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# Selected Problems under Section 351

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gain on transfers of section 1245 property between affiliated members of a group.[82]

### CONCLUSION

Section 1245 effectively restricts the tax bonanza that previously existed for depreciable personal property arising from the interaction of ordinary income deductions for depreciation and capital gains on its disposition at a profit. Because of the broad sweep of section 1245, it is extremely important that its tax impact be considered in every instance where there is a disposition of section 1245 property.

# II

# SELECTED PROBLEMS UNDER SECTION 351

B. J. Adelson

At one time or another almost all attorneys are requested to organize a corporation. The formation of a corporation normally is regarded as one of the few transactions free from tax dangers; the incorporation usually will be within the ambit of section 351 and thus be "tax free." This article will consider some of the more common tax problems which may arise in a transaction intended to be "tax free." No attempt is made to present a comprehensive analysis of the reasons governing the resolution of the initial question of whether or not a business should be incorporated[1] or a detailed discussion of the techniques to be used in forming the corporation.[2] This article is intended to point out some problems which may be present in an intended "tax free" incorporation and to indicate some of the solutions to these problems.

## ACCOUNTING PROBLEMS

### *Accounts Receivable*

#### *Accrual Method*

First, some accounting problems which commonly are overlooked should be examined. These problems cannot be handled by the accountant after the incorporation has been accomplished; they must be

82. However, it is interesting to note that the Regulations under § 1502 provide that a transaction not involving a sale or exchange of a capital asset or of property subject to the provisions of § 1231 is not considered an intercompany transaction if the transaction occurs in the regular course of the trade or business and the members of the affiliated group adopt a consistent accounting practice with respect to gains or losses incurred in such transactions. Treas. Reg. § 1.1502-31(b)(1) (1955).

resolved prior to the transfer of assets to the corporation. The transfer of a going business, proprietorship, or partnership to a corporation normally will not cause tax problems as to which entity is to report various items of income and/or expense if both transferee and transferor use the accrual method of accounting. All transactions occurring prior to the date of transfer will be accrued on the books of the transferor, and transactions entered into after that date will be reflected on the books of the transferee.[3] The tax aspects of the changeover will not differ significantly from the tax aspects of the termination of a fiscal year.

### *Cash Method*

If both transferor and transferee use the cash method of accounting, and the corporation acquires accounts receivable, there is some question whether the income generated by the collection of these accounts will be income of the transferee or the transferor. Any business reporting income on the cash receipts and disbursements method probably will have a substantial amount of accounts receivable at any one time. Under the cash method of accounting, these accounts receivable will not be included in income because they are uncollected.[4] If the business is incorporated, the parties must determine whether it will be most beneficial, from the tax viewpoint, to have the income from collections on these receivables included in the income of the transferor or whether it will be more advantageous to have this income taxable to the transferee corporation.

For example, suppose a group of architects decides to incorporate its partnership. The partnership keeps its books on the cash method and has a large amount of receivables outstanding. When these receivables are collected, the proceeds will have to be reported as income. The question is whether the parties prefer to have this income included in the income of the partners or in the income of the corporation. If it is determined that the smallest tax would result if the income is taxed to the partners, then the accounts receivable should *not* be transferred to the corporation. The partners should retain the accounts and report the income as the accounts are collected. The income will not be taxed to the corporation since the corporation never acquires title to the accounts and does not receive the cash when the receivables are collected.

1. See Calkins, Coughlin, Hacker, Kidder, Sugarman & Wolf, *Tax Problems of Close Corporations: A Survey*, 10 W. RES. L. REV. 9, 10-15 (1959).

2. See Sugarman, Colquhoun, Adelson & Hawkins, *Incorporation Techniques: Planning Today for Tax Advantages Tomorrow*, 12 W. RES. L. REV. 182 (1961).

3. See Treas. Reg. § 1.446-1(c)(1)(ii) (1957) [hereinafter cited as Reg. §], as amended, T.D. 6584, 1962-1 CUM. BULL. 67.

4. Reg. § 1.446-1(c)(1)(i) (1957), as amended, T.D. 6584, 1962-1 CUM. BULL. 67.

On the other hand, if less tax would be generated if the corporation realized the income, there is some authority which indicates the transaction can be arranged to obtain this result.[5] The extent to which this authority can be relied upon can best be gauged by an analysis of cases in related areas.

