THE TAX EFFECTS OF A SHAREHOLDER'S POST-INCORPORATION SALE OF STOCK: A REAPPRAISAL

ROBERT I. KELLER *

Introduction ................................................................. 91
I. Control "Immediately After The Exchange ............. 93
   A. Background ........................................... 93
   B. Three Forms, One Substance .................. 96
   C. Current Law ........................................ 98
       1. Post-Formation Sales of Stock ............. 98
          a. Generally .................................. 98
          c. The Problem of Qualifying a Combined Primary and Secondary Best Efforts Public Offering Under Section 351 .................. 101
       2. Pre-Formation Sales of Property and Boot Transactions ...................... 102
          a. Generally .................................. 102
          b. Co-op Conversions ...................... 105
       3. Summary ............................................. 106
   D. The Policy Behind Section 351 ......................... 107
       1. Generally ...................................... 107
       2. Mere Change in Form .......................... 107
       3. The Facilitation of Business Readjustments .... 109
       4. What is Left of the Immediately After the Exchange Requirement ................. 111
   E. Conclusion and Summary ................................. 112
II. Income and Basis Issues: The Case for the Boot Transaction Route .......................... 114
   A. Introduction ....................................... 114
   B. Income and Basis Issues Where P Transfers Property Having a Basis in Excess of Fair Market Value .......... 115
       1. The Example .................................. 115
       2. The Tax Consequences Under the Three Formal Routes .................................. 115
          a. The Post-Formation Sale of Stock Route .... 115
          b. The Pre-Formation Sale of Property Route .... 116
          c. The Boot Transaction Route ......... 116
          d. Summary of Tax Consequences ......... 117

* Professor of Law, University of Maryland; B.S. 1963, University of Pennsylvania; L.L.B. 1966, Harvard University.
3. The Case for the Boot Transaction Route .................. 117

C. Income and Basis Issues Where P Transfers Property
   Having a Value in Excess of Basis ...................... 119
      1. The Example ........................................ 119
      2. The Tax Consequences Under the Three Formal
         Routes ............................................. 120
            a. The Post-Formation Sale of Stock Route ...... 120
            b. The Pre-Formation Sale of Property Route .. 121
            c. The Boot Transaction Route ................... 121
            d. Summary of Tax Consequences ................. 121
      3. The Case for the Boot Transaction Route ............. 122
            a. Effect of Transaction on Newco's Basis in the
               Property ........................................ 122
            b. Character of Gain Recognized by P ............ 123
            c. Amount of Gain Recognized by P ............. 125

D. Summary ................................................................ 125

III. The Tax Consequences of an Incorporation Transaction In
     Which Newco Issues Stock To C to Discharge P's Pre-
     existing Indebtedness to C .............................. 126
     A. Introduction: The Control Issue in the Discharge of
        Indebtedness Situation ............................... 126
     B. Gain, Loss, and Basis Consequences: The Case for the
        Assumption of Liability Route ...................... 127
            1. Treatment of Liabilities Assumed in a Section 351
               Transaction ...................................... 127
            2. The Case for the Assumption of Liability Route
               Where the Liability Being Discharged is of a
               Nondeductible Variety .............................. 129
                  a. The Example .................................. 129
                  b. The Various Paths Available ................. 129
                  c. The Tax Consequences under the Post-Forma-
                     tion Sale of Stock Route and the Assumption
                     of Liability Route Compared ................. 129
                  d. The Case for the Assumption of Liability Route
                     .................................................. 131
            3. The Case for the Assumption of Liability Route
               Where the Assumed Liability Would Have Been
               Deductible Had it Been Paid by the Transferor ... 132
                  a. The Incorporation of a Cash Basis Business .. 132
                  b. The Example .................................. 134
                  c. The Tax Consequences Under the Assumption
                     of Liability Route and the Post-Formation Sale
                     of Stock Route Compared ..................... 134
                  d. The Case for the Assumption of Liability Route
                     .................................................. 136
     C. Summary .................................................. 136

Summary and Conclusion ........................................ 137
INTRODUCTION

When the step transaction doctrine\(^1\) is discussed, the example often used to illustrate it is that of a taxpayer who transfers property to a newly formed corporation in exchange for all of its stock intending to immediately sell more than 20 percent of such stock to a third party.\(^2\) If the two steps are mutually dependent,\(^3\) the courts and the Internal Revenue Service have long concluded that the property transferor will not be considered in control of the new corporation "immediately after the exchange" for purposes of qualification under section 351.\(^4\) The result, therefore, is that the property transferor will be required to recognize all

---

2. See, e.g., B. Bittker, infra note 1, § 4.3.5., at 4-50 to 4-52. Bittker uses this example to illustrate what he calls the "critical step" variation of the step transaction doctrine. This variation is "concerned with whether a particular step with significant legal or business consequences should be treated as part of a larger single transaction. . . ." Id. at 4-50. Bittker also refers to an "unnecessary step variation," where "particular steps in an integrated transaction are disregarded as transitory events or empty formalities." Id. at 4-52. See infra note 31.
3. Commentators have "attempted to synthesize from judicial decisions several tests to determine whether the step-transaction doctrine is applicable to a particular set of circumstances. . . ." Redding v. Commissioner, 630 F.2d 1169, 1175 (7th Cir. 1980), cert. denied, 450 U.S. 913 (1981). Under the broadest test, the so-called "end result" test, purportedly separate transactions will be amalgamated with a single transaction when it appears that they were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result." King Enterprises, Inc. v. United States, 418 F.2d 511, 516 (Ct. Cl. 1969). A second and narrower test is the "interdependence" test. Under the "interdependence" test, purportedly separate steps will be viewed as a single transaction where "the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series." Redding v. Commissioner, 630 F.2d 1169, 1177 (7th Cir. 1980). The third and most restrictive test is the "binding commitment" test. Under that test, application of the step-transaction doctrine is restricted to those cases where "if one transaction is to be characterized as a 'first step' there [is] a binding commitment to take the later steps." Redding, 630 F.2d at 1178 (quoting Commissioner v. Gordon, 391 U.S. 83, 96 (1968)). See generally McDonald's Restaurants v. Commissioner, 688 F.2d 520, 524-25 (7th Cir. 1982).

