it is the "true intention" which must be gleaned from the court's examination of all the surrounding facts and circumstances.¹⁶ The major shortcoming of such a test is that it fails to specify the weight to be given the presence or absence of any particular fact or circumstance, and consequently there is no uniformity in the decisions. The factors have been variously characterized by the courts, and they overlap to a great extent. They can, however, be categorized for purposes of this discussion into the following basic groups.

A. *Accouterments of a Sale.* As noted above, the substance of the transaction, rather than its form, is controlling in determining the proper tax treatment to be accorded the alleged sale. The question of whether the transaction is in substance, as well as in form, a sale is essentially one of fact.¹⁷ The burden of proof of this fact falls on the taxpayer as a result of the presumption of correctness accorded the deficiency assessment.¹⁸ The courts are willing to give some weight to the bare

12. *John Kelley Co. v. Comm'r*, 326 U.S. 521 (1946); *Talbot Mills*, 3 T.C. 95, 99 (1944), *aff'd*, 146 F.2d 809 (1st Cir. 1944), *aff'd*, 326 U.S. 521 (1946); *Proctor Shop, Inc.*, 30 B.T.A. 721, 725 (1934), *aff'd*, 82 F.2d 792 (9th Cir. 1936); *Emanuel N. Kolkey*, *supra* note 11; *Gooding Amusement Co.*, 23 T.C. 408 (1954), *aff'd*, 236 F.2d 159 (6th Cir. 1956), *cert. denied*, 352 U.S. 1031 (1957).

13. *Charles E. Curry*, 43 T.C. 667 (1965); *Gooding Amusement Co.*, *supra* note 12; *Aqualane Shores, Inc.*, 30 T.C. 519 (1958), *aff'd*, 269 F.2d 116 (5th Cir. 1959); *Foresun, Inc.*, 41 T.C. 706 (1964), *modified and aff'd*, 348 F.2d 1006 (6th Cir. 1965).

14. *Gooding Amusement Co.*, *supra* note 12; *Proctor Shop, Inc.*, *supra* note 12.

15. *1432 Broadway Corp.*, 4 T.C. 1158 (1945), *aff'd*, 160 F.2d 885 (2d Cir. 1947); and *Sherwood Memorial Gardens, Inc.*, 42 T.C. 211 (1964), *aff'd*, 350 F.2d 225 (7th Cir. 1965).

16. *Isador Dobkin*, 15 T.C. 31, 33 (1950), *aff'd*, 192 F.2d 392 (2d Cir. 1951); *Gooding Amusement Co.*, *supra* note 12. *Proctor Shop, Inc.*, *supra* note 12.

17. *Gooding Amusement Co.*, *supra* note 12; *Burr Oaks Corp.*, 43 T.C. 635 (1965), *aff'd*, 365 F.2d 24 (7th Cir. 1966), *cert. denied*, 385 U.S. 1007 (1967); *Marsan Realty Corp.*, 22 CCH Tax Ct. Mem. 1513 (1963); *Ewvalt Dev. Corp.*, 22 CCH Tax Ct. Mem. 220 (1963); *F. Devere Fleming*, 25 CCH Tax Ct. Mem. 1284 (1966); *Arthur M. Rosenthal*, 24 CCH Tax Ct. Mem. 1373 (1965).

18. *Gilbert v. Commissioner*, 262 F.2d 512 (2d Cir.), *cert. denied*, 359 U.S.

facts that the transaction was cast in the form of a sale rather than an equity contribution.¹⁹ Before doing so, however, courts will burrow behind the surface of the transaction as reflected by the face of the transfer documents and bookkeeping entries to determine whether the accouterments of a sale are present.²⁰ These accouterments include a purchase price approaching the fair market value of the property.²¹ A sale in excess of that amount will be viewed as an attempt to participate in the future profits of the business, a right normally enjoyed only by the equity owners.²² If there is no other clear evidence available, an independent appraisal of the property to be sold cannot be too strongly suggested, and the sales price should not vary from it without substantial reasons.

The accouterments of a sale also include a down payment.²³ In more than one decision²⁴ the court rejected what appeared at first glance to be a substantial down payment by showing it to be in reality a mere circulation of checks of no economic substance.

Written notes or evidence of indebtedness as well as a mortgage or other security device affording normal creditor protection on the deferred purchase money are considered normal paraphernalia of a sale.²⁵ To be given weight the courts require the security device to be fully perfected.²⁶ A reasonable rate of interest on the deferred purchase notes is also germane.²⁷

1002 (1959); Charles E. Curry, *supra* note 13; Ewvalt Dev. Corp., 22 CCH Tax Ct. Mem. 220 (1963); Harry F. Shannon, 29 T.C. 702 (1958).

19. Crawford Drug Stores, Inc. v. United States, 220 F.2d 292 (10th Cir. 1955); Charles E. Curry, *supra* note 13; and Emanuel N. Kolkey, *supra* note 11.

