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Taxation: Tax Free Transfers of Property to Corporations: Transferor in Control of Corporation Despite Direct Issuance of Stock to Third Party. (D'Angelo Associates, Inc. v. Commissioner)

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acceptance of this offer, or seller may, exercised by written notice to buyer, declare this offer null and void and forthwith return all deposits to buyer.

As this article illustrates, no magic words will make a financing clause free of all doubt. While this suggested clause attempts to include all "material elements" which could have an economic impact on the financing buyer is to procure and adds the word "initial" in specific response to *Woodland,* its strength rests in seller procuring an executed written waiver[64] of the condition. Without the waiver, the issue of whether the condition was fulfilled will still be present.

To summarize, the *Woodland* case reillustrates the problems that arise in drafting an offer to purchase subject to a financing condition. Financing is dynamic and complicated and for that reason makes a contract subject to a financing condition subject to the same complications. Whenever possible, financing conditions should be avoided. When this is not possible, the party in whose favor the condition was made should be required to sign a waiver once the condition has been fulfilled.

PATRICIA D. JURSIK

TAXATION — Tax Free Transfers of Property to Corporations — Transferor in Control of Corporation Despite Direct Issuance of Stock to Third Party. D'Angelo Associates, Inc. v. Commissioner, 70 T.C. 121 (1978). In the recent decision of *D'Angelo Associates, Inc. v. Commissioners,*[1] the Tax Court invalidated yet another transfer scheme designed to avoid section 351 of the Internal Revenue Code which provides for the nonrecognition of gain on the contribution of property to a corporation by its owners. In doing so the court treated a taxpayer who sold some of his assets to a corporation as an owner of the corporation even though he never owned any of the corporation's stock.

should he/she fail to fulfull this requirement. *See* note 39 *supra.*

64. Goebel v. First Fed. Sav. & Loan Ass'n, 83 Wis. 2d 668, 266 N.W.2d 352 (1978). Provisions included for the benefit of a party may be waived.

1. 70 T.C. 121 (1978).

I. Section 351 and the Reasons for Avoiding It

Section 351(a) provides in part:

> 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.[2]

Section 351 was intended to allow sole proprietorships and partnerships to incorporate without incurring any tax on the transfer of assets to the corporation.[3] Section 351 merely defers the recognition of gain on the property transferred.

However, the transferor's basis in property qualifying for a tax free transfer under section 351 is carried over to the transferee corporation.[4] Since the gain on a transfer is often a capital gain, the parties to the transaction may prefer a stepped-up basis which affords the corporation additional depreciation which can then be used to offset ordinary income. Thus, in certain instances it may be desirable to avoid section 351 and have the transfer of assets to a corporation be treated as a taxable sale.

It should be noted, however, that the transfer of depreciable property does not always result in preferential capital gain treatment. Gain may have to be treated as ordinary income where there is "a sale or exchange of property, directly or indirectly, between related persons,"[5] or where depreciation is subject to recapture under sections 1245 or 1250.[6] Still, it is conceivable that in certain situations the deduction of depreciation by the transferee corporation might offset the recognition of gain even as ordinary income, especially if the transfer takes the form of an installment sale, thereby deferring the transferor's recognition of gain.

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2. I.R.C. § 351(a).

3. I.R.C. § 351 was first enacted as § 202(c) of the Internal Revenue Bill of 1921. *See* S. Rep. No. 275, 67th Cong., 1st Sess. 11 (1921), *reprinted in* 1939-1 pt. 2 C.B. 181, 188-89.

4. I.R.C. § 362(a). *See also* I.R.C. § 358(a)(1) (providing that the transferor's basis in the stock or securities received equals the basis of the property transferred). For a detailed discussion of the historical background and operation of these sections, see Burke, *Section 351: The Beginning of Life in Subchapter C*, 24 Sw. L.J. 742 (1970).

5. *See* I.R.C. § 1239(a). Section 1239(b) defines "related" persons to include spouses and corporations of which 80% or more of the stock is owned by an individual, either directly or indirectly.

6. *See* I.R.C. §§ 1245, 1250.