In deciding whether the property transferor's post-incorporation stock sale to the third party can be integrated with the initial incorporation transfer, courts have generally referred to only two of these: the "interdependence" test and the "binding commitment" test. The courts have generally asked two questions: "(1) Were the transferees subject to a binding obligation (entered into before the section 351 exchange) requiring them to dispose of the stock they received? (2) Would the section 351 exchange have failed to take place if the subsequent disposition were not certain to occur?" Tillinghast & Pauly, The Effect of the Collateral Issuance of Stock or Securities on the "Control" Requirement of Section 351, 37 TAX L. REV. 251, 252-53 (1982). If either question is answered affirmatively, then the disposition of the stock is considered to be "merely a step in a plan to put property into the corporation, cash or other consideration into the hands of the property's original owner, and stock into the hands of a formerly unrelated third party who has made no transfer to the corporation." Id. at 253. In such cases, the transferor has been held not to be in control of the corporation "immediately after the exchange". Id. See infra text accompanying notes 23-28.

4. See, e.g., Culligan Water Conditioning v. United States, 567 F.2d 857 (9th Cir. 1978); May Broadcasting Co. v. United States, 200 F.2d 852 (8th Cir. 1953); S. Klein on the Square, Inc. v. Commissioner, 188 F.2d 127 (2d Cir. 1951), cert. denied, 342 U.S. 824 (1951); Hazeltine Corp. v. Commissioner, 89 F.2d 513 (3d Cir. 1937); Maine Steel, Inc. v. United States, 174 F. Supp. 702 (D. Me. 1959); Intermountain Lumber Co. v. Commissioner, 65 T.C. 1025 (1976); Manhattan Bldg. Co. v. Commissioner, 27 T.C. 1032 (1957);
of his realized gain or loss on exchanging his property for the corporation's stock.\textsuperscript{5}

Part I of this article challenges the correctness of that long-standing and almost universally accepted conclusion. It is argued that, properly interpreted, section 351 should apply to an incorporation transaction even where the only person formally transferring property to the corporation is under a binding commitment to immediately sell more than 20 percent of his newly issued stock to some third party.\textsuperscript{6} In those circumstances, either the third party purchaser of stock should also be treated as part of the control group,\textsuperscript{7} or the words "immediately after the exchange" should be interpreted to require no more than momentary control in the formal transferee of property.\textsuperscript{8}

Part II then considers the tax and basis consequences of an integrated post-formation stock sale which does not disqualify the initial transaction from section 351 treatment. Continued qualification under section 351 would result even under existing law if the integrated post-formation stock sale to the third party was either of less than 20 percent of the outstanding stock, or was of more than 20 percent, but was made to a third party who also had directly transferred property for stock of the new corporation.\textsuperscript{9}

Under existing law, the nondisqualifying, though integrated, post-formation stock sale is taxed as if it were entirely unrelated to the incorporation transaction.\textsuperscript{10} Such stock sale results, therefore, in capital gain or loss (short or long-term) to the seller regardless of the nature of the assets he had just transferred to the new corporation;\textsuperscript{11} moreover, the stock sale has no effect on the new corporation's basis in the assets received.\textsuperscript{12} Part II concludes that these results are erroneous; that despite the form of the transaction as a post-formation sale of stock to the third person, the transaction should be recast and taxed to all parties as a "boot transaction", i.e., as a transaction in which the cash received by the property transferee was first paid directly into the new corporation by the third party in exchange for the corporation's stock, and then immediately distributed to the property transferee as boot in the section.

\begin{footnotes}
\item[6] If section 351 is not applicable to the transaction, then a transfer of property to a corporation in exchange for stock is fully taxable. I.R.C. § 1001(c); Reg. § 1.1002-1(a).
\item[7] In a recent article on the control requirement in I.R.C. § 351, the authors effectively demonstrate "that an issuance of stock or securities by a newly organized corporation—during or after, as an integral part of or separate from the incorporation itself—can never, or virtually never, trigger a violation of the control requirement of section 351." Tillinghast & Fauly, infra note 3, at 251. The authors conclude, however, that loss of control can take place by a post-formation sale of stock by a transferor of property to a nontransferor. Id. at 252-55 and 267. A specific weakness in the authors' analysis is set forth infra in the text accompanying notes 44-46.
\item[8] See infra text accompanying notes 29-32.
\item[9] See infra text accompanying notes 33-38.
\item[10] See infra text accompanying notes 39-46.
\item[11] See infra text accompanying notes 115-121 and 137-142.
\item[12] See infra text accompanying notes 140-42.
\end{footnotes}
351 exchange.\textsuperscript{13}

Finally, Part III deals with control, basis, and gain and loss consequences to the parties in a transaction in which the third party is a creditor of the property transferor who agrees, as an integral part of the incorporation transaction, to accept the newly formed corporation's stock in discharge of the property transferor's preexisting indebtedness to him. Particular attention is given to the situation where the stock is being issued to discharge a deductible liability owed to the creditor by the property transferor's cash basis proprietorship or partnership.\textsuperscript{14} Part III rejects the conclusion under current law that section 351 is inapplicable if the third party creditor in an integrated transaction ends up with more than 20 percent of the new corporation's outstanding stock.\textsuperscript{15} It also rejects the assumption under current law that, even where control is not at stake, tax consequences should be determined as if the property transferor first received all of the new corporation's stock in a section 351 transaction, and then transferred part of the stock to the creditor in discharge of the indebtedness. Rather, Part III concludes that all tax consequences should be determined as if the new corporation had first assumed the property transferor's liability to the creditor, and then discharged that liability by its issuance of stock to the latter\textsuperscript{16} under what this article calls "Assumption of Liability" approach.

I. CONTROL "IMMEDIATELY AFTER THE EXCHANGE"

A. Background

Section 351 of the Code provides for nonrecognition of gain or loss to persons who transfer property\textsuperscript{17} to a corporation in exchange for stock or securities,\textsuperscript{18} provided such persons (i.e., the transferors of property) possess 80 percent control\textsuperscript{19} of the transferee corporation "imme-