*Installment Method*

The transfer of a contract, the profit from which is being reported on the installment method, appears to be analogous. The Regulations provide that in a transfer of an installment contract in a tax free incorporation under section 351, the transferor will not realize income.[6] This conclusion has been reached in several cases.[7] The transferee corporation must report the profit on amounts collected after the date of transfer.[8] The difference between the above example of receivables being transferred and the case of an installment contract being transferred is that in the former, the gross income from collections on the receivables would be included in the income of the corporation, whereas only the net income in excess of cost on the installment contract would be included in the income of the corporation.

*Analogy to Construction Contracts: Completed Contract Method*

A similar situation arises with construction contracts, the income from which is being reported on the completed contract method. Under these contracts, income is not realized until the contract is completed. If the completed contract method of accounting is used, the expenses allocable to the contract are not deducted until the contract is completed and the income realized.[9] What happens if an individual transfers such a contract to a corporation prior to its completion? Will all of the income and all of the expenses be reportable by the corporation?

There is no decision squarely on point,[10] but several courts have resolved the question in the converse situation — when a corporation is liquidated and transfers a partially completed contract to its shareholders. In these cases, the courts have held that the transferee does not realize all of the income from the contract, but rather that the transferor must report the proportion of the income equal to the proportion of the con-

5. Divine v. United States, 62-2 U.S. Tax Cas. 85589 (W.D. Tenn. 1962); Thomas W. Briggs, 15 CCH Tax Ct. Mem. 440 (1956).

6. Reg. § 1.453-9(c)(2) (1958), as amended, T.D. 6590, 1962-1 Cum. Bull. 70.

7. Wobbers, Inc., 26 B.T.A. 322 (1932); Meagher, 20 B.T.A. 68 (1930).

8. Wobbers, Inc., *supra* note 7.

9. Reg. § 1.451-3(b)(2) (1957).

10. *Cf.* Mabee v. Dunlap, 51-2 U.S. Tax Cas. 16864 (N.D. Tex. 1951) (income from similar contracts being reported on accrual method; held, transferor deducts expenses and corporation reports all income when contract is completed).

tract completed by the transferor.[11] It seems likely that an individual who transfers a partially completed construction contract to a corporation in a tax free incorporation would similarly have to include in his income the proportion of the net income on the contract equivalent to the percentage of completion of such contract at the time of transfer.

The construction contract cases are distinguishable from this situation in two respects: first, the work has not been completed and, accordingly, all of the expenses have not been incurred; and second, there is no right to any funds at the time of transfer. It must be noted, however, that even though all proceeds are received by the transferee, the income is prorated between transferor and transferee, and the income prorated is the net income after expenses.

The Internal Revenue Code specifically gives the Commissioner authority to apportion gross income and expenses among taxpayers to prevent evasion of taxes or to clearly reflect the income of the various taxpayers.[12]

### *Analogy to Growing Crops*

The Commissioner has exercised this power to reallocate expenses between taxpayers in cases involving transfers of land with growing crops.[13] In these cases, the expenses allocable to specific income can be clearly designated. In a typical transaction, the individual will incur all of the expenses of growing the crops and then, immediately prior to harvest time, the farm will be transferred to a corporation. The Commissioner has successfully contended that an individual cannot deduct the expense of growing the crop; this expense is properly allocable to the corporation.[14] In these cases, although the corporation has the right to include all of the income from the sale of the crops, the Commissioner can allocate to the corporation those expenses properly allocable to the income eventually realized by the corporation. The effect of such an allocation is that the corporation realizes only the *net* income from the sale of the crops and not the gross income represented by the proceeds of the sale.

Both the growing crop and construction contract cases involve situations in which the expenses attributable to the prospective income can be identified with comparative ease. In both instances, the courts have

11. Dillard-Waltermine, Inc. v. Campbell, 255 F.2d 433 (5th Cir. 1958); Standard Paving Co. v. Commissioner, 190 F.2d 330 (10th Cir. 1951); Jud Plumbing & Heating, Inc. v. Commissioner, 153 F.2d 681 (5th Cir. 1946); *cf.* Commissioner v. Montgomery, 144 F.2d 313 (5th Cir. 1944).