20. Doyle v. Mitchell Bros. Co., 247 U.S. 179 (1918); and Emanuel N. Kolkey, *supra* note 11.

21. In the majority of the decisions considering this issue, the sale at an inflated price has been a factor given much emphasis by the courts. Thus, see, Burr Oaks Corp., *supra* note 17; Piedmont Corp., 25 CCH Tax Ct. Mem. 1344 (1966); Marsan Realty Corp., *supra* note 17; Arthur M. Rosenthal, *supra* note 17; Aqualane Shores, Inc., *supra* note 13; Emanuel N. Kolkey, *supra* note 11; Ainslie Perreault, 25 T.C. 439 (1955); and F. Devere Fleming, *supra* note 17. The requirement seems to be not that the sales price be exactly equal to the fair market value, but rather that it be within the range of reason. Charles E. Curry, *supra* note 13.

22. *Cf.*, Arthur M. Rosenthal, *supra* note 17, holding that an excessive sales price alone is not decisive and the transaction may stand as a sale with the excessive purchase price being held to be a disguised dividend.

23. Aqualane Shores, Inc., *supra* note 13.

24. Thus, in Aqualane Shores, Inc., *supra* note 13, the court found the down payment to be in reality a mere circulation of checks. Likewise, in Foresun, Inc., *supra* note 13, the down payment obtained by placing a loan on the property prior to the transfer and contributing it to the corporation which in turn "paid" it to the seller as a down payment was held "mere window dressing."

25. Marsan Realty Corp., *supra* note 17.

26. *Ibid.*

27. Piedmont Corp., *supra* note 21; Charles E. Curry, *supra* note 13.

Equally important is the maturity date of the notes.²⁸ An unusually long term indicates an intention to share in the corporate adventure.²⁹ Each of these factors seems proper for the courts to consider. The variance of a given transaction from the conventional form of a sale, however, should not be overly criticized until the variance has been scrutinized in light of local or industry custom as reflected by similar transactions.^{29a}

B. *Subordination of Security Interest to Other Creditors.* The courts are quick to examine a transaction to determine whether the noteholder has subordinated his security interest or right to payment to other creditors of the business. The inquiry is first whether the shareholder has, under the provisions of local law, accepted a priority behind that of the present or future general creditors of the business.³⁰ Accepting a priority behind those creditors to whom conventional lending institutions would be willing to be subordinated is not found as indicative of an intent to create an equity interest.³¹ Although not always mentioned by the courts, while the noteholders may often be in equality with the other general creditors of the business, it is the unusual case when their interests are subordinate to them under local law. The question which is probably more crucial in the majority of the decisions is whether the noteholder has in practice subordinated his interest to that of general creditors.³² This question is easily resolved. The court need merely determine whether the corporate entity has diligently met its payment schedule, both principal and interest. Except in the unusual case and for sound business reasons,³³ the court will not overlook that the noteholders have consistently deferred payments of principal and interest in favor of other creditors of the business. The courts feel that the noteholders, by refusing to enforce their right to

28. Foresun, Inc., *supra* note 13.

29. Charles E. Curry, *supra* note 13.

29a. *Ibid.*

30. Charles E. Curry, *supra* note 13; and Foresun, Inc., *supra* note 13.

31. Charles E. Curry, *supra* note 13.

32. The failure to keep interest current and pay the notes when due has been noted in substantially all of the decisions considering the debt versus equity issue. Whether or not it is proper to do so is an interesting question in that it could be argued that the inquiry should be directed at the evidence of indebtedness only at the time of issue. The courts, however, give the failure to pay interest and principal heavy emphasis. See, for example, Emanuel N. Kolkey, *supra* note 11. Perhaps, even under the test suggested later herein, the failure in fact to pay would bear on the question of whether the expectation of payment was "reasonable." See, Burr Oaks Corp., *supra* note 17; Aqualane Shores, Inc., *supra* note 13; Foresun, Inc., *supra* note 13; Emanuel N. Kolkey, *supra*; Gooding Amusement Co., *supra* note 12; Warren H. Brown, 27 T.C. 27 (1956); F. Devere Fleming, *supra* note 17.

33. Arthur M. Rosenthal, *supra* note 17.

prompt payment regardless of the performance of the business, are treating their evidences of indebtedness as equity. Another device for subordinating the interest of the noteholder to trade creditors is to provide in the note that repayment shall be made only out of earnings of the business (or out of earnings in excess of a specified dollar amount). The courts have frowned on such provisions³⁴ and they are to be avoided. A better indication of a noteholder accepting the risks attendant equity ownership would be hard to imagine.

It is submitted that, in furtherance of an attempt to formulate a single test to be applied in this sale versus equity contribution area, the various factors grouped under "accouterments" and "subordination" can be expressed as evidence of part one of a two-part test. Part one of the recommended test is "whether the debt instruments comply with arm's length standards." Under this test, the purchase price and down payment and the debt's form, terms, conditions, and treatment in practice must all be consistent with those arrived at in arm's length dealings. The balance of the test will be set forth after a discussion of several more groups of the factors considered by the courts.

C. *Business Purpose.* The question of whether the existence of a business purpose is a proper criterion to consider in making the sale or equity contribution decision is far from settled. The Tax Court³⁵ has consistently placed heavy emphasis on the independent non-tax or business motive for a sale (rather than a contribution) of the assets to the corporation. A good example of a decision in which such a non-tax motive was given considerable weight is *Warren H. Brown*.³⁶ There the Tax Court accepted as a legitimate business purpose for the sale the vehement objections of the more conservative owner of a business to transferring certain equipment to the corporation. He did not want to subject it to risks involved in a proposed program of expansion. The Circuit Courts in such cases as *Sun Properties, Inc. v. United States*,³⁷ on the other hand, are quite firm in holding that a sale is not required to have any business pur-

34. *Piedmont Corp.*, *supra* note 21; *Emanuel N. Kolkey*, *supra* note 11; *Warren H. Brown*, *supra* note 32; and *Sherwood Memorial Gardens, Inc.*, *supra* note 15.