\textsuperscript{13} See infra text accompanying notes 128-35 and 148-59.
\textsuperscript{14} See infra text accompanying notes 190-213.
\textsuperscript{15} See infra text accompanying notes 160-70.
\textsuperscript{16} See infra text accompanying notes 187-213.
\textsuperscript{17} Stock or securities received in exchange for services performed for the corporation will not be considered as issued in exchange for "property." I.R.C. § 351(d)(1). The word "property" as used in section 351 does, however, include cash. Rev. Rul. 69-357, 1969-1 C.B. 101. See generally B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders §§ 3.03 (4th ed. 1979) [hereinafter cited as Bittker & Eustice].
\textsuperscript{18} See infra note 75. The meaning of the word "stock" is reasonably clear and generally presents little difficulty. Considerably more difficult is the definition of "securities." Courts have concluded that long-term debt interests are ordinarily "securities," while short-term interests are ordinarily not "securities." See Pinellas Ice and Cold Storage Co. v. Commissioner, 287 U.S. 462, 468-69 (1933); Turner Constr. Co. v. United States, 364 F.2d 525, 535 (2d Cir. 1966). See generally Bittker & Eustice, supra note 17, § 3.04 at 3-14 to 3-19.
\textsuperscript{19} "Control" is defined in I.R.C. § 368(c) to mean ownership of "at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation." The American Law Institute would extend nonrecognition treatment under section 351 "to any transfer of property to a corporation in exchange for stock of the corporation if no issue of stock of the corporation is regularly traded in any established market or exchange and if the transferor owns, immediately after the exchange, at least 20 percent of the voting stock and at
diately after the exchange." Under this section, it is the transferors of property together and not any individual transferor who must have the requisite 80 percent control.20 Thus, the stockholdings of two or more transferors can be aggregated in determining whether they control the corporation "immediately after the exchange" if their transfers are part of a single transaction.21

Thus, if previously unrelated individuals A, B, and C form a corporation with each contributing equal value appreciated property and each taking back one-third of the new corporation's outstanding stock, section 351 will apply to the transaction and none of the transferors will be required to recognize any gain realized on the transaction. Rather, gain will be deferred both at the shareholder and corporate levels through the Code's carryover basis provisions.22

Much litigation has taken place under section 351 concerning the requirement that control must exist in the transferors of property "immediately after the exchange."23 The issue generally arises where a person (or persons) transfers property to a newly formed corporation in exchange for all of its stock intending to immediately sell more than 20 percent of such stock to a third person. If the two steps—i.e., the initial incorporation exchange and the post-formation sale of stock—may properly be integrated for step transaction purposes, it goes virtually unquestioned today that section 351 will not apply to the transaction. The person who initially exchanges the property for stock is considered to be the sole transferor of property for section 351 purposes,24 and he alone is not deemed to be in control of the corporation immediately after his integrated post-formation stock sale to the non-transferor third party.25 (Hereafter, the property transferor in this type of transaction will be referred to as "P," the purchaser of the stock as "C," the newly formed corporation as "Newco," and the transaction as the "P-C transaction.")

The only issue for the courts in all recent cases involving P-C transaction has thus been whether P's stock sale to C could properly be integrated with the initial incorporation transfer. Resolving this issue has required courts to closely analyze the particular facts of each case, and to decide which of a number of possible tests for applying the step-transaction doctrine it would apply.26 For purposes of this article, how-

---

20. See Bittker & Eustice, supra note 17, § 3.09, at 3-10.
22. I.R.C. §§ 358 and 362. See infra Parts II and III.
23. See, e.g., cases cited supra note 4.
24. See, e.g., Intermountain Lumber Co. v. Commissioner, 65 T.C. 1025 (1976). The Tax Court in Intermountain noted that "[s]ince Wilson ["C" was not a transferor of property and therefore cannot be counted for control under section 351, ... we must determine if Shook ["P"] alone owned the requisite percentage of shares for control." Id. at 1031.
25. See, e.g., id. at 1033.
26. See supra note 3.
ever, the propriety of using the step-transaction doctrine in a P-C transaction need not concern us. It will simply be assumed throughout that at the time of P’s initial transfer of property to Newco, he was under a binding contractual obligation to sell part of the Newco stock to C, and, therefore, even under the most restrictive application of the step-transaction doctrine, the so-called “binding commitment test,” 27 P’s initial incorporation transfer and post-formation stock sale would be viewed as integrated steps. This article, however, will argue that in the end the applicability or nonapplicability of the step-transaction doctrine to the P-C transaction is irrelevant since both the integrated and nonintegrated P-C transaction should be deemed to qualify under section 351. 28

27. Id.

28. An area of substantial current interest, and one which seems entirely analogous both factually and analytically to the P-C transaction, concerns the effect of certain pre- and post-reorganization sales of stock by the acquired corporation’s shareholders on the “continuity of interest” requirement. See generally McGuffey and Hunt, Continuity of Shareholder Interest in Acquisitions Corporate Reorganizations, 59 Taxes 659 (1981); Wolfman, “Continuity of Interest” and the American Law Institute Study, 57 Taxes 840 (1979).

In earlier days, the Code did not specifically speak to the type of consideration that an acquiring corporation had to issue to qualify the transaction as a “reorganization.” This remains true today, however, only in the case of statutory mergers. A literal reading of the older statute (and of the current one with respect to statutory mergers and consolidations) seems to allow reorganization treatment of a transaction even if the acquiring corporation paid only cash for the stock or assets of the acquired corporation. Very early on, however, the Supreme Court added the judicial requirement of “continuity of interest” to the statute. See Pinellas Ice and Cold Storage Co. v. Commissioner, 287 U.S. 462 (1933). Over the years, this requirement came to mean not merely that some stock, whether common or preferred, had to be issued by the acquiring corporation, Le-Tulle v. Scafiled, 318 U.S. 415 (1940), but that such stock had to represent a substantial part of the consideration received by the acquired corporation’s shareholders. Helvering v. Minnesota Tea Co., 296 U.S. 378 (1935); John A. Nelson Co. v. Helvering, 296 U.S. 374 (1935). Today, the Internal Revenue Service will not issue an advanced ruling unless the stock issued represents at least 50% of the total consideration. Rev. Proc. 77-37, 1972-2 C.B. 568.

Although the Supreme Court had never “suggested or even hinted that the proprietary interest held necessary had any implication for anything beyond a requirement as to the nature or composition of the consideration paid,” Wolfman, supra note 28, at 841, such a requirement has developed over the years. For example, if in a statutory merger the acquiring corporation issues solely voting stock to the sole shareholder of the acquired company, who, under a binding commitment to do so, immediately sells that stock for cash to an outsider, both the Service and the courts have concluded that the continuity of interest requirement is not met and the transaction does not qualify as a corporate reorganization. McDonald’s Restaurants v. Commissioner, 688 F.2d 320 (7th Cir. 1982), rev’d, 76 T.C. 972 (1981); Heintz v. Commissioner, 25 T.C. 132 (1955).