12. INT. REV. CODE OF 1954, § 482 [hereinafter cited as CODE §].

13. Rooney v. United States, 305 F.2d 681 (9th Cir. 1962); Central Cuba Sugar Co. v. Commissioner, 198 F.2d 214 (2d Cir.), *cert. denied,* 344 U.S. 874 (1952).

14. Rooney v. United States, *supra* note 13.

insisted that the entity which realizes the income be charged with the expenses of producing that income.

In the normal situation, the expenses are not easily related to particular income; accordingly, if the income is taxed to the transferee it would be extremely difficult to determine which expenses are properly allocable to that income. The question, therefore, will be whether the proceeds of the receivables assigned to the corporation are properly to be regarded as income to the corporation. In arriving at this determination it must be recalled that the expenses incurred in producing this income were deducted by the transferor, and the only unclosed portion of the transaction is the collection of the receivables.

*Analogy to Assignments of Patents and Copyrights*

A situation similar to that of accounts receivable arises when a patent or copyright is assigned to a corporation. Future royalties will be taxed to the corporation.[15] There are, however, two distinctions between this case and the accounts receivable problem. First, there is no present right to the royalties, whereas accounts receivable are presently receivable. Second, to use the language of the Supreme Court in similar situations, the patent or copyright which corresponds to the tree is being assigned along with the fruit. This latter distinction seems to be extremely important.

*Judicial Action*

It has been held that if an individual assigns a single receivable to a corporation after performing all the services giving rise to its creation, the income realized when the receivable is collected by the corporation will be taxed to the individual.[16] This holding was based upon Supreme Court cases which held that a man could not assign the income arising from the fruits of his labor.[17]

However, the two courts which have decided the accounts receivable problem have not followed the cases in which a single receivable is transferred with the obvious, sole intention of causing the income to be taxed to a different taxpayer.[18] Perhaps there is a distinction when the receivables are transferred as a part of a larger transaction encompassing the transfer of an entire business.

It would appear that one could analogize the going business to the tree which produces the income and the receivables to the fruit, but since

15. Fontaine Fox, 37 B.T.A. 271 (1938).

16. H. Lewis Brown, 40 B.T.A. 656, *aff'd*, 115 F.2d 337 (2d Cir. 1940).

17. See, *e.g.*, Lucas v. Earl, 281 U.S. 111 (1930).

18. Divine v. United States, 62-2 U.S. Tax Cas. 85589 (W.D. Tenn. 1962); Thomas W. Briggs, 15 CCH Tax Ct. Mem. 440 (1956).

the receivables have matured, they would seem more analogous to fruit which has been picked from the tree.[19]

In any event, the decisions seem to permit the corporation to report all of the income, despite the fact that the transferor would have previously deducted all of the expenses of generating this income. If reliance is placed upon these decisions and they eventually are distinguished or overruled, the consequences could be serious. The parties would be faced with a situation in which the corporation has received the entire proceeds of the receivables, but the individual transferor is to be taxed on the income represented by the proceeds. The individual may have a significant tax liability without cash to pay this liability. In view of this possible consequence, the transferor may not desire to transfer the receivables with the other assets in his business.

### *Depreciation*

A second major accounting problem arising upon the incorporation of a business concerns depreciation. In a tax-free incorporation, the transferee corporation takes, as its basis for the assets transferred to it, the same basis these assets had in the hands of the transferor.[20] Thus, if an individual owns machinery worth $90,000, but with a basis after depreciation of $77,000, and he transfers this machinery to a corporation in an exchange qualifying under section 351, the machinery will have a basis of $77,000 to the corporation. If the individual was the first owner of the machinery, he may have been using an accelerated method of depreciation such as the double declining balance method or the sum of the years digits method. These accelerated methods will not be available to the corporation because the corporation will be a second user of the property.[21]

In addition to the loss of the use of an accelerated method of depreciation, it is possible that the corporation could be forced to use a different and longer useful life than was being used by the individual. Assume the machinery has a useful life of ten years under the Internal Revenue Service guidelines.[22] Further assume it originally cost $110,000 and is three years old. There are three possible answers to the proper method for computing the amount of depreciation to be taken each year in the future. First, if the corporation utilizes the straight-line method of depreciation and records on its books the net basis of the machinery or $77,000, under a literal reading of the Internal Revenue Service guidelines, the depreciation rate would be 10% of the cost basis of $77,000

19. *Cf.* Helvering v. Eubank, 311 U.S. 122 (1940).