35. *Charles E. Curry*, *supra* note 13; *Emanuel N. Kolkey*, *supra* note 11; *Warren H. Brown*, *supra* note 32; *Sherwood Memorial Gardens, Inc.*, *supra* note 15; and *Gooding Amusement Co.*, *supra* note 12.

36. 27 T.C. 27 (1956).

37. 220 F.2d 171 (5th Cir. 1955). See also, *Marsan Realty Corp.*, *supra* note 17, and the comments contained in *Hickman, Incorporation and Capitalization*, 40 TAXES 974, 985 (1962); *Nassau Lens Co. v. Comm'r.*, 308 F.2d 39 (2d Cir. 1962); *Rowan v. Comm'r.*, 219 F.2d 51 (5th Cir. 1955).

pose beyond that of realizing a capital gain. There the court pointed out that there are many situations in which the acceptance of a transaction's form for tax purposes will depend on the existence of an independent business purpose.³⁸ It stated, however, that it would be most reluctant to impose such a court-made rule for sales since it is common knowledge that vast numbers of sales are made for the purpose of taking gains and losses at times which provide the optimum tax benefits.³⁹ The business purpose for the existence of the alleged indebtedness has received somewhat less emphasis of late.⁴⁰ The better rule would draw no inference from the lack of a business (non-tax-motivated) reason for the selection of a sale over an equity contribution since an opportunity to recognize a capital gain seems to be sufficient justification for the selection. The important inquiry is "what in fact was done," and the question of why it was done is unimportant. If a bona fide sale creating arm's length deferred purchase money rights in the seller is effected (*i.e.*, if the transaction has economic substance under the test suggested below) that it was done for tax motives is inconsequential. To hold otherwise would seriously jeopardize all tax planning. Rather, if a business purpose should be considered at all it would be more appropriate to consider it only as evidence of the presence of other factors, such as the reasonable expectation of payment, rather than as direct criterion itself. Whatever the rule in theory should be, however, in light of present case law it would be naive to plan a sale to a newly-organized corporation without giving some consideration to developing or refining a business purpose for a sale rather than a contribution. Corporate minutes, records, and general correspondence reflecting and supporting the business motive should be preserved.

D. *Undercapitalization.* The question of whether a newly-organized corporation is undercapitalized, in light of its stated objectives and estimated cost of embarking upon the corporate journey, is considered as a factor in virtually all of the cases attempting to resolve the issue of sales versus equity contribution.⁴¹ The term "undercapitalization" (or sometimes called "thin capitalization") is often used by the courts, but generally without much indication as to the meaning then being ascribed

38. *E.g.*, recognition of a corporate reorganization, of a corporate entity, or of a sale and leaseback arrangement.

39. *Sun Properties, Inc. v. United States*, *supra* note 37.

40. Hickman, *The Thin Corporation—Another Look at an Old Disease*, 19TH ANNUAL FED. TAX CONF. OF CHICAGO LAW SCHOOL, p. 883 (1966).

41. *Burr Oaks Corp.*, *supra* note 17; *Emanuel N. Kolkey*, *supra* note 11; and *Sherwood Memorial Gardens, Inc.*, *supra* note 15.

to it. Unfortunately, the term is often used to express the conclusion that an instrument purportedly representing a debt obligation of the corporation will not be recognized as such for tax purposes. The real purpose the term is designed to serve, however, is not to reflect such a conclusion but rather to be a factor to be weighed in arriving at the conclusion. It should also be pointed out that the sale versus equity contribution question is but a species of the broader debt or equity issue, which includes not only "sales" but also simple "loans" of cash in exchange for debt instruments. For the reasons which will become apparent below, the undercapitalization factor is probably the single most important factor to be understood in planning a sale to a controlled corporation.

The general rule is that the existence of an excessively debt-laden capital structure is a factor which will be weighed but will not alone decide the sale or capital contribution issue.⁴² Thus, courts have found the transfer to be an equity contribution rather than a sale after they specifically held that the capital structure and debt-equity ratios were sound.⁴³ To compound confusion in this area, however, there are a number of cases stating that the inquiry into the thinness of capitalization of the corporation is not, without more, proper or germane to the issue of whether the transaction should be recognized as a sale.⁴⁴ Such cases have themselves limited their holding to the situation where only the debt-equity ratio is being considered and none of the other factors tending to indicate equity rather than debt are present.⁴⁵ It is submitted that a good deal of this confusion is due to the failure of the courts to define precisely what is meant by the term "thin capitalization" or "undercapitalization" when cited as a factor to be weighed in the sale versus equity contribution issue. It may safely be said that the cases in the thin capitalization area are not always consistent⁴⁶ and an attempt to reconcile even the major decisions would be beyond the scope of this effort. In fact, it appears that the various Circuit Courts are presently at odds on what are the proper criteria to be considered in determining whether a corporation is "thinly capitalized."⁴⁷

For some time the thinness of a corporate capital structure was

42. Gooding Amusement Co., *supra* note 12.

43. *Ibid.*

44. See, e.g., Sun Properties, Inc. v. United States, *supra* note 37.

45. *Ibid.*

46. For an excellent study of the thin capitalization issue, see Caplin, *The Calorie Count of a Thin Corporation*, N.Y.U. 17TH INST. ON FED. TAX, 771 (1959).