In the only two cases to have decided the issue, the courts assumed that the continuity of interest requirement would not be met if the step-transaction doctrine could be applied to link the post-reorganization sale by the shareholders of the acquired corporation with the initial stock issuance by the acquiring corporation. McDonald’s Restaurants, 688 F.2d at 525-26; Heintz, 25 T.C. at 141-42. In McDonald’s Restaurants, the Tax Court and the Seventh Circuit differed on which test for applying the step-transaction doctrine should be used, and on how the test chosen should be applied to the circumstances of the case. See McDonald’s Restaurants, 688 F.2d at 524-25. Yet, while disagreeing on those matters and reaching different results, in this they both agreed: that to the extent the step-transaction doctrine could be applied to the facts, the transaction would not qualify as a reorganization under section 368(a)(1)(A). Compare 688 F.2d at 523 with 76 T.C. at 995.

In reaching the conclusion that the continuity of interest requirement prevented qualification of the transaction as a reorganization, the courts are making the same mistake they have been consistently making in the P-C transaction. They are forgetting that the application of the step-transaction doctrine, by itself, does not produce any tax consequences, but rather simply supplies the facts to which the statute is applied. A number of
B. Three Forms, One Substance

When a court concludes that P's integrated post-formation stock sale of more than 20 percent of Newco's stock to C disqualifies the transaction from section 351, it is necessarily deciding first that C is not a transferor of property who may be counted as part of the control group,29 and second that P, the only transferor, is not himself in control of the corporation "immediately after the exchange". In reexamining the correctness of these conclusions, it is important to note that the post-formation stock sale is but one form by which the parties can accomplish their desired end results (i.e., that P and C end up owning all of the outstanding stock of Newco; that P ends up with C's cash; and that Newco ends up as the owner of P's property). The identical end results can be accomplished in two formally different but economically identical ways, referred to in this article as the "Pre-Formation Sale of Property" route and the "Boot Transaction" route.

To illustrate the three economically identical, but formally different paths that a P-C transaction might take, the following hypothetical facts will be used. Assume that individual P owns appreciated land worth $100,000, while individual C has $50,000 cash to invest. It is decided that a corporation ("Newco") will be formed to own the land, with P and C becoming equal shareholders of Newco, and P ending up with C's $50,000 cash contribution. These goals can be accomplished by P and C in the following three formal ways:

First, the goals can be reached by following the formal path that has already been described and is hereafter referred to as the "Post-Formation Sale of Stock" route. In this route, P formally contributes the land to Newco in exchange for all of Newco's stock, and then (under a binding commitment to do so) sells a 50 percent interest in the Newco stock to C for $50,000.

Second, P might first sell an undivided one-half interest in the land to C for $50,000, with P and C then, under a binding commitment to do so, each contributing his undivided one-half interest in the land to Newco in exchange for 50 percent of the stock (the "Pre-Formation Sale of Property" route); and

Third, C might pay $50,000 cash directly to Newco to purchase 50 percent of Newco's stock, while simultaneously P would contribute his land to Newco in exchange for the other 50 percent of the stock plus

commentators have persuasively argued that post- or pre-reorganization sales of stock, even those made under a binding commitment, should have no relevance to the continuity of interest requirement. McGaffey and Hunt, supra note 28, at 683; Wolfman, supra note 28, at 841. Professor Wolfman suggests that the transmutation of the concern about proprietary interest into one about the identity of the proprietors is a distortion of enormous magnitude. . . . [T]he mandate to look to shareholder identity had no legislative or judicial imprimatur. Indeed, it seems . . . to be quite senseless and contrary to the evaluation of judicial decisions.

Wolfman, supra note 28, at 841.

29. See supra text accompanying notes 17-21.
$50,000 cash, i.e., the $50,000 cash just contributed by C. (the "Boot Transaction" route).

No one of these three formal routes more accurately describes the substance of what is happening to P, C and Newco than do either of the others. It is not a situation, to paraphrase the Supreme Court's language in *Minnesota Tea Co. v. Helvering*, 30 where one form can be considered to be a straighter path to the end result than the others. Each route, it might be said, contains its own detour. There simply is no straight path.

In the Post-Formation Sale of Stock route, for example, the detour is found in the two-step movement of stock from Newco to P, and then from P to C. The straight path for the stock would be directly from the issuing corporation, Newco, to P and C, but that path is not followed. On the other hand, there is, in this route, a direct movement of both the property and the cash. The $50,000 of cash is transferred directly from C, the original owner, to P, the ultimate possessor. Likewise, the land moves directly from P, the original owner, to Newco, the ultimate owner.

The deviation in the Pre-Formation Sale of Property route involves the property. Initially, the land is owned entirely by P, and, in the end, it is owned entirely by Newco. Yet, in between, a one-half interest has moved from P to C and then on to Newco. In this route, however, the path is straight with regards to the movement of stock and cash. The stock goes directly from the issuing corporation, Newco, to P and C, the ultimate stockholders. Likewise, the $50,000 cash moves directly from C, who originally owned it, to P who ends up with it.

Finally, in the Boot Transaction route, both the flow of stock and the flow of property are direct. The stock moves from Newco to the ultimate owners P and C, and the land moves from the original owner, P, to the ultimate owner, Newco. The flow of money, however, moves

---

31. The specific quote from *Minnesota Tea Co. v. Helvering* is as follows: "A given result at the end of a straight path is not made a different result because reached by following a devious path." *Id.* at 613. Professor Bittker describes this *Minnesota Tea* formulation as the classic statement of what may be called the "unnecessary step" variation of the step-transaction doctrine. B. Bittker, supra note 1, § 4.3.3, at 451. Courts use this formulation when they want to disregard an unnecessary step, and tax the transaction as if that step had not taken place. *Id.* For example, a taxpayer, in order to recognize gain on a transfer of property to a controlled corporation, might first purchase all of a corporation's stock for cash, and then, as part of an integrated transaction, "sell" appreciated property to the corporation for the same amount of cash just contributed. See, e.g., Labrot v. Burnet, 57 F.2d 413 (D.C. Cir. 1932). On these facts, the taxpayer's transfer and receipt of cash are unnecessary and devious steps and should be ignored. The transaction should be taxed as if the straight path had been followed, i.e., as a qualifying section 351 in-kind transfer of property in exchange for stock. See *id.* See generally Bittker & Eustice, supra note 17, § 3.15, at 3-62. The exchange of cash is a mere device intended to obscure the true character of the transaction. See Gregory v. Helvering, 293 U.S. 465, 469 (1935). But this formulation of the step-transaction doctrine seems entirely inapplicable to the P-C hypothetical, where no one of the three formal paths can be said to be straighter than any of the others. See infra text following note 31.
along a circuitous path. That circuitous path takes the money from C to Newco before it is transferred by Newco to P.