Purposeful tax minimization or avoidance not being, of itself, grounds for upsetting legal transactions,[7] the crucial question under section 351 is how to comply with or avoid the section. The Service has fully detailed the steps necessary to comply with section 351.[8] Consequently, avoidance remains the most controversial and uncertain area.

II. Methods of Avoiding Section 351

Several methods of achieving a taxable transfer of assets to a corporation have been attempted.[9] Section 351 applies only when the transfer of assets to a corporation is "in exchange for stock or securities in such corporation" and the transferor, or transferors, are "in control" of the corporation "immediately after the exchange."[10] Consequently, most of the attempts to avoid section 351 have involved asserting either (1) that the consideration received in return by the transferor did not constitute "stock or securities" of the transferee corporation or (2) that the transferor, or transferors, were not "in control" of the corporation at the appropriate time.

A. *"Stock or Securities"*

If, instead of receiving "stock or securities," the transferor receives cash or other property, the transaction is treated as a sale or exchange,[11] rather than as a contribution of capital under section 351 where no gain is recognized on the transfer. However, in order to accomplish this the transferee corporation must generally have cash or other property to exchange. Furthermore, the corporation's cash or other property must originate with someone other than the transferor. Thus, an incorporator cannot contribute cash to a new corporation and subsequently sell it assets and receive the cash in return, thereby avoiding section 351. The "step transaction doctrine," which

7. U.S. v. Cumberland Pub. Serv. Corp., 338 U.S. 451 (1950); Gregory v. Helvering, 293 U.S. 465, 469 (1935); Sawtell v. Commissioner, 82 F.2d 221 (1st Cir. 1936); Chisholm v. Commissioner, 79 F.2d 14, 15 (2d Cir. 1935); Commissioner v. Yeiser, 75 F.2d 956 (6th Cir. 1935).

8. Rev. Proc. 70-17, 1970-2 C.B. 490 (superseded by Rev. Proc. 73-10, 1973-1 C.B. 760).

9. Avoidance of § 351 upon reorganization of an existing corporation is beyond the scope of this article.

10. I.R.C. § 351(a).

11. In a property-for-property exchange, the recognition of gain may still be postponed under the tax free exchange rules even if § 351 does not apply. *See* I.R.C. §§ 1031, 1034.

treats several "steps" in a transaction as a single integrated event, would short circuit such an arrangement and treat it simply as a contribution of property subject to section 351.[12]

Similarly, in the *D'Angelo* case, D'Angelo and his wife contributed $15,000 to a newly formed corporation, all of which was used to pay for assets which D'Angelo subsequently transferred to the corporation. The court ruled that "the economic substance of a transaction must govern for tax purposes rather than the time sequence or form in which the transaction is cast."[13] Consequently, the "step transaction doctrine" was applied and the steps "taken pursuant to a plan to achieve an intended result" were regarded as "an integrated whole for tax purposes."[14]

Even if the transferee corporation does not presently have cash or other property to pay the transferor for the property it receives, it is possible for the corporation to promise to pay in the future and still have the transaction treated as a sale or exchange, instead of a tax free capital contribution under section 351. In order to accomplish this the corporation's obligation must not create a "security" covered by the phrase "stock or securities" in section 351.[15] "[S]ecurities are investment instruments which give the holder a continuing participation in the affairs of the debtor corporation."[16] Whether or not a particular debt creates a "security" depends upon an "over-all evaluation of the nature of the debt."[17] The term of the obligation is an important factor — only short-term notes generally avoid being classified as "securities."[18] For example, a $96,727.85 "demand" note issued as part payment for the

12. *See* Truck Terminals, Inc. v. Commissioner, 33 T.C. 876 (1960), *aff'd*, 314 F.2d 449 (9th Cir. 1963)(where a $22,000 sale of business assets to a newly formed corporation by its owner shortly before his purchase of the stock issued by the corporation was disallowed and treated as a section 351 transfer). *See also* Hobbett, *The Step Transaction Doctrine and Its Effect on Corporate Transactions*, 1970 TUL. TAX INST. 102.