20. CODE § 358.

21. Reg. § 1.167(c)-1(a)(6) (1956).

22. Rev. Rul. 62-21, 1962-2 CUM. BULL. 418.

or $7,700 per year. Second, the corporation might contend that the machinery is used machinery and, therefore, has a shorter useful life than the guideline life, and that the $77,000 basis should be depreciated over a seven year period or at the rate of $11,000 per year.[23] Third, if the corporation records both the original cost to the transferor and the accumulated reserve for depreciation of the transferor, the yearly depreciation would be 10% of the original cost of $110,000 or $11,000 per year.

The Revenue Procedure which establishes new guideline lives gives no clear answer as to which method is proper, but it has been indicated that the Treasury Department will permit the third method, assuming, of course, that the requirements of the reserve ratio test are met.[24]

The only depreciation factor which normally may be disregarded in a section 351 transfer is the recapture of depreciation provision of section 1245.[25] Accordingly, the major factor to be considered in determining whether to transfer depreciable assets to the corporation in a section 351 transaction will be the consequences of the loss of the use of an accelerated method of depreciation. If this change is deemed significant, it may be concluded that the depreciable property should be excluded from the transfer and leased to the corporation by the proprietor or partners.

### *Stock for Services*

This discussion concerns a factor which could disqualify a transfer from the tax-free provisions of section 351. Section 351 applies if the transferors of property acquire ownership of 80% of the corporation's stock. The statute expressly excludes services from the definition of property.[26] Thus, if the persons rendering services to the corporation are to acquire more than 20% of the stock for their efforts, the entire transaction could be rendered taxable. Such an unfortunate result would be particularly embarrassing to an attorney if he were one of the persons receiving stock for his services.

There are two simple methods to insure that the transfer will be tax free despite the fact that various persons receive stock for their services. The first method is to require the persons receiving stock for services to purchase additional stock for cash or other property. All stock, including stock received for services, acquired by a person contributing property for stock will be taken into account in determining whether the 80% requirement has been satisfied.[27] Thus, unless 20% of the stock is issued

23. Question and Answer 18, *Ibid.*
24. See Mendenhall, *New Depreciation Rate Guidelines*, 40 TAXES 746, 766 (1962).
25. See Kerester & Katcher, *Selected Problems under Section 1245*, 15 W. RES. L. REV. 281 (1964); CODE § 1245(b)(3).
26. CODE § 351(a).
27. Reg. § 1.351-1(a)(2) Ex. (3) (1955).

for services to persons who do not also acquire stock in exchange for property, the entire transfer will qualify under section 351.

The second method to assure compliance with the provisions of section 351 is to provide that all stock is to be issued to persons contributing property, and that one or more of these persons will in turn transfer some of their stock to the persons performing services. Thus, the services will be rendered for a transferor instead of the corporation. The Regulations recognize this distinction and provide that the initial exchange with the corporation will be tax free under section 351.[28]

The tax effect to the person performing services is identical whether he works for the corporation or a transferor; he will realize ordinary income in an amount equal to the value of the stock he receives. The effect on the other taxpayers, however, will be different. If the corporation issues the stock, the services probably will qualify as organization expenses and should be deductible as such.[29] If another shareholder exchanges stock for services, he will have a gain or loss on the sale of his stock. Whether he will be able to deduct the cost of the services will depend upon the nature of the services.

### *Securities*

The next question is whether the new corporation should issue debt securities in addition to common stock. In most cases there should be no question; the corporation should issue notes.[30] The advantages are threefold. First, the corporation will be able to deduct the interest paid on the notes — it would not be permitted to deduct dividends paid on stock. Second, the payments of principal on the notes normally will be free of tax to the recipient, whereas the payment of dividends or partial redemption of stock normally will be taxed as ordinary income to the recipient. Third, to the extent that the corporation's cash is depleted by reason of the payments on the notes, the corporation will not have funds available for the payment of dividends and thus will be less susceptible to the imposition of the penalty tax for accumulating earnings beyond the reasonable needs of its business.

