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THE ELUSIVE DEFINITION OF PROPERTY UNDER INTERNAL REVENUE CODE SECTION 351

J. Denny Moffett*

I. INTRODUCTION

Services are not property, at least from the perspective of the Internal Revenue Service. Simple as that rule may seem, it is at issue often and its tax effects are many. Moreover, the fact that section 351 of the Internal Revenue Code defines property only by excluding services leaves the taxpayer with no actual definition of "property."

Section 351 of the Internal Revenue Code of 1954, as amended, provides that no gain or loss shall be recognized if property is exchanged solely for stock or securities of a controlled corporation.¹ The nonrecognition provisions of section 351 apply solely to transfers of property. The very purpose of the section is to encourage incorporation by making the exchange of property for stock a tax free exchange. The Code and the Treasury Regulations² make clear that a contribution of services is not a transfer of property within the meaning of section 351. Any gain or loss incurred from the receipt of stocks or securities in exchange for such services is therefore recognized as ordinary income. Equally important is the fact that the stock transferred for services cannot be included in determining the control group required by section

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1. I.R.C. § 351(a) provides:

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.

Section 368(c) defines control as, "the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation." I.R.C. § 368(c).

2. Treas. Reg. § 1.351-1(a)(1)(i), (a)(2) Ex. (3); T.D. 6152 (1955), 1955-2 C.B. 61, 169.

351.³

“Property” is defined in section 351 of the Code only by the negative implication arising from the exclusion of services. This apparently innocent distinction between property and services takes on great magnitude because of the tax effect which results from the exchange of stock or securities for services. Because one who receives stock in exchange for services would not be a transferor of property, the stock he receives cannot be used to determine whether the eighty percent control test is satisfied.⁴ If more than twenty percent of the stock is issued for services, the nonrecognition treatment of section 351 is foregone.⁵ Because the applicability of section 351 may turn on what percentage of stock was transferred for property and what percentage was transferred for services, the definition of property and the delineation of the categories of property and services are all important. The dividing line between these two categories is unclear.

In his classic article,⁶ Professor Herwitz raised the classification problem as it pertains to promoters’ or organizers’ stock; but classification problems are more widespread today. This article, through an examination of the case law and rulings which have attempted to define and explain the concept of section 351 property, will determine the current posture of the Internal Revenue Service and the courts, and will make several potentially helpful suggestions.

II. RELATIONSHIP OF PROPERTY UNDER SECTION 351 TO SECTION 1221 OF THE CODE

In examining the treatment of property under section 351, it is nec-

3. For purposes of section 351, the “control group” is defined in section 368(c) to mean the ownership of at least 80 percent of the total combined voting power of all classes of stock entitled to vote, and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

4. See I.R.C. §§ 351(a), 368(c). Besides the nonavailability of the stock in computing the all important control test of section 368(c), the recipient of the stock must recognize any gain or loss on the exchange. The transferor of the non-includable “property” thereby loses the benefits of the § 351 transaction even if the control test is otherwise satisfied.

5. However, an exchange does not automatically fail to satisfy section 351 merely because the corporation issues a part of its stock or securities for services. Rather the effect of the statute is that stock received by a transferor for services where the transferor also contributed property can be included in determining the satisfaction of the 80 percent control test. B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS*, § 3.03 at 3-10, 3-11 (4th ed. 1979). However, the transfer of a nominal amount of property along with the services for the purpose of qualifying under § 351 will be ignored. *Kamborian v. Commissioner*, 56 T.C. 847, 862-64 (1971); Treas. Reg. § 1.351-1(a)(1).

6. Herwitz, *Allocation of Stock Between Services and Capital in the Organization of a Close Corporation*, 75 HARV. L. REV. 1098 (1962).

essary to recognize that the word "property" appears in more than one section of the Code.⁷ The cases attempting to define property within these other sections may aid the taxpayer in interpreting section 351, especially when the varying purposes of these sections are considered. The predecessor⁸ to section 351 was drafted with a broad purpose in mind: to permit and encourage the transfer of property to capitalize a newly formed or reorganized corporation.⁹ This was necessary inasmuch as the incentive to incorporate lies in the ability to avoid the recognition of gain or loss in the change of business form, a penalty that otherwise accompanies such a change. Other Code sections requiring an interpretation of the term property have different purposes. For example, section 1221¹⁰ has a narrower statutory purpose. It excludes certain types of property from being considered capital assets,

7. See *Regenstein v. Commissioner*, 35 T.C. 183, 189 (1960) (citing a line of cases construing "property" under I.R.C. § 1221 and deciding capital gains treatment thereunder).

8. Int. Rev. Code of 1939, ch. 1, § 112(b)(5), 53 Stat. 37 (now I.R.C. § 351(a)).

9. S. Rep. No. 275, 67th Cong. 1st sess. (1921).

10. I.R.C. § 1221 reads as follows:

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;

(3) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by—

(A) a taxpayer whose personal efforts created such property,

(B) in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or

(C) A taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B);

(4) accounts or notes receivable acquired in the ordinary course of trade or business for services or from the sale of property described in paragraph (1);

(5) an obligation of the United States or any of its possessions, or of a State or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue; or

(6) a publication of the United States Government (including the Congressional Record) which is received from the United States Government or any agency thereof, other than by purchase at the price at which it is offered for sale to the public, and which is held by—

(A) a taxpayer who so received such publication, or

(B) a taxpayer in whose hands the basis of such publication is determined, for purposes of determining gain from a sale or exchange, in whole or in part by reference to the basis of such publication in the hands of a taxpayer described in subparagraph (A).

and thus restricts the type of property transfers that will receive capital gains treatment. If the different statutory goals are to be given meaning, the definition of property under section 351(a) should develop more broadly than under section 1221.