13. 70 T.C. at 129.

14. *Id.*

15. The term "securities" is not defined under the Corporate Organization sections of the Internal Revenue Code, but *is* defined under the Reorganization sections and apparently this definition is of at least arguable significance. *See, e.g.*, Burke, *Sec. 351 — Problems, Planning and Procedures*, 1975 TAX ADVISOR 103, 112 [hereinafter cited as Burke].

16. 70 T.C. at 134.

17. Camp Wolters Enterprises, Inc. v. Commissioner, 22 T.C. 737, 751 (1954), *aff'd*, 230 F.2d 555 (5th Cir. 1956).

18. Rev. Rul. 56-303, 1956-2 C.B. 193 (revoked for procedural reasons in Rev. Rul. 63-28, 1963-2 C.B. 767).

transfer of property to the corporation in the *D'Angelo* case was held to be a "security" because it represented a "continuing interest in the business" of the corporation. Emphasis was placed on the fact that no principal or interest payments were made for over ten years and that, consequently, the note was not the equivalent of cash.[19] On the other hand, installment sales have been held not to create "securities."[20] Unfortunately, interpretive case law on the subject of "securities" is anything but consistent, and at least one writer has suggested that "[t]his much litigated area should be avoided . . . ."[21]

Furthermore, even assuming that the "securities" problem can be avoided through the use of carefully drafted short-term notes or contractual obligations, a transfer of property to a corporation involving the corporation's promise to pay in the future, instead of an immediate transfer of cash or property in return, may still fail to qualify as a "sale." A bona fide debtor-creditor relationship may not exist between the transferee corporation and the transferor, because the debt cannot reasonably be expected to be enforced.[22] This is especially likely in cases of "thin capitalization."[23] In either event the transfer of property will not be treated as a sale, but as a contribution of capital under section 351.

Where it is not possible for the transferee corporation to transfer cash or other property, or to incur a "security" free debt, in return for all of the property transferred to it, a common compromise device is the so-called "boot transaction."[24] In such a transaction the transferee corporation transfers "boot," consisting of cash, property or obligations not covered by section 351,[25] in addition to "stock or securities" covered by

19. 70 T.C. at 134-35.

20. Warren Brown v. Commissioner, 27 T.C. 27 (1956), *acq.* 1957-2 C.B. 4.

21. Dean, *Transfers to Controlled Corporations: Analyzing the Problem Areas*, 41 J. TAX. 72, 73 (1974) [hereinafter cited as Dean].

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

23. *See* Aqualane Shores, Inc. v. Commissioner, 30 T.C. 519 (1958), *aff'd*, 269 F.2d 116 (5th Cir. 1959). *But see* Sun Properties v. United States, 220 F.2d 171 (5th Cir. 1955); Hollywood, Inc. v. Commissioner, 10 T.C. 175 (1948), *acq.* 1948-1 C.B. 2.

24. *See* Burke, *supra* note 15, at 104, 109; Dean, *supra* note 21, at 72; O'Connor, *Tax Problems on Transfer of Assets to Corporations*, 52 TAXES 756, 756-57, 765-67 (1974).

25. The assumption of liabilities or the acceptance of property subject to liabilities by the transferee corporation is generally not considered "boot" for this purpose. *See* I.R.C. § 357(a). *But cf.* I.R.C. § 357(b) (providing that such assumption or acceptance will be treated as a transfer of cash where the taxpayer's "principle purpose" was to

that section. Gain is recognized to the transferor to the extent of any "boot" received and the transferee corporation's basis is increased by the amount of gain recognized.[26] If the amount of "boot" received is greater than the gain to be recognized, the result is the same as a "sale." Otherwise only part of the gain is recognized and the transferee corporation's basis is only partially stepped up.