If form were allowed to govern the tax consequences, then a P-C transaction accomplished via either the Boot Transaction route or the Pre-Formation Sale of Property route would clearly qualify under section 351. In both routes, P and C are formally transferring property to Newco in exchange for stock, and, therefore, the stock received by both would be counted toward meeting the 80 percent control requirement of section 351. Together, P and C, both transferors of property, would have 100 percent control of Newco. In the Pre-Formation Sale of Property route, P and C are formally exchanging their undivided interests in land for the stock of Newco, while in the Boot Transaction route, P is transferring land to the corporation, while C is paying cash, which is considered property for section 351 purposes, for his stock.

Where the Post-Formation Sale of Stock route is formally followed, however, the literal words of section 351 do not give as clear an answer to the qualification question. As the sole formal transferor of property to Newco, P must himself have control of the corporation “immediately after the exchange” if section 351 is to apply. The problem, of course, is the ambiguity of the statutory term “immediately after the exchange”. Should that phrase be read to refer only to a particular point in time, so that if the transferors of property control the corporation even momentarily, that is sufficient for section 351 purposes? Or, on the other hand, was the phrase intended to encompass a period that includes any integrated post-formation disposition of the stock?

C. Current Law

1. Post-Formation Sales of Stock

   a. Generally

   In fact, despite the inherent ambiguity of the “immediately after the exchange” requirement, with one historic exception, courts have concluded or simply assumed that the statute contemplated continuing control, and that a P-C transaction carried out by the Post-Formation Sale of Stock route would, therefore, not qualify under section 351.33

   The one exception was the First Circuit Court of Appeals’ 1940 decision in Portland Oil Company v. Commissioner.34 In Portland Oil, a post-formation sale of stock case, the court found nothing in the legislative history or in rational tax policy to lead it to conclude that Congress intended that a property transferor had to obtain more than momentary control of a corporation in order to meet the “immediately after the exchange” requirement.35 If the transferors of property were in control of a corporation immediately after their initial exchange of property for

---

33. See cases cited supra note 4. The historic exception is Portland Oil Company v. Commissioner, 109 F.2d 479 (1st Cir. 1940).
34. 109 F.2d 479 (1st Cir. 1940).
35. Id. at 490.
stock, the court concluded that "the statutory reason for non-recognition of gain or loss in that exchange is fully satisfied, for there has been a mere change in the form of ownership without a relinquishment of control." Other courts, however, both before and after the Portland Oil Company case, have not agreed with the First Circuit's interpretation of the "immediately after the exchange" language of section 351, and the contrary rule that momentary control is not enough now seems well settled.

b. Post-Formation Stock Sales Between Transferors: Revenue Ruling 79-194

Despite these cases, however, the Service has ruled in Revenue Ruling 79-194 that a binding post-formation sale of more than 20 percent of a new corporation's outstanding stock to a third person will not disqualify a transaction from section 351 treatment so long as the third person purchaser had also directly transferred other property (including cash) to the new corporation in exchange for its stock.

In Situation 1 of Revenue Ruling 79-194, P (Corporation Z in the ruling) and C (a group of investors in the ruling) transferred property to Newco in exchange for all of Newco's stock. Eighty percent of the stock was issued to P and the rest to C. Pursuant to a binding agreement between them, P then immediately sold enough stock to C to bring P's ownership interest down to 49 percent. The Service concluded that P's post-acquisition sale of stock to C did not disqualify the initial transaction from section 351 treatment, since both P and C had, on the initial incorporation transaction, transferred property to the corporation. This meant that all the stock owned by P and C, both considered to be transferors of property, would be counted in determining control "immediately after the exchange." The fact that P sold more than 20 percent of the corporation's outstanding stock to C was not, therefore, relevant to the control determination. Thus, P recognized gain only on the stock he sold to C, and C recognized no gain on the property he initially transferred to the corporation.

36. Id.
37. See, e.g., cases cited supra note 4.
38. In Culligan Water Conditioning, Inc. v. United States, 567 F.2d 867 (9th Cir. 1978), the Ninth Circuit explicitly recognized that the circuit courts have failed to follow the Portland Oil rationale:

Despite the fact that a relatively early case, Portland Oil Co. v. Commissioner . . . , stated that momentary control, followed by immediate loss pursuant to a preconditioned plan or agreement, would satisfy § 351, it is now well settled that momentary control is not enough if a plan to part with control existed at the time of the incorporation.

40. Id. at 146.
41. See, however, Part II of this Article which concludes that P, in a transaction like the one described in Rev. Rul. 79-194, should have been treated as receiving the cash as boot from the corporation, and not on a sale to C. This recasting of the transaction as a Boot Transaction has implications for the amount and kind of gain to be recognized by P, as well as the basis to be taken by Newco in the property received.
Not only, however, did the results in Revenue Ruling 79-194 turn on whether C had or had not acquired stock directly from Newco as well as from C, but also on just how much stock C had, in fact, acquired from Newco. Having determined that C's direct exchange with Newco of property for stock would require that all of C's stock be counted in determining control for section 351 purposes, the Service was forced to face an additional issue: what would happen if the amount of stock acquired by C directly from the corporation was de minimis compared with the amount of stock he acquired from P. Using a provision of the Treasury Regulations applicable in analogous circumstances,42 the Service ruled in Situation 2 of Revenue Ruling 79-194 that where C's direct purchase of stock from Newco was de minimus, C would not be treated as a transferor of property, and the transaction would not qualify under section 351 (since P, once again considered the sole transferor, would not have retained control "immediately after the exchange").43

The seeming absurdity of this de minimis, non-de minimis distinction of Revenue Ruling 79-194 was pointed out by the authors of a recent article, who noted that the Service's focus in Revenue Ruling 79-194 on "the de minimis issuance of stock to the purchasers of shares seems misplaced."44 The authors concluded that

a party who acquires a substantial stock interest in the corporation should be regarded as a transferor regardless of the portion of his holdings which he acquired directly or through another participating party. In either case, the buyer has acquired a substantial ongoing interest in the corporation and his participation in the control group has real substance.45

In the end, however, the authors of the aforementioned article implicitly assume that persons must make at least a de minimis direct contribution to the corporation to qualify them as transferors.46 This is, indeed, an odd proposition. If, as the authors conclude, a purchaser's de minimis contribution to a corporation should qualify him as a transferor because of his substantial on-going interest obtained directly from other participants, then surely his acquisition of stock from other participants even without any direct contribution to the corporation should have the same effect. Otherwise, the qualification of a P-C transaction under section 351 would turn on the economic irrelevancy of whether or not C, in addition to purchasing stock from P, also formally purchased some stock, no matter how little, directly from Newco.