47. *Ibid.*

measured or gauged almost entirely in terms of the "debt-equity ratio."⁴⁸ Although the courts still mention the ratio in their decisions today,⁴⁹ the ratio, standing alone, seems to be of only make-weight consequence. Courts have found sales (*i.e.*, true debt) when the debt-equity ratio was as high as 320:1⁵⁰ and 50:1⁵¹ while finding equity contributions (*i.e.*, not true debt) with ratios as low as 1:1⁵² and 3:1.⁵³ The once-cited rules of thumb for a "safe" debt-equity ratio⁵⁴ are now generally rejected in favor of an only slightly more analytical "shot gun" approach seeking the "intent" of the alleged seller.

The question raised by the undercapitalization factor for present purposes is two-fold. First, it must be determined what is meant by the term "undercapitalization" when cited as criterion to be used in distinguishing a sale from an equity contribution. Only when the meaning of the term is clearly in mind is it worthwhile to consider the second question; namely, whether "undercapitalization" is a proper factor to be weighed in the sale versus equity contribution question. Rather than attempting to set forth all the various theories of the case supporting the thin capitalization issue, an effort will be made to present what seems to be the proper theoretical test to determine the existence of this factor, yet a test which is sufficient for planning purposes in light of the present confused status of the law. It is submitted that much of the loose language in the decisions such as "assets being at the risk of the business" or "risk capital" or "capital cushions" could be clarified or eliminated if the courts could employ a consistent and meaningful test in this area.

The suggested test is not based on language from any one decision so much as it is on an examination of many of the later cases and a condensation of what is felt to be the general attitude permeating the

48. See *John Kelley Co. v. Comm'r*, *supra* note 12. *Caplin*, *supra* note 46, states that the period 1946-1956 can be called the Age of Ratios, coming to an end with the *Gooding* decision.

49. The courts which have persisted in considering the thin capitalization issue in terms of the debt-equity ratio as well as those that search for a "substantial" amount of capital will accept as additional property contributed (as opposed to sold) good will and other intangible items if a value, however tenuous, can be placed thereon. *Ainslie Perrault*, *supra* note 21; and *Gooding Amusement Co.*, *supra* note 12.

50. *Aqualane Shores, Inc.*, *supra* note 13.

51. *Hoguet Real Estate Corp.*, 30 T.C. 580 (1958).

52. *Gooding Amusement Co.*, *supra* note 12.

53. *Ainslie Perrault*, *supra* note 21.

54. *Cf.*, *Treusch, Corporate Distributions and Adjustments: Recent Case Reminders of Some Old Problems Under the New Code*, 32 TAXES 1023, 1026-27 (1954).

decisions that have at least attempted to delve into the heart of this issue. Basically, the test may be stated as follows: A corporation will not be found to be undercapitalized "if its capital structure is economically realistic when considered in light of the nature of its corporate objectives." In turn, whether a capital structure is "economically realistic" means "whether the corporation can reasonably be expected to service the debt currently and repay the principal amount as it comes due."⁵⁵ The existence of such an "economically realistic" capital structure should halt further assault by the commissioner. There simply exists no statutory authority or judicial doctrine which permits the commissioner to reshuffle a capital structure as "thin" if this test is satisfied.⁵⁶ The test suggested herein as an accurate expression of the "undercapitalization" factor is the second part of the two-part test urged as the true test in the sale versus equity contribution issue.

The question of whether the corporation can "reasonably" be expected to repay the loan is in the nature of a reasonable man test rather than whether a conventional lender would make the same loan. Since an income statement does not reflect certain cash payments, such as amortization of the principal amount of a debt or the creation of reserves for contingencies, and since certain non-cash items, such as depreciation, appear as expenses reducing income, cash-flow projections would probably be more technically accurate than projections of profits.

Shareholder loans to the corporation *after* the alleged sale in order to assist it in accomplishing its corporate objectives have been held to be

55. See the test urged in Hickman, *supra* note 40. This attitude can be seen lurking in the shadows in both the Tax Court and the Circuit Court decisions. See the Circuit Court decisions of Nassau Lens Co. v. Comm'r, *supra* note 37; and Gloucester Ice & Cold Storage Co. v. Comm'r, 298 F.2d 183 (1st Cir. 1962). In Charles E. Curry, *supra* note 13, the Tax Court stated that the simple fact that the notes took on a degree of risk of the business would not mean they had no reasonable expectation of being paid. See also Burr Oaks Corp., *supra* note 17; Ewvatt Development Corp., *supra* note 17; Marsan Realty Corp., *supra* note 17; and Charles D. Vantress, 23 CCH Tax Ct. Mem. 711 (1964). Of course, whether the expectation of payment is reasonable is more easily determined in a proven business rather than one which is untried. Compare Burr Oaks Corp., *supra*, with Ainslie Perrault, *supra* note 21, and Sheldon Tauber, 24 T.C. 179 (1955), questioned, David v. Phinney, 350 F.2d 371, 367 (5th Cir. 1965), *cert. denied*, 382 U.S. 983, *reh. denied*, 384 U.S. 958 (1966).