Therefore, in order to avoid section 351 by having the transferor receive something other than "stock or securities" the transferee should have, or soon expect to have, independent assets to give to the transferor in return for the property transferred, at least in the amount of gain to be recognized. These independent assets must generally come either from profits or from contributions by stockholders other than the transferor. In the case of newly formed corporations, profits are generally not available for distribution. Consequently, sales, exchanges and "boot transactions" are only feasible if there are persons, other than the original contributors of property to the corporation, who are capable of and willing to contribute additional capital to the corporation on terms acceptable to the original contributors.[27]

B. *"In Control"*

In situations where it is not feasible or desirable to avoid section 351 by having the transferor receive something other than "stock or securities" in return, it may still be possible to avoid section 351 by failing to meet the "control" requirement. The section 351 tax free transfer rules only apply where, "immediately after the exchange," the transferor or transferors are "in control . . . of the corporation."[28] For this purpose "control" is defined as the "ownership of stock posssessing at least 80 percent of the total combined voting power . . . of stock entitled to vote and . . . of all other classes of stock."[29] Thus, the section 351 rules do not apply to the transfer of property to a corporation by one or more shareholders who together own less than eighty percent of either all of the voting

avoid federal income taxes or was not a "bona fide business purpose"). *See also* Burke, *supra* note 15, at 103.

26. I.R.C. §§ 351(b)(1), 362(a). *See also* Treas. Reg. § 1.351-2(a) (1955).

27. Naturally, the contributions by these other persons may qualify for tax free treatment under § 351.

28. I.R.C. § 351(a).

29. I.R.C. § 368(c).

stock or any class of nonvoting stock.[30]

Therefore, in the case of an existing corporation it is possible to avoid section 351 whenever shareholders who do not participate in the transfer of property to the corporation own more than twenty percent of the voting stock or of any class of nonvoting stock. However, it is more difficult to avoid section 351 in transfers to newly formed corporations since the original shareholders often acquire their stock by transferring property to the corporation. In order for section 351 not to apply to the original transfers of property to a corporation, more than twenty percent of any of the appropriate classes of stock must be treated as owned by parties who did not transfer any of the original property to the corporation. This may occur where, for example, the persons who transfer the original property to the corporation receive the original stock but are under a "prior binding commitment" to convey some or all of the stock to nontransferor third parties.[31] Usually this happens where the owners of the property to be transferred to the corporation, the "transferors," have decided to part with a portion of their interest in the corporation. For example, as part of a more comprehensive agreement in *Heberlein Patent Corp. v. United States,*[32] the owners of several patents formed a patent holding company to which they transferred the patents in return for all of its stock and immediately conveyed more than twenty percent of the stock to third party licensees of the patents. The patent owners were held not to be "in control" of the newly formed corporation and, therefore, not eligible for tax free

30. *See* Rev. Rul. 59-259, 1959-2 C.B. 115 (where transferors who owned 83% of all the voting common stock, 83% of the nonvoting common stock and 22% of the nonvoting preferred stock were found not to have the required "control" even though they owned more than 80% of the outstanding nonvoting stock).

31. However, a "prior binding commitment" to convey stock to a nontransferor third party should not disqualify a transfer from § 351 treatment where, for example, *X* transferred property to *Y* who, in turn, transferred the received property and some of his own property to a newly formed corporation pursuant to an agreement whereby *X* and *Y* were each to receive stock. The "mutually interdependent" test, which treats several "steps" as one transaction where they are "so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series" would probably apply and both *X* and *Y* would be regarded as having transferred property to the corporation. *See* American Bantam Car Co. v. Commissioner, 11 T.C. 397, 405 (1948). Thus, it is important to distinguish between cases involving a commitment to transfer additional property to a corporation and those involving the purchase of a partial interest in the corporation to which the property is transferred.