III. MONEY AS PROPERTY

In sections of the Code other than 351, the term "property" does not always include money. Originally, in interpreting section 112(b)(5) (the predecessor of section 351(a)), the Service ruled that money was not to be regarded as property.¹¹ In *Halliburton v. Commissioner*,¹² however, the Ninth Circuit overruled the Board of Tax Appeals and determined that property included money. The cases of *Claude Neon Lights, Inc. v. Commissioner*¹³ and *Portland Oil Co. v. Commissioner*,¹⁴ decided soon thereafter, also held that money constituted property. The more recent case of *Holstein v. Commissioner*¹⁵ and a revenue ruling¹⁶ under the 1954 Code have settled the issue and money now is clearly regarded as property under section 351(a).

IV. PATENTS, TRADEMARKS, COPYRIGHTS, AND TECHNICAL KNOW-HOW AS PROPERTY

The principles applied to the treatment of patents and patent rights provided the first significant analysis of the meaning of property within section 351. These principles are of continuing validity in determining the characterization of property today.

In the patent cases, the courts and the Service began to define property in terms of legally protectable rights.¹⁷ The protection of inventions and ideas, however, is by no means always based on the concept of property. Generally, only those ideas which might be patented or copyrighted are afforded legal protection on a "property basis,"¹⁸ though other touchstones are utilized to protect other forms of intellectual property. Regardless of the foundation for various interpretations,

11. G.C.M. 2862, VII-1 C.B. 161 (1928).

12. 78 F.2d 265 (9th Cir. 1935).

13. 35 B.T.A. 424 (1937), *acq.*, 1937-2 C.B. 5.

14. 109 F.2d 479 (1st Cir. 1940), *cert. denied*, 310 U.S. 650 (1939).

15. 23 T.C. 923 (1955).

16. Rev. Rul. 69-357, 1969-1 C.B. 101.

17. *Kronner v. United States*, 110 F. Supp. 730 (Ct. Cl. 1953); *Myers v. Commissioner* 6 T.C. 258 (1946); Rev. Rul. 64-56, 1964-1 C.B. 133; Rev. Rul. 58-353, 1958-2 C.B. 408.

18. Schramm, *Basis for Protection of Intellectual Property Other Than Patents, Trademarks and Copyrights*, 44 J. PAT. OFF. SOC'Y 75 (1962).

the tax law has followed the directions of the general law regarding patents, trademarks, and copyrights.¹⁹ There is little serious disagreement today that those concepts which are protected under the general law, whether they be trademark, patent, or copyright, are indeed property under section 351(a).

When characterizing concepts other than patents, trademarks, and copyrights, the distinction between property and services is more difficult to make. Trade secrets, secret processes, technical know-how, and the like do not conform to the pattern established in the patent cases because of their intangible nature. Thus, the courts and the service have difficulty accepting these as property. Yet, it should be obvious that these intangible items command a value upon which fortunes are often built.²⁰ Further, these rights may be transferred as a substantial part of the assets of the company utilizing them.

In approaching this definitional problem, the Service has been unwilling to abandon the principles it utilizes in characterizing patents. Property for purposes of section 351 includes "secret processes and formulas," and any other secret information pertaining to processes in the general nature of a patentable invention, without regard to whether a patent has been applied for or whether the information is patentable.²¹ Other secret information is considered under section 351(a) on a case-by-case basis.²²

This method of defining property is of questionable validity when the realities of the business world today are considered. Such a narrow definition eliminates many rights and intangibles which clearly have value. Entire corporate structures are often based upon a secret which would not qualify as property under this interpretation.

Secret processes which may not be in the nature of a patentable invention have been included in the definition of property by the courts.²³ For example, in *E.I. duPont de Nemours & Co. v. United*

19. *Watson v. United States*, 222 F.2d 689 (10th Cir. 1955).

20. One of the most obvious and classic examples of a trade secret of this nature is the formula for Coca-Cola syrup.

21. Rev. Rul. 64-56, 1964-1 C.B. 133. It is noteworthy to mention that this position was established by inference many years earlier in G.C.M. 21507, 1939-2 C.B. 189.

22. Rev. Rul. 64-56, 1964-1 C.B. 133, 134.

23. *Huckins v. United States*, No. 4323-Civil-J. (S.D. Fla. 4/1/60) (*reprinted in* 60-1 U.S. Tax Cases (CCH) ¶ 9394 (1960)); *Nelson v. Commissioner*, 203 F.2d 1 (6th Cir. 1953). In these cases the authorities defined the secret process as property within the meaning of I.R.C. section 1221 which defines the phrase "capital asset" in terms of property. Although these cases relate to property in another section of the Code as opposed to section 351, it seems safe to assume that the

*States*²⁴ the court held that the “essential element” of the ownership of a trade secret or secret process is the “right” of the inventor or the discoverer “to prevent unauthorized disclosure” of the process.²⁵ If the Service were to adopt the reasoning of this court, it would likely be required to redraft its present position and thus apply this expanded concept of property to section 351(a). In *E.I. duPont*, the Service conceded that the trade secret was property under section 117(a) (the predecessor of section 1221).²⁶ Although such a trade secret might fail to meet the Service’s current criteria for property under section 351(a) (as not being in the nature of a patentable invention), it still has great practical business value. As the court in *E.I. duPont* recognized, one value of such a secret is the discoverer’s right to transfer his knowledge and control to another so that the transferee can make use of it without liability to the discoverer.²⁷ Realistically, such secrets offer a competitive benefit that may be of even greater value to a corporation than patentable articles. Unlike patents, their monopoly is not limited in time, but is instead dependent solely on the ability of the owner of the trade secret to prevent disclosure.