56. Since 1954 there have been several proposed legislative solutions in the debt equity area. See II ALI FED. INCOME TAX STAT. 231 (Feb. 1954 draft); ABA SECTION OF TAXATION, 1956 PROGRAM AND COMMITTEE REPORTS TO BE PRESENTED AT THE SEVENTEENTH ANNUAL MEETING, 36-38 (1958); and SUBCHAPTER C, ADVISORY GROUP REPORT ON CORPORATE DISTRIBUTIONS AND ADJUSTMENTS, SUBCOMMITTEE ON INTERNAL REVENUE TAXATION, HOUSE WAYS AND MEANS COMMITTEE 20 (Dec. 24, 1957).

evidence that the original capitalization was not realistic.⁵⁷ Conventional bank financing after the sale does not necessarily carry the same stigma. The proof of its availability may help to cure the shareholder loan.⁵⁸ Conventional bank financing after the sale will not be helpful, however, if obtained by the corporation, not because of its earning power or future prospects, but because of personal guarantees of the shareholders. In fact, such bank indebtedness itself has been attacked as equity in several recent decisions.⁵⁹

E. "*Risks of the Business*" Test. The courts have frequently stated that the alleged debt should not be recognized as such if the funds loaned or the properties sold in exchange for notes were "placed at the risks of the business." The two most common indicia found by the courts to be evidence of the assets or funds being "at the risks of the business" are (i) the funds or assets constitute permanent or necessary assets of the business, frequently called the "core asset" test and (ii) stockholder debt was held in direct proportion to the stock ownership. The core asset test,⁶⁰ as laid down in the cases, is neither well articulated nor particularly responsive to the issue. The immediate question which comes to mind is what assets are not to some extent subject to the risks of the business. That the assets acquired by the issuance of the debt are permanent or necessary is largely irrelevant to the question of whether the capital structure is to be recognized for tax purposes. If carried to its logical extreme, the test would seem to allow only shareholder loans which were incurred to finance short-lived, non-essential assets.

The second "risks of the business" factor which has been given heavy emphasis by the courts is that the stockholders of the corporation hold the debt obligations in the same proportion as their stock.⁶¹ If this factor alone was found to have much weight, it would seriously jeopardize many a closely held business's capital structure. The validity of the factor is clearer when the stock and the debt are held in different proportions. The discharge of the indebtedness will then have a substantial economic effect

57. F. Devere Fleming, *supra* note 17.

58. Emanuel N. Kolkey, *supra* note 11.

59. See, e.g., *Murphy Logging Co. v. United States*, 239 F. Supp. 794 (D. Ore. 1965).

60. *Marsan Realty Corp.*, *supra* note 17; *Burr Oaks Corp.*, *supra* note 17; *Charles E. Curry*, *supra* note 13; *Sherwood Memorial Gardens, Inc.*, *supra* note 15; *Bruce v. Knox*, 180 F. Supp. 907 (D. Minn. 1960); and *Warren H. Brown*, *supra* note 32.

61. *Piedmont Corp.*, *supra* note 21; *Charles E. Curry*, *supra* note 13; *J. I. Morgan, Inc.*, 30 T.C. 881 (1958), *Rev'd* on other grounds, *Commissioner v. Morgan*, 272 F.2d 936 (9th Cir. 1959), and *Ewvalt Development Corp.*, *supra* note 17.

in that the relative rights of the debt holder and the shareholder to the corporate assets are being altered with each payment on the debt.⁶² Although this type of factor would at first glance seem to bear on the question of whether the debt is true debt or equity, it is submitted that it is not in reality a proper factor in searching for the existence of a true sale. Fortunately, to date the courts have not gone so far as to hold that no debt will be recognized which is held by shareholders in the same ratio they hold their stock. The existence of a pro rata holding of debt and stock should be used merely to show that the capitalization is so structured that the stockholders could be improperly reaping the tax benefits of an equity interest masquerading as debt. Thereafter, whether the debt is in fact stock should not be further affected by the proportionate holding of debt and stock.

The "risks of the business" test, then, will not withstand close scrutiny. In fact, it is more of a statement of a conclusion than of a test. The more valid questions appear to be "how substantial are the risks to which the creditor is subjected" and "whether a creditor would be willing to incur it." These, however, are the questions posed by the undercapitalization issue. Regretably, this product of loose thinking is still present in some of the latter decisions, and therefore cannot be completely ignored in planning a sale.

F. A Sensible Test. The lack of a clear and sensible test in this area has led to the unfortunate "balance of factors" approach to determine whether a sale is to be recognized as such for tax purposes. This approach is unfortunate in two respects. First, it fails to specify either (i) a consistent set or group of factors to be considered in all cases or (ii) the weight to be given any one factor when it is found present. The result has been that the courts both have considered a different set of factors in almost every decision and have given varying weight to the same factor in different decisions. Second, the lack of a clear guideline for so long has allowed numerous irrelevant factors to be nurtured as proper criteria.