32. 105 F.2d 965 (2d Cir. 1939).

treatment under a predecessor of section 351.[33] It also appears that any two persons with separate businesses may avoid section 351 by incorporating the two businesses separately and entering into "prior binding commitments" for each to receive more than twenty percent of an appropriate class of stock in the other's corporation in return for a similar interest in their own corporation.[34]

A prior commitment on the part of a person who transfers property to a corporation to convey part or all of the stock received to "nontransferor" third parties will not affect the application of the "control" test unless it is "binding." In *Wilgard Realty Co. v. Commissioner*,[35] an incorporator transferred all of the original property to a corporation for its original stock and immediately gave all of the stock to his brother and his three children pursuant to a prearranged plan. Emphasizing the fact that the incorporator, as recipient of the stock, had "legal title to it 'immediately after the exchange' " and had the "legal right" to keep that control,[36] the court held that he was in control of the corporation, because he was under no binding obligation to make the gifts.[37]

Just as persons who have received shares by purchase or by gift from "transferors" are treated as nontransferors because they have not in fact transferred property *to the corporation*, original shareholders of a corporation might be treated as nontransferors if they contributed something other than "property" in return for their original shares. Although cash is considered "property" for this purpose,[38] the guarantee of a

33. *Id.* at 969. *See also* Intermountain Lumber Co. v. Commissioner, 65 T.C. 1025 (1976) (where an incorporator's irrevocable commitment to sell 50% of the corporation's stock to a third party left him without control immediately after the exchange); May Broadcasting Co. v. United States, 200 F.2d 852 (8th Cir. 1953) (where a binding agreement to sell a one-fourth interest in a newly formed corporation caused the transfer of assets to the corporation to be a taxable exchange).

34. *See* Rev. Rul. 70-522, 1970-2 C.B. 81. However, it should be noted that in this instance the parties were trying to qualify for § 351 tax free treatment. Additionally, in appropriate circumstances the Service may contend that the separation of the two businesses into two corporate entities is a "sham."

35. 127 F.2d 514 (2d Cir. 1942).

36. *Id.* at 516.

37. *Id.*

38. Portland Oil Co. v. Commissioner, 109 F.2d 479 (1st Cir. 1940), *cert. denied*, 310 U.S. 650 (1940). However, the transfer of cash directly to a corporation as additional capital should be distinguished from the transfer of cash to a shareholder of the corporation to buy out an interest already existing in the corporation as exemplified by the "prior binding commitment" cases.

note of the corporation is not considered the transfer of "property" to the corporation.[39]

Section 351 expressly provides that persons contributing services are not considered "transferors" of property for purposes of determining whether "transferors" are "in control . . . of the corporation" "immediately after" the transfer. In *Florida Machine & Foundry Co. v. Fahs,*[40] a father and his son incorporated the family business. The father contributed all of the property and the son promised to continue working as a manager "of the business." In return each received fifty percent of the stock. The court noted that in contrast to *Wilgard,* "the stock was not issued to the corporation's transferor and then conveyed . . . to someone else."[41] Rather, fifty percent of the stock was "issued directly" to the son. The court found, therefore, that the father, the "transferor," was not "in control" "immediately after the exchange," and permitted the corporation to use its cost of acquisition as its basis.[42]

The implication in *Florida Machine & Foundry Co.* that section 351 could be avoided simply by having more than twenty percent of an appropriate class of stock issued directly to nontransferors, regardless of whether there was a binding commitment to do so, was rejected in *D'Angelo Associates, Inc. v. Commissioner.*[43] In 1960 Dr. D'Angelo, a dentist, and his wife organized D'Angelo Associates, Inc. They contributed $15,000 in cash and had the corporation's original sixty shares of no par value common stock issued in equal amounts to Mrs. D'Angelo and each of their five children.[44] Seven days later Dr. D'Angelo "sold" his business assets to D'Angelo Associates in exchange for $15,000 cash, a $97,000 six percent demand note and the corporation's assumption of the mortgage on the property transferred.

Treating the transaction as a sale, Dr. D'Angelo reported a long-term capital gain,[45] and D'Angelo Associates claimed de-

39. *See* Intermountain Lumber Co. v. Commissioner, 65 T.C. 1025, 1031 (1976).

40. 73 F. Supp. 379 (S.D. Fla. 1947).

41. *Id.* at 381. The case is "further distinguished" from *Wilgard* on the basis of binding agreement in *Fahs.*

42. *Id.*

43. 70 T.C. 121 (1978).