42. Reg. § 1.351-1(a)(1)(ii).
43. 1979-1 C.B. at 146.
44. Tillinghast & Pauly, supra note 5, at 266 n.59.
45. Id.
46. Id. at 252-53.
The holding of Revenue Ruling 79-194 that post-formation sales of stock between transferors cannot lead to disqualification of a transaction under section 351 raises sticky problems where there is a combined primary and secondary best efforts public offering of stock. In a “best efforts” public offering of stock, an underwriter agrees to “find buyers [for the stock] if it can but does not promise to buy [the] stock.” The Service ruled in Revenue Ruling 78-294 that, in a “primary” best efforts public offering (i.e., one in which the underwriters are selling newly issued stock of the corporation to the public), the eventual public purchasers are generally considered transferors of property for section 351 purposes. Thus, if, for example, P exchanges appreciated property for 50 percent of Newco stock, while at the same time, the public investors purchase the other 50 percent of the stock (with the underwriter, in effect, acting as Newco’s sales agent), section 351 will apply to the transaction. P and the public investors will all be considered transferors of property, and together they will be in control of the corporation “immediately after the exchange.” Therefore, neither P nor the public investors will recognize gain or loss in the transaction.

Under the Service’s analysis, however, there are potential problems of qualification under section 351 where there is a combined primary and secondary best efforts public offering of stock, i.e., one in which an underwriter “agrees to market . . . not only directly issued shares but also shares issued to one or more of the persons participating in the section 351 transaction . . . .” For example, assume P transfers appreciated property to Newco in exchange for 750 shares. At the same time, an underwriter, on a best efforts basis, agrees to, and succeeds in selling to the public 250 newly issued shares of Newco and 250 of P’s 750 shares.

47. 1979-1 C.B. 145.
48. Tillinghast & Pauly, supra note 3, at 260. In a “firm commitment” underwriting, on the other hand, “the underwriter agrees to purchase the issue and bears sole responsibility for resale.” Id.
49. 1978-2 C.B. 141.
50. Since the business involved in the ruling needed additional capital, the Service concluded that “the public stock offering was integral to A’s plan to incorporate the going business”; and, therefore, it was appropriate “to treat the incorporation and subsequent public offering as elements in a single transaction that may be tested for qualification under section 351 of the Code.” 1978-2 C.B. at 144. Since “the sale of stock to the public [in the best efforts underwriting] took place in a short period of time with no change in the terms of the offering,” the service concluded that “the public investors . . . should be treated, along with A, as transferors for purposes of section 351 of the Code.” Id. at 142. Under the same circumstances, in a “firm commitment” underwriting, see supra note 48, the Service concluded that the underwriter, not the public investors, was the transferor of property. Id. The analysis, although not the result reached in Rev. Rul. 78-294, is criticized in Tillinghast & Pauly, supra note 3, at 261-269.
51. See supra note 50 and text accompanying notes 17-22.
52. See Tillinghast & Pauly, supra note 3, at 266-67.
53. Id. at 266.
Under existing law, the rather odd possibility exists that the qualification of the entire transaction under section 351 depends on whether each public shareholder is found to have purchased his stock from both Newco and P (in which case the public shareholders will, under Revenue Ruling 79-194,54 be considered transferors and section 351 will apply); or some public shareholders are deemed to have purchased P's stock and others Newco's stock (in which case the purchasers of P's 250 shares would not be considered transferors and section 351 would be inapplicable to the transaction).

The problem can, of course, be resolved by adopting a "pro rata rule",55 i.e., one that assumes that the public shareholders purchased a pro rata share of both P's and Newco's stock. Nevertheless, the need to adopt such an arbitrary "pro rata rule" to reach a sensible result in this situation points toward the basic irrationality of ever interpreting the statute in a manner that would disqualify a transaction from section 351 treatment because of post-formation stock sales.56

2. Pre-Formation Sales of Property and Boot Transactions

a. Generally

While there are numerous cases dealing with the tax consequences of a P-C transaction carried out using the Post-Formation Sale of Stock

54. 1979-1 C.B. 145.
55. See Tillinghast & Paully, supra note 3, at 267.
56. A similar problem arises where C, as part of an integrated incorporation transaction, becomes both a creditor and stockholder of Newco. For example, assume C formally advances $100,000 to Newco in exchange for Newco's $50,000 promissory note and 50 percent of its stock (worth $50,000). If P concurrently transfers his $100,000 worth of land to Newco in exchange for the other half of the Newco stock plus $50,000 cash boot, the qualification of the transaction under section 351 would seem to turn, under existing law, on whether the cash received by P came from the money that was loaned to Newco by C or from the money that C paid to Newco for the stock. If P received the loaned funds, then the cash remaining in the corporation would represent the amount paid by C for his stock, making C (as well as P) a transferor of property, and qualifying the transaction under section 351. If, however, P could be said to have received the $50,000 paid by C for the stock, with C's $50,000 of loaned funds remaining in Newco, then C would presumably not be considered a transferor of property and section 351 would not apply. The fact that a nonshareholder transfers cash to a corporation in exchange for a debt instrument does not make that person a transferor for purposes of the control requirement of section 351(a). Rev. Rul. 79-70, 1979-1 C.B. 144, 145. See Rev. Rul. 73-472, 1973-2 C.B. 114; Rev. Rul. 73-473, 1973-2 C.B. 115.

While it would obviously be impossible to determine which ones of C's fungible dollars remained in the corporation, and which were paid out to P, it seems likely that a court, following the lead of other loss of control cases, would find loss of control and no section 351 qualification so long as a cash amount ended up in P's hands which was at least as great as the amount C contributed for his stock (i.e., $50,000 in the above example). In fact, in Rev. Rul. 79-70, 1979-1 C.B. 144, where C (Y in the ruling) purchased securities directly from Newco, and also 40 percent of Newco's outstanding stock in a post-formation purchase from P (Corporation X in the ruling), the Service ruled that section 351 did not apply. Neither C's purchase of securities from Newco nor his purchase of stock from P made him a transferor of property. The I.R.S. concluded that P, the only transferor, was not in control of Newco immediately after the exchange. Id. at 145.