The current interpretation in Revenue Ruling 64-56 appears to be based on the administrative convenience offered by narrow classifications rather than an appreciation of the practical business value such transferable interests have. The Service may fear that a practical definition that qualifies the transfer of such interests as were identified in *E.I. duPont* would open section 351 to certain abuses not present under the restrictive interpretation provided by Revenue Ruling 64-56. Because section 351 is intended to permit and encourage the tax-free incorporation of ongoing businesses, however, the restrictive interpretation is unwarranted.

V. GOODWILL AS PROPERTY

At this point in the “property-services spectrum”²⁸ the concepts

definition for section 1221 purposes would, or at least should, be more narrow than for purposes of section 351. See text accompanying notes 8-10 *supra*.

24. 288 F.2d 904 (Ct. Cl. 1961).

25. *Id.* at 911.

26. *Id.* at 910.

27. *Id.* at 912-13.

28. The “property-services spectrum” is a term referred to in an effort to delineate the attempts by the courts and Service to clarify the vague area between property and services. At the extreme property end of the spectrum are buildings, land, and money. At the services end are accounting and legal fees. In between these extremes lie the problem areas discussed in this article.

under the current law begin to blur. The ideas and principles of property classification for section 351(a) purposes migrate into an area in which rigid definitions are clearly inapplicable.

The sale of a successful ongoing business often brings a higher price than the assets on the balance sheet indicate the business is worth. This difference is sometimes attributable to various indices of valuation.²⁹ Often, however, the difference in book value and price may be attributable, at least in part, to that intangible asset termed goodwill. Goodwill may be present in small personal service businesses or in the largest corporations. Goodwill is considered by businessmen, accountants, and lawyers to be an asset for which consideration is required in the sale of a business. It is a by-product of a well organized, profitable business enterprise. Clearly goodwill is intangible, but it is an asset within the full meaning of the word.³⁰

The case law holds that goodwill may be a salable asset, depending on the facts and circumstances involved. Salable goodwill is the reasonable expectation of a preference, for which a buyer pays a premium in the transfer of articles accompanying it, such as a physical plant, an entire business, or rights in a trade name.³¹ The abstract concept of goodwill as a quality which attracts customers to a business and keeps them has not been recognized as transferable property, whereas salable goodwill (that reasonable expectation of a preference that is connected to the sale of a business or part of one) can be transferred as property.³² Several court decisions have indicated that even a professional practice or any other one-man business which is dependent solely upon the professional skill or characteristics of the owner, may possess salable goodwill within sections 61 and 1221 of the Code.³³ The effect of these decisions is important to many small professional practices, particularly in law and medicine. Although assets such as books and office furniture may have a minimal value, an entire practice may command a price far above the value of those few tangible assets.

29. Examples include higher values of real property due to nothing more than inflation or to technologically high replacement costs.

30. *Compare* *Persson v. Commissioner*, 296 F.2d 915 (7th Cir. 1961) with *Grace Bros. v. Commissioner*, 173 F.2d 170 (9th Cir. 1949).

31. *Grace Bros. v. Commissioner*, 173 F.2d 170, 176-77 (9th Cir. 1949).

32. *See id.* at 175.

33. *Brooks v. Commissioner*, 36 T.C. 1128 (1961), *acq.*, 1962-2 C.B. 4; *Horton v. Commissioner*, 13 T.C. 143 (1949), *acq. in result only*, 1959-2 C.B. 5; *Herndon v. Commissioner*, 21 T.C.M. (CCH) 1013 (1962).

This is because the goodwill and continued expectation of patronage by former clients accompanies the transfer.

After encountering decisions which were contrary to the Service's position that salable goodwill cannot exist in the transfer of a one-man business,³⁴ the Commissioner issued Revenue Ruling 64-235, modifying the Service's position so that it would be consistent with those decisions.³⁵ It is reasonable to assume that both the Service and the courts will treat salable goodwill as property under section 351(a).³⁶ If goodwill is a salable asset under section 1221, it is not illogical to consider the asset property under section 351(a) in the exchange of an ongoing business for stock. As indicated earlier,³⁷ section 1221 definitions of property should be even more narrow than section 351 definitions because of the different purposes of the sections. Therefore, if an asset is deemed property under section 1221, that same asset should be property under section 351.