44. The stock issued to the children was held for them by Dr. D'Angelo as trustee under the Uniform Gifts to Minors Act.

45. 70 T.C. at 124. This capital gain was wholly offset by long-term capital loss carryovers.

preciation on the transferred property using a stepped-up adjusted basis equal to the amount it had paid. The Commissioner regarded the transfer as a section 351 exchange and gave statutory notice of deficiency, which was appealed to the Tax Court.

As mentioned earlier, the court refused to treat the transaction as an independent "sale," because the cash received had originated with the transferor,[46] and the note received constituted a "security."[47] The crucial issue, then, was whether Dr. D'Angelo, the "transferor," was "in control . . . of the corporation" "immediately after the exchange."

The court held that the section 351 "control" requirement "is satisfied where, as here, the transferors transfer by gift the stock they were entitled to receive in exchange for the property they transferred to the corporation."[48] In doing so the court rejected D'Angelo's contention that he could not be "in control . . . of the corporation," because he had never owned any of its stock. It also cleared up some of the confusion that had been created by the *Wilgard* and *Florida Machine & Foundry Co.* decisions:

> We recognize that the Wilgard decision was predicated on the transferor's freedom of action after he acquired the stock, and that Fahs v. Florida Machine & Foundry Co. . . . may be read to support petitioner's viewpoint. . . .
>
> . . . .
>
> Nevertheless, the decisions . . . were clearly predicated on the power of the transferor to designate who will receive the stock rather than the precise moment that the power was exercised. These cases do not turn on whether the tune Dr. D'Angelo called was written in two/four time, but on his power to call the tune.[49]

The Tax Court concluded that D'Angelo had been "in control" of the corporation, because he had had the power to designate to whom more than eighty percent of the shares would be is-

46. *See* text accompanying notes 13-14 *supra*.
47. *See* text accompanying note 19 *supra*.
48. 70 T.C. at 132.
49. *Id.* at 132-33. The court noted that if the property had been given to the children and then transferred to the corporation, the basis would have been that of Dr. D'Angelo. Similarly, if D'Angelo had transferred the property directly to the corporation in return for stock and then given the stock to the children the carryover basis rules for § 351 would apply. That the D'Angelo transaction "has been squeezed into the seemingly nonexistent time interval between these two situations surely cannot produce a different result." *Id.* at 133 n.8.

sued and that a tax free section 351 transfer had occurred.

Therefore, in order to avoid having section 351 apply to a particular transfer by failing to meet the "control" requirement, nontransferors must hold in their own right more than eighty percent either of the voting stock or of any class of nonvoting stock of the transferee corporation. Where the transfer is to an existing corporation it does not matter how the nontransferors acquired their shares, as long as their acquisition of stock was not part of the same series of transactions which included the transfer. When the nontransferors' acquisition of stock and the transfer of assets to the corporation are part of the same series of transactions, the nontransferors can acquire stock in their own right by contracting with the "transferors" to have stock received in the transfer conveyed over to them or by having the corporation issue stock directly to them in return for contributions of something other than "property" to the corporation. However, the "control" requirement cannot be avoided simply by having stock of the "transferors" gratuitously conveyed or issued directly to nontransferors who have contributed or paid nothing to receive it.

III. Conclusion

There is no doubt that in some instances it is desirable to avoid section 351 and achieve a stepped-up basis. The *D'Angelo* case suggests that there may be no practical way of avoiding section 351 completely. In order to avoid section 351 in a particular transfer by failing to satisfy the "stock or securities" requirement, the corporation must have assets which were not acquired from the transferors in the same series of transactions as the transfer and which are not needed in the business of the corporation. In order to avoid section 351 by failing to satisfy the "control" requirement, the transferors must part with ownership of over twenty percent of an appropriate class of stock in exchange for consideration received by the transferors pursuant to a prior binding commitment or in exchange for nonproperty contributed directly to the corporation. However, such devices should be employed only with the utmost care, for the *D'Angelo* decision serves as a baleful reminder that section 351 and its companion statutes are indeed deserving of their reputation as a "trap for the unwary."[50]

James K. Muehlbauer

50. Bongiovanni v. Commissioner, 470 F.2d 921 (2d Cir. 1973).