Again the only rational solution in a situation like that of Revenue Ruling 79-70 would be to allow the transaction to qualify under section 351. The words of the statute would literally permit this result, and the policy objectives would demand it.
route, there is scant judicial authority available when the transaction takes the form of a Pre-Formation Sale of Property or a Boot Transaction. The little authority that does exist, however, indicates that where either of the latter routes are formally followed, the transaction will, in effect, first be recast as a Post-Formation Sale of Stock, and then disqualified from section 351 treatment because P, the only transferor of property in the recast transaction, would not himself be in control of the corporation "immediately after the exchange." 58

Among the few decisions dealing with the alternative P-C routes is Edlund Co. v. United States, 69 a Pre-Formation Sale of Property case decided by the Second Circuit in 1961. In that case, several months before a partnership was incorporated one of the two 50 percent partners (Oscar Edlund) sold his partnership interest to an unrelated third party, Willett Foster. 60 At the time of Foster's purchase of Oscar Edlund's interest there was an understanding, although not a binding commitment, between Foster and the continuing partner, Walter Edlund, that the partnership would be incorporated. This in fact occurred five months later. 61 In Edlund Co. the plaintiff corporation, desiring a stepped up basis in the partnership's assets, 62 argued that section 351 did not apply to the incorporation of the partnership because the real transferors of property, Oscar Edlund and Walter Edlund, were not in control of the corporation immediately after the exchange:

The transfer of the property to the plaintiff corporation was not, realistically considered, a transfer from Walter Edlund [the continuing partner] and Foster [the new partner], but was a transfer from Oscar Edlund [the former partner] and Walter Edlund, because its ultimate destination in the corporation was contemplated from the time that Oscar Edlund transferred his interest to Foster. 63

The Court acknowledged that if the new partner, Foster, had been under a binding obligation to form a corporation with the continuing partner, Walter Edlund, at the time Foster purchased the partnership interest from Oscar Edlund, the transaction would not have qualified under section 351 because in such case, "Oscar Edlund, though in reality the transferor of one-half of the property to the corporation, [would have received] none of the stock of the corporation." 64 The Court noted that the step-transaction doctrine was equally applicable in determining who the transferors were (in a P-C transaction using the Pre-Formation Sale of Property route), as it was in determining whether

---

57. See, e.g., supra cases cited in note 4.
58. See, e.g., Edlund Co. v. United States, 288 F.2d 17 (2d Cir. 1961); Winterburn v. Commissioner, 27 T.C.M. (CCH) 910 (1968). Cf. West Texas Refining and Development Co. v. Commissioner, 68 F.2d 77 (10th Cir. 1933).
59. 288 F.2d 17 (2d Cir. 1961).
60. Id. at 18.
61. Id.
62. Id. at 17.
63. Id. at 18.
64. Id.
there had been a loss of control "immediately after the exchange" (where the Post-Formation Sale of stock route was formally followed). 65

In fact, however, the Court held that section 351 did apply to the incorporation transaction because there was no proof of a binding agreement between Walter Edlund (the continuing partner) and Foster (the new partner) requiring a corporation to be formed. 66 The Court said:

There is no evidence that when Oscar Edlund [the old partner], on January 1, 1953, transferred his partnership interest to Foster [the new partner], Foster and Walter Edlund [the continuing partner] obligated themselves to form a corporation and transfer the partnership assets to it. They continued for nearly five months to operate the business as a partnership, and so far as appears, could have continued to do so indefinitely. They were the owners of the property in question when they transferred it to the plaintiff corporation later in May. The requirements of section [351] were satisfied. 67

Just as the Second Circuit in Edlund Co. implicitly recast a P-C transaction formally following the Pre-Formation Sale of Property route as a Post-Formation Sale of Stock, so also did the Tax Court in its 1968 decision in Winterburn v. Commissioner 68 do for a P-C transaction formally accomplished as a Boot Transaction. The simplified facts of Winterburn are these: P owned some encumbered real estate which it intended to sell to Newco for a combination of cash, Newco's assumption of the liability encumbering the property, and Newco's purchase money note. 69 The cash to pay P was to come from Newco's sale of its stock to a variety of investors ("C"). 70 As it turned out, however, there were not sufficient investors to provide the necessary cash, and P, therefore, agreed to take Newco stock as part payment for the transferred real estate. 71 The stock received by P in the transaction constituted less than 80 percent of Newco's outstanding stock. In form, the final transaction had thus followed the Boot Transaction route: ignoring the liabilities, P had transferred real estate in exchange for Newco stock (less than 80 percent) plus cash boot, and C had purchased stock of Newco for cash, all of which cash wound up in the hands of P.

P argued that section 351 applied to the transaction, but the Tax Court disagreed stating,

It seems clear that section 351 could not have any governing effect here in view of the fact that . . . [P] emerged with considerably less than 80 percent of the stock in [Newco] and thus did not have the necessary "control" of [Newco] within the meaning of section 368(c) which is specifically made applicable by

65. Id. at 19.
66. Id. at 18-19.
67. Id.
68. 27 T.C.M. (CCH) 910 (1968).
69. Id. at 913.
70. Id.
71. Id. at 914.
P responded by stating that he need not alone have control of Newco, since the cash investors (C) should also be treated as transferors of property, "and that all such transferors taken together had the necessary control."78 P relied on Holstein v. Commissioner,74 a case which stands for the proposition that cash is property for section 351 purposes. But the Tax Court said that Holstein was inapplicable since, unlike Winterburn, Holstein was a case where the cash contributions had not been paid out to the other shareholders. Query, whether the result would have been otherwise had more than a de minimis part of the investors' cash payments remained in Newco.75

While the Court in Winterburn made no reference to the fact that the transaction before it could have been equally carried out by P's transferring the property to Newco solely for stock and then transferring more than 20 percent of such stock to the investors ("C"), its refusal to treat the investors ("C") as transferors is entirely consistent with recasting the transaction from a Boot Transaction to a Post-Formation Sale of Stock.

b. Co-Op Conversions

The determination of whether or not a Winterburn-type transaction qualifies for section 351 has taken on considerable importance in recent years in the area of co-op conversions.76 Generally, where a promoter transfers rental property to a co-op, the promoter, like the taxpayer in Winterburn, receives back from the corporation a combination of cash, stock, and notes.77 As in Winterburn, the cash comes from money simultaneously paid into the co-op by unit owners to acquire shares.78 Also,