The test developed in the discussion above may be stated in its entirety as follows: A sale to a controlled corporation is to be recognized as such for tax purposes if (i) the capital structure of the corporation immediately after the transaction is economically realistic when considered in light of the nature of its corporate objectives and (ii) the evidences of indebtedness issued in connection with the transaction comply with arm's

62. See Charles E. Curry, *supra* note 13.

length standards. Under this test the traditional tests of business purpose and core assets do not have to be totally rejected as criteria. They can survive as evidence to the extent they bear on the questions of whether the expectation of repayment was realistic and whether the terms of the debts were based on arm's length standards. The test may admittedly be difficult to apply in many cases, but it does have the benefit of providing the inquirer with a clear and uniform expression of his task. Further, although it is difficult to apply it should not necessarily be totally condemned. The courts have managed with some tests at least as nebulous, a good example being the "reasonably prudent man" test in negligence cases.

G. *Planning the Sale.* The sale versus equity cases have presented over a period of time such diverse approaches to the question of the proper test of a sale which will be recognized as such for tax purposes that it is now an extremely difficult area in which to plan with certainty. Although the test set forth above should sustain a taxpayer in his ultimate burden before the higher courts, it is probably wise to plan only in light of the multitude of factors cited by the various tribunals in the presently favored balance of factors approach. The following factors are offered as considerations consistent with good planning of a sale to a controlled corporation in light of the present status of the law. Some of the factors are set forth reluctantly; it is hoped that mentioning them as consistent with good planning under the present status of the law will not be viewed as an endorsement which will serve to perpetuate their appearance in the opinions.

1. Employ debt instruments which are clear and unambiguous.
2. Use debt instruments which contain arm's length interest rates, dates of maturity, terms of payments, etc.
3. Sell at price not exceeding fair market value and with a reasonable downpayment.
4. Avoid subordination of debt to general creditors.
5. Avoid proportionate holding of debt and stock.
6. Reflect intention to create debt in corporate records.
7. Document non-tax business motives for selection of sale over equity contribution.
8. Meet principal and interest payments on debt when due.
9. Substantiate reasonable expectation of payment of debt with profit and cash-flow projections.

III. BOOT TRANSACTIONS

A second method of intentionally causing a transfer to a controlled

corporation to be taxable is the so-called "section 351(b) boot transaction." Section 351(b) provides that if the transferor receives from the corporation "money" or "other property" as well as the "stock or securities" permitted to be received under section 351(a), then gain (if any) will be recognized but not in excess of the money and the fair market value of the other property received.⁶³ No loss is recognizable in boot transactions.⁶⁴ The clearest example of a boot transaction is when property is transferred in exchange for stock or securities and a substantial amount of money. This example, however, is not representative of the normal factual situation since money is not generally available for distribution in sufficiently large sums to enable the transferor to recognize as sufficiently large gain.

The crucial terms in section 351 under this technique are "securities" and "other property." If property is found to be "securities" then no gain will be recognized, while the opposite is true if the property is found to be "other property." "Other property" may generally be said to be anything of value which is neither "stock," "securities," or "money." "Stock," of course, means an equity interest. The definition of the term "securities" is not as clear. It is a tax species of a debt instrument, but its exact characteristics are not sharply defined. The meaning of the term, however, is important under this technique and should be examined briefly.

The term "securities" is not defined in either the CODE or the REGULATIONS. It is well settled, however, that the definition is the same for section 351 as it is for the reorganization provisions of Subchapter C.⁶⁵ The proper definition to be given the term has been considered in a sizeable number of decisions. Unfortunately, the decisions have not as yet culminated in a clear set of guidelines as to what constitutes a "security." Perhaps most representative of the cases is *Camp Wolters Enterprises, Inc.*⁶⁶ In that decision, before finding that promissory notes which matured over a five-year period starting with the sixth year after date of issuance were

63. It appears to be the rule that if a transaction is found to be a "sale," then § 351 cannot be applied to cause the non-recognition of gain. Charles E. Curry, 43 T.C. 667, 697 (1965). However, it has been argued that even if the sale is found valid and the debt is accepted as real, the debt instruments received by the seller can still be found to be "securities" and thereby require the application of § 351. See, Note, *Section 351 Transfers to Controlled Corporations: The Forgotten Term—"Securities,"* 114 U. PA. L. REV. 314 (1965).

64. INT. REV. CODE OF 1954, § 351(b)(2).

65. *Lloyd-Smith v. Comm'r*, 116 F.2d 642, 644 (2d Cir.), cert. denied, 313 U.S. 588 (1941).

66. 22 T.C. 737, 750-51 (1954), aff'd, 230 F.2d 555 (5th Cir. 1956), cert. denied, 352 U.S. 826 (1956).

securities, the Tax Court⁶⁷ stated the standard to be applied in such cases is as follows:

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 over-all 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.

Similarly, the Supreme Court's pronouncement of the basic distinction between a "security" and other indebtedness is that the former gives a creditor some "assured participation in the business" while the latter encompasses short-term loans or debts representing "temporary advances for current corporate needs."⁶⁸ The proper rule would seem to be that the courts' inquiry should be focused on the evidences of indebtedness as they exist at the date of issue. The time when the notes are in fact paid could also be considered, but only as evidence of the debt holder's intention to continue participation in the business enterprise.