Like cash, stock transferred to the owners of an ongoing business upon incorporation is a form of payment. If the payment is of stock having a fair market value greater than the book value of the transferred business, the excess value could be attributed to goodwill and the stock would be exchanged for property within section 351. Under the current Service interpretation, however, the proportionate amount of stock value that would be attributable to goodwill could not be exchanged for property. Thus, the value of this amount has to be recognized as gain by the transferor. Additionally, if the goodwill portion of the total value in the exchange is sizable (as in a professional practice), then the remaining value of the tangible items would not be sufficient to qualify the transaction for section 351 treatment. The more flexible interpretation argued for above would enable a concern to incorporate and not lose the benefits of nonrecognition of gain from goodwill. The anticipation of these consequences may discourage an ongoing business from incorporating.

Although there is no extensive body of law on goodwill as it relates to property under section 351, there is no reason to interpret section 351 property to exclude goodwill. The Service could be protected from potential abuses of such a ruling through its ability to treat the alleged transfer of property as a device for compensation for past or future

34. See Rev. Rul. 60-301, 1960-2 C.B. 15; Rev. Rul. 57-480, 1957-2 C.B. 47.

35. Rev. Rul. 64-235, 1964-2 C.B. 18.

36. See *id.* at 19.

37. See text accompanying notes 8-10, *supra*.

services or an attempt to unlawfully convert ordinary income to capital gain.³⁸

VI. CONVERSION OF COMPENSATION FOR SERVICES INTO PROPERTY

A. *Past Services Are Rarely Property*

Section 351 does not allow nonrecognition of gain when the stock or securities are payment for services rendered or to be rendered. This contributes to the difficulty in defining property under section 351. When stock is issued as compensation for past services rendered to the corporation, section 351 does not apply and the payment of such stock is a taxable event.

The case of *Columbia Oil and Gas Co. v. Commissioner*³⁹ illustrates the context in which such transfers often occur. During the organization of the corporation, one person performed underwriting services involving the procurement of stock subscriptions and agreed to become the chief executive officer of the company. Another individual provided the legal expertise necessary for the transaction. The Board of Tax Appeals concluded that neither participant transferred property to the corporation, and therefore, the individuals who had transferred property in exchange for stock of the new corporation did not have the requisite control.⁴⁰

A similar finding was made in *Record Petroleum Co. v. Commissioner*.⁴¹ There, the Board found a disproportionate distribution of stock to the transferors. Two members of the group of stockholders had contributed significantly less than the other five members. In order to induce them to lend their business expertise and knowledge to the corporation, however, these two were given shares equal to the others. In construing section 203(b)(4) of the Revenue Act of 1924, the Board implicitly held that the expertise of the transferor is not property.⁴²

As the facts diverge from those in *Columbia Oil* and *Record Petroleum*, the decisions become less clear. The main problem lies where

38. Also in the Commissioner's arsenal are the assignment of income principles, tax benefit rule, and his statutory authority under I.R.C. sections 446(b) and 448 to require an allocation of income and deductions to "clearly reflect income."

39. 41 B.T.A. 38 (1940), *aff'd on other grounds*, 118 F.2d 459 (5th Cir. 1941).

40. *Id.* at 45. The Board found the property transferred to the company solely in exchange for stock amounted to 72.5 percent of the total ownership.

41. 32 B.T.A. 1270 (1935), *acq.*, XIV-2 C.B. 18 (1935).

42. *Id.* at 1271.

services may have been converted into a property interest prior to the exchange of that interest for stock. An early example of this situation was seen in *The Roberts Co. v. Commissioner*,⁴³ a case involving a law firm whose contingency fee was to be an interest in the assets of the estate in question in exchange for successfully defending the claims made against the estate. Upon incorporation of the assets of the estate, the firm received its share of the stock of the corporation. The Tax Court applied local law and held the contingency agreement to be an equitable interest in the transferred property. The Court therefore determined that the exchange was tax-free under the predecessor to section 351. The value of this case may be limited, however, since it was the government—not the law firm—that argued the firm had received stock in exchange for property. The petitioner, one of the heirs, was attempting to receive the property with the higher basis at the time of transfer, rather than have the basis of the property determined by its basis in the hands of the transferors.

At least two other cases have recognized an equitable interest as property. In *Straubel v. Commissioner*,⁴⁴ the Board of Tax Appeals determined that property under the predecessor to section 351 included the equitable interest in a patent held by persons who had contributed to its development. In *Fahs v. Florida Machine & Foundry Co.*,⁴⁵ the Fifth Circuit recognized the viability of the theory that an equitable interest could be property within the Code, but decided that on the facts shown, no equitable interest in the transferred property had been earned by the taxpayer. The court suggested that on stronger facts a transferor of an equitable interest would be a transferor of property.⁴⁶

The major body of case law in this area, however, has not recognized the transfer of unmaturing rights to a property interest as a transfer of property. An example of this majority position may be found in *United States v. Frazell*.⁴⁷ In *Frazell*, a geologist agreed to perform geological services in return for a thirteen percent share of the profits of the venture once the investors had received a return on their own capital. The venture proved to be a success, and before the interest of the taxpayer vested, the assets of the partnership were transformed into a newly created corporation. The taxpayer then received thirteen percent

43. 5 T.C. 1 (1945).

44. 29 B.T.A. 516 (1933).

45. 168 F.2d 957 (5th Cir. 1948).

46. *See id.* at 959.