Naturally, each of these advantages is increased as the amount of debt is increased. Unfortunately, pitfalls exist and have caused many taxpayers to come to grief when they have attempted to carry a good thing too far.

The first pitfall is the issuance of debt obligations which will not qualify as securities. Section 351(b) provides that the transferors will

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28. Reg. § 1.351-1(b)(2) Ex. (1) (1955).

29. CODE § 248.

30. Adelson, *Choosing and Creating the Appropriate Corporate Structure*, 12 W. RES. L. REV. 204 (1961).

realize taxable gain to the extent of the property, other than stock or securities, received by such transferors. In other words, the transaction will be taxable, at least in part, if the debt obligations do not qualify as stock or securities. The courts have held that open account indebtedness and short-term notes do not qualify as either stock or securities.[31] Although there is no definite dividing line, it probably is safe to assume that notes with a maturity date of five years or more will qualify as securities.[32]

The second pitfall is that the debt will not be treated as debt, but as stock. If this occurs, everything sought to be accomplished through the use of debt obligations will be lost.[33] Both the purported interest payments and the supposed payments of principal will also be treated as dividends.

Many persons attempt to resolve the question of whether the debt will be treated as debt by employing a mathematical formula; their view is that if the ratio of debt to stock is within certain limits the debt will be accepted as such. The courts, however, are not deciding solely on that basis. Normally, a court will not decide a case in this area on one factor alone, but on many related factors.[34]

Several factors are commonly used by the courts in making their determinations. Naturally, if an obligation is truly a debt, it must have all the attributes of a debt, such as a fixed maturity, a fixed rate of interest, etc.[35] The courts also examine the ratio of debt to stock,[36] but this is often done as part of a determination of whether the corporation has adequate equity capital.[37] Much of the analysis of the corporate structures is really an attempt to determine whether there was a reasonable expectation that the obligations could be paid as they fell due.[38] Perhaps this results from the fact that the cases often reach the courts after the date on which the obligations should have been paid. If the taxpayer can

31. *E.g.*, Harrison v. Commissioner, 235 F.2d 587 (8th Cir. 1956), *cert. denied*, 352 U.S. 952 (1957).

32. See Rev. Rul. 56-303, 1956-2 CUM. BULL. 193; Turner v. Commissioner, 303 F.2d 94 (4th Cir. 1962), *cert. denied*, 371 U.S. 922 (1963); Sheldon Tauber, 24 T.C. 179 (1955).

33. See Calkins, Coughlin, Hacker, Kidder, Sugarman & Wolf, *Tax Problems of Close Corporations: A Survey*, 10 W. RES. L. REV. 1, 26-40 (1959); Schlesinger, *Acceptable Capital Structures: How Thin Is Too Thin?* 1952 TUL. TAX INST. 26.

34. See O. H. Kruse Grain & Milling Co. v. Commissioner, 279 F.2d 123 (9th Cir. 1960), for a list of 11 factors.

35. *E.g.*, McSorleys, Inc. v. United States, 63-2 U.S. Tax Cas. 90146 (10th Cir. 1963) (four-to-one ratio of "debt" to stock — held all equity); Gloucester Ice & Cold Storage Co. v. Commissioner, 298 F.2d 183 (1st Cir. 1962).

36. *E.g.*, Daytona Marine Supply Co. v. United States, 61-2 U.S. Tax Cas. 81215 (S.D. Fla. 1961).

37. *E.g.*, Laidley, Inc., 20 CCH Tax Ct. Mem. 917 (1961).

38. *E.g.*, Carter Foundation Co., 63-2 U.S. Tax Cas. 89836 (5th Cir. 1963) (25:1 ratio — held, debt is really debt); Brake & Sales Corp. v. United States, 287 F.2d 426 (1st Cir. 1961) (ratio of debt to stock either 4:1 or 1:2, depending upon whether goodwill considered — held, "debt" is equity capital); 2554-58 Creston Corp., 40 T.C. No. 102 (Sept. 10, 1963).