The courts have considered various factors in determining whether the evidences of indebtedness represented short-term loans or temporary advances on the one hand or "securities" on the other. Undeniably, the emphasis has been on the length of the term of the obligation. Significant in this regard, in addition to the cases, is a revenue ruling which was issued but subsequently withdrawn for procedural reasons. Rev. Rul. 56-303⁶⁹ in effect held that short-term notes with an average maturity of two and one-half years were "other property" and not securities for purposes of section 351. The only factor which was stressed in the ruling was the term of the notes. Among the other factors the courts have considered, the following seem important: (i) whether the notes were subordinated to other debts,⁷⁰ (ii) whether the notes were issued as part of the integral initial capitalization of the corporate enterprise as opposed to being issued as part of an isolated purchase and sale transaction after the formation of the corporation,⁷¹ and (iii) whether the indebtedness in question was payable on demand.⁷²

67. *Id.* at 751.

68. *Pinellas Ice & Cold Storage Co. v. Comm'r*, 287 U.S. 462 (1933).

69. 1956-2 CUM. BULL. 193 (1956).

70. *Camp Wolters Enterprises, Inc.*, *supra* note 66.

71. *Ibid.*

72. *Pacific Pub. Ser. Co.*, 4 T.C. 742 (1945), *aff'd*, 154 F.2d 713 (9th Cir. 1946).

The often-cited rule of thumb in this area is that obligations of less than five years in length will not be considered as "securities."⁷³ For obligations of longer duration, the rule is that the chances for an obligation to be held a security are greater as the duration of the obligation gets longer.

There appear to be no decisions in the last several years on the question of what constitutes a "security" for purposes of section 351. The commissioner has not shelved this weapon, however. In fact, the commissioner has raised the issue on several occasions as an alternative argument in the event that his contention that the debt was in fact equity failed.⁷⁴ So far the courts have found equity and have not ruled on the alternative argument.

It is interesting to note that it is not entirely settled as to how section 351(b) applies when more than one item of property is transferred in exchange for stock or securities and boot. The question is (i) whether the bases of all the assets are to be totalled to determine total gain or (ii) whether each asset is to be treated separately. If the answer to question (ii) is yes, then the additional interesting problem arises as to whether the gain is to be allocated to the various assets on the basis of their relative fair market values or their relative bases.⁷⁵ These problems leave much uncertainty and make it correspondingly more difficult to plan a transaction to achieve a desired tax result, such as a stepped-up basis,⁷⁶ on a specific asset or group of assets.

The transfer of property in exchange for "money" or "other property" as well as stocks and securities may not always meet the objectives of the transferor as precisely as the sale technique. First, the step up in basis of a specific asset can be controlled in a sale, but can be a problem in a boot transaction if more than one asset is being transferred. Second, while the sale technique may be reported on the installment method, boot transactions apparently do not meet the "sale or other disposition" language

73. See Camp Wolters Enterprises, Inc., *supra* note 66; and BITTKER AND EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 73 (1966).

74. See Arthur M. Rosenthal, 24 CCH Tax Ct. Mem. 1373 (1965); Charles E. Curry, *supra* note 63; Burr Oaks Corp., 43 T.C. 635 (1965), *aff'd*, 365 F.2d 24 (7th Cir. 1966), *cert. denied*, 385 U.S. 1007 (1967).

75. See, Rev. Rul. 55-79, 1955-1 CUM. BULL. 370 (1955) for a discussion of how such an allocation is made in connection with the sale of a going business.

76. Bases of assets received by a corporation in a § 351 transfer are determined under § 362, which provides the basis shall be the same as it was in the hands of the transferor increased by the amount of the gain recognized in the transfer.

of section 453. Third, section 1239 does apply to boot transactions, and so do sections 1245 and 1250.

IV. LIABILITIES IN EXCESS OF BASIS

A third method of intentionally causing taxation upon the transfer of property to a controlled corporation is presented by section 357. Section 357(a) provides the general rule that the assumption of liabilities by the corporation in a section 351 transfer will not be treated as the receipt of "money or other property" by the transferor. Section 357(c), however, provides that the normal tax free rules of section 351(a) will not apply to exchanges if the sum of (i) the liabilities assumed and (ii) the liabilities to which the property is subject exceeds the total of the adjusted basis of the property transferred. The excess is considered as gain from the sale or exchange of a capital asset or a non-capital asset as the case may be. The rule of section 357(c) is applied individually to each transferor, but as to each transferor the total bases of all assets transferred will be balanced against the liabilities assumed from him or acquired in connection with property transferred by him. In the case of a transfer of more than one item, the character of the gain is determined by allocating it ratably over all the assets in accordance with their fair market values.

The rules of section 357(c) appear to be automatic or mandatory. The subsection contains no subjective tests or business purpose requirements. It would seem therefore that a taxpayer, by mortgaging low-basis appreciated property prior to transferring it to a corporation, can have the excess of the mortgage over the basis automatically taxed as gain and added to the basis of the property in the hands of the corporation.⁷⁷ If the corporation is in existence at the time the mortgage is placed on the property, it should be clearly documented that the loan was negotiated, acquired, and distributed to the shareholders prior to the transfer of the property to the corporation. If the corporation requires the proceeds of the loan to carry on its corporate objectives and the proceeds of the loan are contributed to the corporation along with mortgaged property, the courts may conceivably find the loan to the shareholders was a sham and that in fact the loan was to the corporation.