47. 335 F.2d 487 (5th Cir. 1964).

of the corporate stock in exchange for his partnership interest. The district court held that Frazell had received the stock in exchange for his joint venture interest and therefore receipt of the stock should not be taxed as income.⁴⁸ The circuit court reversed, reasoning that the value of the stock was taxable compensation to the extent that the stock was payment for geological services performed for the partnership.⁴⁹ In so doing, the court identified two alternative views of these transactions,⁵⁰ but stated that under either, the stock was taxable as ordinary income to Frazell.⁵¹ Had the court relied on its first identified alternative, under which Frazell's interest vested and became taxable to him prior to the transfer of the partnership assets to the corporate entity, such right should have been treated as section 351 property under the same theory as that in *The Roberts Co.* The distribution of stock under this approach would be tax-free to the recipient. The stock could then be used for purposes of computing the eighty percent control required under section 351.⁵²

The theory suggested by the district court in *Frazell* would have been more consistent with the purpose of section 351 and within the reasoning of the earlier cases indicating that an equitable interest in property is within the meaning of the section.⁵³ Because the purpose of section 351 is to permit the incorporation of an ongoing business without tax consequences, there is little reason to suggest that equitable

48. *Frazell v. United States*, 213 F. Supp. 457, 468 (W.D. Kan. 1963).

49. Two alternative views were stated but not distinguished by the court: whether the taxpayer had received a possessory interest at termination which should be recognized as compensation for services taxable under Treas. Reg. § 1.721(b)(1); or whether the stock distributed to the taxpayer was in substitution for the partnership interest promised in the original agreement, thereby taxable as ordinary income. Similar situations were faced in *Vestal v. United States*, 498 F.2d 487 (8th Cir. 1974) and *McDougal v. Commissioner*, 62 T.C. 720 (1974), *acq.* 1975-1 C.B.Z.

50. *United States v. Frazell*, 335 F.2d 487, 490 (5th Cir. 1964). In a somewhat cursory opinion, the court determined that the claim of the taxpayer against the partnership for his compensation for services rendered to the partnership was not property within the meaning of section 351.

51. The court stated:

The transactions . . . may be viewed in either of two ways: (1) If Frazell's partnership interest became possessory immediately upon the termination of the 1951 contract, so much of that interest received as compensation for services was taxable to him under the rule of Treasury Regulation § 1.721(b)(1). Thereafter, the transfer of his interest . . . was tax-free under section 351(a). (2) If the . . . stock was given in substitution for the partnership interest originally contemplated, so much of that stock received in compensation for services was taxable to Frazell under section 351(a). As either view of the 1955 transactions results in ordinary income to Frazell there is no reason to split hairs and choose between them.

Id.

52. See note 44 *supra* and accompanying text.

53. See *Fahs v. Florida Machine & Foundry Co.*, 168 F.2d 957 (5th Cir. 1948); and *Straubel v. Commissioner*, 29 B.T.A. 516 (1933).

rights in a business should be treated differently than other rights in it. If the theory of the district court was followed, provisions would be available elsewhere in the Code for preventing any abuses of section 351.⁵⁴

Currently, however, few courts are interpreting section 351 as not recognizing income upon the incorporation of an ongoing business where equitable interests such as claims created by personal services are involved.⁵⁵ Although future litigants might be successful in arguing this point, the current trend of the decisions is to the contrary.

B. *Future Services Are Even More Rarely Property*

Taxpayers attempting to qualify stock issued for contemplated future services under section 351(a) have fared no better than those with stock issued for equitable interests created by past services. In *Kimble Acquisition Co. v. Commissioner*,⁵⁶ an inventor transferred his invention to a group which planned its commercial exploitation. The sale agreement provided that the transferor was to develop his invention further and utilize his best efforts in informing the transferees of any development in related fields. The court held that this agreement contained a contract for personal service and was more than a mere transfer of property.⁵⁷ In *Mailloux v. Commissioner*,⁵⁸ the court held that stock received by the taxpayers for their agreement to assist in promoting the company and selling its stock was income, and taxable at the fair market value of the stock upon receipt. The court saw no obstacle to treating the stock as compensation for future services, making it doubtful that such a transfer may be held to constitute property within section 351.⁵⁹ The Tax Court reached a similar result in *Washburne v. Com-*

54. These include the assignment of income principles, tax benefit rules, device rules, and the Commissioner's statutory authority to require a clear reflection of income. See note 39 *supra*.

55. See, e.g., *Vestal v. United States*, 498 F.2d 487, 492 (8th Cir. 1974); *McDougal v. Commissioner*, 62 T.C. 720 (1974); *United States v. Frazell*, 335 F.2d 487 (5th Cir. 1964). In *Frazell*, the court stated:

[V]iewing the agreement as a whole and the conduct of the parties in the light of the usages and practices characteristic of joint ventures in the oil industry, we conclude that the agreement of February 9, 1951, constituted a joint venture as distinguished from a contract of employment. . . . It follows, therefore, upon termination of the joint venture . . . and the creation of the W.W.F. Oil Corporation, the transaction constituted a tax-free exchange of "property" for stock within the meaning of section 351(a).

Id. at 743.

56. 9 T.C. 183 (1947), *acq.*, 1947-2 C.B. 3.

57. *Id.*

58. 320 F.2d 60 (5th Cir. 1963).

59. See *Garrett v. Campbell*, 360 F.2d 382 (5th Cir. 1966) wherein the court discussed in-

missioner,⁶⁰ indicating income received for an agreement to perform future services was compensation rather than an intangible property interest. In *Allen v. Commissioner*,⁶¹ the Fourth Circuit held that stock transferred from a corporation to an attorney principally for future legal services was taxable upon receipt as compensation income.

C. *And Properly So*

From these cases it is apparent that the taxpayer who attempts to persuade a court or the Service that services are property is likely to enjoy little success.⁶² Though courts use the property or services terminology, it is apparent that judges are actually looking to the original source of the value, thereby avoiding any unnecessary entanglement with the nonrecognition provisions. With the exception of two cases⁶³ recognizing that equitable interests may have been created by the efforts of individuals, most courts and the Service consider substance over form in distinguishing services from property.⁶⁴

While this paper advocates a broad enough meaning of property under section 351 to accommodate services when their substance is property, the narrower reading has strong support. A blanket rule treating services as equitable property interests would, for instance, permit a group of promoters to form a partnership to which some of the

structions to the jury on whether stock in a mining company received by the taxpayer was compensation for services rendered to the company or an exchange for his interest in mining property.

60. 27 T.C.M. (CCH) 577 (1968).

61. 107 F.2d 151 (4th Cir. 1939).

62. It should be noted, however, that in some cases the courts have found that the receipt of the stock was a gift. This is far from a satisfactory solution because the necessary donative intent is difficult to prove. *E.g.*, *Baltimore v. Commissioner*, 17 T.C.M. (CCH) 388 (1958). *But see*, *Clem v. Campbell*, Civ. No. 9222 (N.D. Tex. 10/1/62) (*reprinted in* 62-2 U.S. Tax Cas. (CCH) ¶ 9785 (1962)). In any event, a finding that receipt of the stock constitutes a gift would benefit only the recipient. There would be no exchange of property within section 351(a) and the stock could not be used in computing the 80 percent control group.

63. *Fahs v. Florida Machine & Foundry Co.*, 168 F.2d 957 (5th Cir. 1948); *The Roberts Co. v. Commissioner*, 5 T.C. 1 (1945).

64. *See, e.g.*, *Columbia Oil & Gas Co. v. Commissioner*, 41 B.T.A. 38 (1940), *acq.*, 1940 C.B.Z. In *Columbia*, two brothers owned oil and gas properties which they wanted to incorporate. The brothers contracted individually with another and promised to give him 475 of the 1500 shares issued to them as consideration for procuring cash subscribers for 25 percent of the stock to be issued. Additionally, they contracted with an attorney to set up the plan of incorporation in exchange for 75 shares. The court disregarded the form of the transaction, holding:

We do not think the transfer of the 550 shares [475 + 75] . . . can be disregarded in deciding the issue. The transfer was not a separate and independent transaction, but was an essential part of an integral plan. For income tax purposes this plan must be treated as a single transaction.

Id. at 44. *See also* *Boles v. United States*, 72-2 U.S.T.C. ¶ 9493 (S.D. Ohio 1972) and *Mailoux v. Commissioner*, 320 F.2d 60 (5th Cir. 1963).

partners would provide services under contract. The simple failure to pay the income to working partners would cause an equitable interest in the partnership to accumulate for them. Upon incorporation, this interest would be transformed into shares of stock in a tax-free exchange.⁶⁵ Such a transaction would provide tax-free income to the recipient; and because the corporation would receive property within the meaning of section 351, the transferred stock would be included for purposes of computing the eighty percent rule.⁶⁶ This would be a clear abuse of the intent of section 351 and would probably move Congress to restrict the provisions of section 351.

VII. THE STARTING-UP—CONTINUING SERVICES DICHOTOMY

In some instances, courts analyzing services have drawn a distinction between start-up services and services of a continuing nature. Only the former are considered property. An application of this distinction was made in *Ruge v. Commissioner*.⁶⁷ In *Ruge*, the taxpayer had transferred certain inventions to the corporation. Additionally, the transfer agreement had provided that Ruge would supply up to sixty days per year of consultation on the establishment of the manufacturing operations and that, for further consideration, Ruge would lend the corporation his efforts and ideas for promoting and developing the business.⁶⁸ The court determined the consulting services to be "ancillary and subsidiary to the assignments of the inventions."⁶⁹ As such, the payments for these services were consideration for the sale of the inventions. The payment for the services rendered to promote and develop the business, unlike the start-up consultation services, was held not to be a part of the consideration for the transfer of the invention. This payment was thus taxable as ordinary income.⁷⁰

65. Rev. Rul. 64-56, 1964-1 C.B. 133.

66. Rev. Rul. 64-56, 1964-1 C.B. 133, which technically could have covered this question, left the area practically untouched. The problem frequently occurs in situations where an invention, patent, or technical process is transferred to a transferee not possessing enough expertise to immediately utilize the asset. Often the agreement will call for the transferor to assist the transferee for a specified period of time until the transferee is capable of operation on his own. Quære: Should not the same principle apply in the transfer of an ongoing business?

67. 26 T.C. 138 (1956).

68. *Id.* at 139.

69. *Id.* at 143.

70. *Id.* See also *Hessert v. Commissioner*, 16 T.C.M. (P-H) ¶ 47,301 at 47-1020. In *Hessert*, as in *Ruge*, it was necessary to distinguish those services which are ancillary and subsidiary to the transfer of patents. The court found that because the services were of "an advisory nature not unusually involved in the sale of a highly technical and intricate device," they were a component of the sale. *Id.* at 47-1025.