One aspect of section 357(c) bears mentioning. The mandatory rule

77. Query whether INT. REV. CODE OF 1954, § 269 may be an unused weapon available to the commissioner in attacking these transactions.

of section 357(c) does not apply if section 357(b) is applicable.⁷⁸ Section 357(b) provides generally that if liabilities are acquired or assumed by the corporation in an exchange and the purpose of the acquisition or assumption was to avoid Federal income tax, or was without a bona fide business purpose, the total amount of the liability assumed or acquired will be treated as boot and taxed to the extent of the gain. The application of section 357(b) rather than (c) will go against the Service in that 357(b) will normally result in the recognition of more gain to the transferor and a correspondingly higher basis in the hands of the corporation. It is doubtful whether the taxpayer could ever employ 357(b) by documenting a tax avoidance motive and lack of business purpose for the assumption of the liability. The courts may even construe the section as available as a tax avoidance weapon to the commissioner, but not as a shield for the taxpayer. Sections 1239, 1245, and 1250 are applicable in the section 357(c) transfer.

V. INTENTIONAL FAILURE TO MEET "CONTROL" REQUIREMENTS

A fourth method for intentionally avoiding the application of section 351 has to do with the control requirements of that section. The objective under this technique is to plan the transfer in such a manner that the transfer of the property which is desired to be taxed does not meet the control requirements so as to avoid the application of the section. Section 351 applies to a transfer of property to a corporation in exchange for stock and securities only if "immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation." Section 368(c) in turn defines "control" to mean "the ownership of stock possessing at least 80 per cent of the total combined voting power of all classes of security entitled to vote and at least 80 per cent of the total number of shares of all other classes of stock of the corporation." It is important to point out that the constructive ownership rules are not applicable in determining control under section 368(c) for purposes of section 351.⁷⁹

The first of the two 80 per cent tests for "control" seems clear enough. The Service, however, has determined that the second 80 per cent test means 80 per cent of *each class* of "other stock" rather than 80 per cent

78. INT. REV. CODE OF 1954, § 357 (c) (2) (A).

79. Rev. Rul. 59-259, 1959-2 CUM. BULL. 115 (1959).

of the total number of shares of all classes of the "other stock."⁸⁰ The test is also 80 per cent of the number of shares outstanding rather than stock representing 80 per cent of the fair market value of all stock outstanding.

What stock is entitled to vote is to be determined under local law. It is doubtful whether it includes stock which can only vote on certain major corporate events, such as mergers and liquidations, or stock with contingent voting rights prior to the occurrence of the contingency.⁸¹ The existence of restrictive stock agreements affecting the voting rights among shareholders is probably not to be considered in determining whether the stock is entitled to vote.

The control requirements of section 351 require that the control exist "immediately after the exchange" and make no reference to the situation before the exchange. The regulations state that the phrase does not necessarily require "simultaneous" exchanges by two or more persons, but comprehends a situation where rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition "consistent with orderly procedure."⁸² The meaning of this phrase has been the concern of decisions too numerous to discuss in detail herein.⁸³ It may safely be said that they add little for present purposes to the statement in the Regulations.

Another means of avoiding the control requirements of section 351 has to do with the transfer of stock or securities in exchange of services rendered or to be rendered. This method will generally not meet the business objectives of the shareholder and will cause recognition of ordinary income upon receipt of the stock as compensation under section 61. It is, however, worthy of mention. Stock or securities issued for services rendered or to be rendered are not deemed issued in exchange for "property."⁸⁴ Thus, if individuals or groups of individuals transfer property to a corporation for seventy-nine per cent of the stock and one individual who trans-

80. *Ibid.*

81. See for comparison, Treas. Reg. § 1.302-3(a)(3) (1966) which gives such an interpretation to the term "voting stock."

82. Treas. Reg. § 1.351-1(A)(1) (1966).

83. See *Manhattan Bldg. Co.*, 27 T.C. 1032 (1957); *American Bantam Car Co.*, 11 T.C. 397 (1948), *aff'd*, 177 F.2d 513 (3rd Cir. 1949), *cert. denied*, 339 U.S. 920 (1950); *Fahs v. Florida Mach. & Foundry Co.*, 168 F.2d 957 (5th Cir. 1948); *Wilgard Realty, Inc. v. Comm'r*, 127 F.2d 514 (2d Cir.), *cert. denied*, 317 U.S. 655 (1942); *May Broadcasting Co. v. United States*, 200 F.2d 852 (8th Cir. 1953); *S. Klien on the Square, Inc. v. Comm'r*, 188 F.2d 127 (2d Cir.), *cert. denied*, 342 U.S. 824 (1951).

84. See INT. REV. CODE OF 1954, § 351(a) and Treas. Reg. 1.351-1(a)(1) (1966).

fers no property receives twenty-one per cent of the stock for services rendered or to be rendered, section 351 will not apply.

The avoidance of the control requirements will cause the transaction to be taxed as a sale or exchange under sections 1001 and 1002. Thus, the advantage of installment reporting and the disadvantage of section 1239 and sections 1245 and 1250 will be present.

VI. CONCLUSION

The discussion above has been provided to make the tax counselor more aware of the tax benefits of intentionally avoiding section 351. The techniques set forth above should be employed only after a most careful analysis of the individual facts, the objective to be achieved, and the alternatives available to reach that objective. Any transactions cast in a form to avoid section 351 will most likely be closely scrutinized by the examining agent, and a final settlement favorable to the taxpayer will often depend on the quality of the work done by the tax counselor.