Clearly under section 351(a) an allocation⁷¹ must be made between property⁷² and additional services furnished in exchange for stock.⁷³ Since issuance of Revenue Ruling 64-56, the earlier cases, treating nominal services merely as a part of the sales agreement and not subject to allocation, no longer represent the position of the Service. Each case is to be decided on the basis of the guideline in that ruling. Under Ruling 64-56, services that are merely ancillary and subsidiary to the property transfer are considered starting-up services.⁷⁴ No allocation needs to be made between property and additional services when those services are so considered. However, a separate contract for services not clearly ancillary to the property transferred will indicate that continuing services are involved and will require an allocation between property and additional services exchanged for the stock.⁷⁵ Implicit in Revenue Ruling 64-56 is a stricter interpretation of ancillary services.

VII. IDEAS AS PROPERTY

The most nebulous area to be considered in an examination of the property or services distinction involves the tax consequences of the transfer of an idea to a corporate enterprise in exchange for stock. Quite often a business enterprise is profitable not because of the value of the assets or the inherent ability of its officers and employees but because of an idea which the business has put to commercial use.⁷⁶ The idea may relate to a specific method of running a business, such as mutual funds which invest primarily in real estate and natural re-

71. 16 T.C.M. (P-H) ¶ 47,301 at 47-1020.

72. *Id.* at 1024-47 and 47-1025.

73. Rev. Rul. 64-56, 1964-1 C.B. 133.

74. The Ruling stated,

Where both property and services are furnished as consideration, and the services are not merely ancillary and subsidiary to the property transfer, a reasonable allocation is to be made.

Training the transferee's employees in skills of any grade through expertness, for example, in a recognized profession, craft, or trade is to be distinguished as essentially educational and, like any other teaching services, is taxable when compensated in stock or otherwise, without being affected by section 351 of the Code. However, where the transferee's employees concerned already have the particular skills in question, it will ordinarily follow as a matter of fact that other consideration alone and not training in those skills is being furnished for the transferor's stock.

Rev. Rul. 64-56, 1964-1 C.B. 133, 134.

75. *See id.* at 134-35.

76. Examples of this type of enterprise are numerous. From the idea of self-service laundries to the one-stop grocery store concept, people have become wealthy on ideas.

sources⁷⁷ or in blue-chip securities.⁷⁸ An even better example is the idea of one mutual fund to foresake investments in cigarettes, liquor, or pharmaceutical stocks in an effort to appeal to investors who are Christian Scientists.⁷⁹

Ideas such as these are probably not protected from duplication in the general legal sense. Frequently, however, they do have value. This value is reflected in the willingness of investors to pay many times the worth of the tangible assets for an interest in a new company. They are investing in the idea behind the business. When a business is transferred, a premium is often paid for nothing more than the successful implementation of an idea.

To date, the Service has been unwilling to accept the value of an idea as property within the meaning of section 351(a).⁸⁰ The courts, however, have referred to the value of that intangible interest comprised of ideas and experience.⁸¹ Possibly of even greater importance is the recognition by at least one court that property includes "whatever may be transferred."⁸² This view of property would clearly include ideas within the meaning of property for section 351(a) purposes.

It is doubtful from the analysis of cases in the earlier sections of this paper that a liberal interpretation such as that suggested above will be forthcoming with regard to ideas. The Service and the courts will probably treat ideas in a manner similar to the analysis found in rulings and cases relating to the value of an individual's name.⁸³

In *Reid v. Commissioner*,⁸⁴ a case involving the sale of a name, the name alone was not, by implication, an asset. The subject of the sales contract, however, was the taxpayer's name, which had been associated with a specific product petitioner had designed and had marketed for

77. An example is the Rowe Price New Era Fund, Inc. in Baltimore, Maryland.

78. An example is the Wellington Fund in New York.

79. Foursquare Fund, Inc., as described in A. WIESENBERGER, INVESTMENT COMPANIES 269 (1967).

80. Rev. Rul. 64-56, 1964-1 C.B. 133 (citing *Regenstein v. Commissioner*, 35 T.C. 183 (1960)). *Regenstein* involved the treatment of payment for the idea and subsequent development of a government employee insurance program as taxable as compensation rather than as a capital asset under § 1221. However, as discussed earlier there are valid reasons for interpreting property more broadly under section 351 than under section 1221. See text accompanying notes 8-10 *supra*.

81. *Knowles v. Commissioner*, 24 T.C.M. (CCH) 129 (1965), *aff'd*, 355 F.2d 931 (3rd Cir. 1966).

82. *H.B. Zachry Co. v. Commissioner*, 49 T.C. 73, 80 n.6 (1967).

83. *Miller v. Commissioner*, 299 F.2d 706 (1956), *cert. denied*, 370 U.S. 923 (1962); *Reid v. Commissioner*, 26 T.C. 622 (1956), *acq.*, 1956-2 C.B. 8; Rev. Rul. 65-261, 1965-2 C.B. 281.

84. 26 T.C. 622 (1956), *acq.*, 1965-2 C.B. 8.

eight years. The transaction involved not only the sale of the name, which had taken on the characteristics of a trade name, but also of certain patents pertaining to the product identified with her name. The court clearly indicated that an intangible (a name) standing alone, would not be an asset within the meaning of section 1221.⁸⁵ The court's position is used in Revenue Ruling 65-261,⁸⁶ where the Service indicated that the sale of the mere right to use and exploit one's name in connection with the manufacture, sale, and advertising of merchandise is not the sale of property which is a capital asset.⁸⁷ The Revenue Ruling distinguished that taxpayer's situation from Reid's, stating "no patents [are] involved nor [is] any product associated with the name as a trade name"⁸⁸ Furthermore, the Service limited its willingness to permit an intangible to qualify as an asset only where the value of the name has manifested itself in some *tangible* form of property interest of value to the commercial world.⁸⁹

Because their essential characteristics are similar, an analogy between names and ideas would be valid in determining which ideas constitute property and which do not. Both names and ideas have no value unless they are exploited,⁹⁰ and both are intangibles. Both are legally protected only when conceptualized in their most concrete state.⁹¹ When names and ideas take on value, the interest in them is discernable only as a property interest which is manifested in assets that are entirely tangible.⁹²

85. *Id.* at 633-34. Again, it is not in error to compare cases defining property under section 1221 with the requirements of section 351 because the latter's requirements are much broader.

86. Rev. Rul. 65-261, 1965-2 C.B. 281. The Ruling however, distinguished *Reid*.

87. *Id.*

88. *Id.*

89. *Id.* (emphasis added).

90. While not within the ambit of tax law, the cases on the right of publicity, a property interest in one's name, likeness, or reputation, make clear that this interest is established, and inheritable, upon proof of exploitation during the owner's lifetime. See *Zacchine v. Scripps-Howard Broadcasting Co.*, 433 U.S. 562 (1977); *Hicks v. Casablanca Records*, 464 F. Supp. 426 (S.D. N.Y. 1978). See generally *Felcher & Rubin, Privacy, Publicity, and the Portrayal of Real People by the Media*, 88 YALE L.J. 1577 (1979); *Gordon, Right of Property in Name, Likeness, Personality and History*, 55 Nw. U. L. Rev. 553 (1960).

91. That is, with the exception of the individual rights a person has with respect to commercial use of his name, the name becomes protected only as a tradename or trademark. Similarly, ideas are generally protected only as trade secrets and patents. *Cf.* the Copyright Act of 1976, 17 U.S.C. § 102(b).

92. *Reid v. Commissioner*, 26 T.C. 622 (1956), *acq.*, 1965-2 C.B. 8. The value of the name was the result of its use in connection with the manufacture, sale, and advertising of any merchandise or services the purchaser (of the right to use the name) chose to associate with them. Rev. Rul. 65-261, 1965-2 C.B. 281. An idea becomes manifested in tangible assets only when that idea is implemented in a business structure.

The position of the Service on know-how, which apparently would be akin to an idea, is set out in Revenue Ruling 64-56.⁹³ As discussed above,⁹⁴ the tone of this ruling equates property with a protectable interest. From a reading of the cases and an examination of the trends discussed earlier in this article, it is relatively safe to conclude that the protectable interest concept most accurately reflects at least the result the Service and the courts will reach in formulating a consistent pattern of legal analysis in cases attempting to include ideas as property within section 351(a) of the Code.

IX. CONCLUSION

From the analysis of cases and other materials considered in this article, several important principles can be derived and areas where the taxpayer is on unsure footing can be identified. Most of these principles are less than absolutely clear. It is even doubtful that they will become so within the near future. Yet, in formulating a definition of property for tax purposes, it is apparent that the courts and the Service have looked to our social and legal concepts of property. They require, generally, a tangible interest, or an intangible interest which is protected by law or has its value manifested in a tangible interest.

Money is clearly considered property under section 351, as are patents, trademarks, copyrights and, in some cases, technical know-how. However, once the interest departs from our somewhat feudal notions of property, the courts begin to waver and the line becomes unclear.

Salable goodwill should be considered property under section 351, but the authority for this interpretation is scant. Nevertheless, the analysis of section 1221 cases involving goodwill may be helpful in learning how the courts and the Service will attempt to arrange interests within the property-service spectrum.

Generally, attempts to convert past or future services to property have been unsuccessful, although a minority of cases have held otherwise. This is not to imply that the distinction between compensation income and property is completely clear. Potentially, the concept most important for dealing with the Service is the possibility that an equitable interest resulting from prior services may be converted to stock within the nonrecognition provisions of section 351.

In the past, cases have permitted starting-up services to be in-

93. Rev. Rul. 64-56, 1964-1 C.B. 133. *See also* Rev. Proc. 69-19, 1969-2 C.B. 301.

94. *See* notes 23-27 *supra* and accompanying text.

cluded within the definition of property for section 351 purposes. These prior decisions, however, have been clouded by the pronouncements of Revenue Ruling 64-56 indicating the Service will now consider these problems on a case-by-case basis.

The treatment of ideas is virtually untouched on any rational basis by the case law, and the Service's position appears to be based on expediency more than reality. The problems inherent in the classification of ideas provide an excellent background for an examination of the conflicts encountered in defining property. Analogizing ideas to names and their classification is a realistic point of departure for attempting to classify ideas.

Although questions remain, the above analysis has illustrated many of the problems and has suggested probable tax treatment for those problems. The principles available from the limited number of cases decided indicate that the courts and the Service can be expected to look through the form and consider the substance in defining property. It appears the doors will remain tightly shut on potential abuses of section 351 by maintaining a strict interpretation of property.