72. Id. at 914. The court's conclusion on the qualification issue was actually dictum since, even if section 351 applied, the taxpayer would have recognized all of his realized gain because the cash boot received by him exceeded such realized gain. Id. at 915. See § 351(b).
73. Id. at 914 n.8.
74. 23 T.C. 923 (1955).
75. See supra discussion of Rev. Rul. 79-194, 1979-1 C.B. 145 at text accompanying notes 39-46. In Lanover Corp. v. Commissioner, 17 T.C. 1178 (1952), the facts as simplified were as follows: P transferred patents to Newco at the same time C transferred to Newco $20,000 cash. In exchange C received 60 percent of Newco's stock, while P received the other 40 percent plus $18,000 in cash. The Tax Court held that the predecessor of section 351 did not apply to the transaction, since P, the property transferor, acquired only a 40 percent interest in the corporation. Id. at 1184. The case may simply be a failure of the court to recognize, as it did three years later in Holstein v. Commissioner, 25 T.C. 923 (1955), that cash is property for purposes of section 351, and that a transferor of cash can be counted as part of the control group. Nevertheless, given the more recent developments in this area, see Rev. Rul. 79-194, 1979-1 C.B. 145, discussed supra at text accompanying notes 39-46, the case is intriguing. It might actually be a correct result under existing law based on the conclusion that C's $2,000 contribution which remained in Newco was de minimis. See supra text at notes 42-46.
77. See Kaster, supra note 76, at 13-12.
78. See id.
as in *Winterburn*, the reason the co-op promoter generally receives shares is that in most co-op conversions not all of the units are sold, and the promoter must accept ownership of the excess.\textsuperscript{79}

Combining the reasoning of *Winterburn*\textsuperscript{80} with that of Revenue Rulings 79-194\textsuperscript{81} and 78-294,\textsuperscript{82} it would seem that the qualification of such a co-op conversion (i.e., one in which the promoter receives shares) under section 351 would depend on whether a part of the cash contributed for shares by the unit owners (more than a *de minimis* part) remained with the corporation, thereby making the unit owner as well as the promoter transferors of property for section 351 purposes. Under the approach taken in this Article, however, the transaction would qualify for section 351 treatment whether or not any of the unit owners' cash remained in the co-op.\textsuperscript{83}

3. **Summary**

It is clear under existing law that a P-C transaction formally carried out as a Post-Formation sale of more than 20 percent of Newco's stock from P to C will be disqualified from section 351 treatment. Nevertheless, as was previously noted, disqualification will not take place if the post-formation stock sale by P is to a person ("C") who has also made more than a *de minimis* direct contribution of cash or other property to Newco in exchange for stock.\textsuperscript{84} In such case, both P and C are technically transferors of property who may together be counted for control purposes. Any tax policy justification for reaching different results depending on whether or not C directly transfers property to Newco for stock is difficult to uncover.

Moreover, the limited authority available indicates that section 351 will not apply to P-C transactions taking the form of Pre-Formation Sales of Property or Boot Transactions (assuming, of course, the requisite binding obligations).\textsuperscript{85} Thus, although all three forms are economic equivalents, the courts will apparently recast the two forms which literally and unambiguously meet the requirements of section 351 (i.e., the Pre-Formation Sale of Property and the Boot Transaction) into the one form in which it is possible for them, because of the ambiguous nature of the statutory language,\textsuperscript{86} to find disqualification. Since neither the literal words of the statute nor the step-transaction doctrine\textsuperscript{87} requires these results, they can be justified only if it can be shown that qualification of a P-C transaction under section 351 (regardless of the particular form followed) would be inconsistent with the policy goals expressed or

\textsuperscript{79} See id.
\textsuperscript{80} See supra text at notes 68-75.
\textsuperscript{81} See supra text at notes 39-46.
\textsuperscript{82} See supra text at notes 49-51.
\textsuperscript{83} The importance of the section 351 question to a co-op promoter is discussed in Kaster, supra note 76, at 13-12 to 13-15, and Jacobs & Kurib, supra note 76, at 56-49.
\textsuperscript{84} See supra text at notes 39-46.
\textsuperscript{85} See supra text at notes 58-75.
\textsuperscript{86} See supra text at notes 33-35.
\textsuperscript{87} See supra text at notes 29-32.
implied by Congress in enacting section 351. The section that follows demonstrates that just the opposite is the case: that the policy behind section 351 is advanced only if all P-C transactions are treated as qualifying for non-recognition treatment.

D. The Policy Behind Section 351

1. Generally

The predecessor of section 351 was enacted in 1921 to achieve two interrelated Congressional purposes. The first was to insure that gain would not be recognized nor a loss deduction allowed "where in a popular and economic sense there has been a mere change in the form of ownership and the taxpayer has not really 'cashed in' on the theoretical gain, or closed out a losing venture."88 A second justification for the enactment of the predecessor of section 351, albeit one related to the mere change in form rationale, was that such section was necessary to facilitate "business readjustments."89 Both the House and the Senate Reports on the 1921 Revenue Act refer to this latter reason;90 moreover, the legislative history of that Act indicates that Congress enacted the predecessor of section 351 primarily to remove any tax disincentive to the incorporation of both ongoing and new businesses.91

2. Mere Change in Form

The mere change in form rationale seems clearest where a single individual is incorporating his sole proprietorship and taking back all of the new corporation's stock. Prior to the incorporation, the individual is the sole owner of an unincorporated business consisting of a number of assets, and afterwards he is the sole owner of the stock of a corporation owning those same assets. Similarly, where a partnership incorporates, the change of form rationale seems clear. The persons who previously owned partnership interests in an unincorporated business own, after the incorporation, equivalent stock interests in the same business.

Where, however, a new corporation is formed by a number of previously unassociated individuals, the mere change in form rationale seems more problematic. For example, previously unrelated individuals A, B, and C may join together to form a new corporation, with A and B transferring equal value appreciated property and C transferring cash. While

88. Portland Oil Co. v. Commissioner, 109 F.2d 479, 488 (1st Cir. 1940).
89. S. REP. No. 275, 67th Cong., 1st Sess. 11-12 (1921); H.R. REP. No. 350, 67th Cong., 1st Sess. 10 (1921).
91. Id. at 830-31.

The Legislative history of the Revenue Acts of 1918 and 1921 show that the predominant congressional concern in enacting the nonrecognition provisions for both reorganizations and certain transfers of property to corporations was the need to stimulate the economy after World War I by both removing any tax disincentives and providing tax incentives for a variety of corporate activities, including corporate combinations and the incorporation of ongoing or new businesses.
it might be argued that the transaction constitutes more than a mere change in form for A and B so that their gain should be recognized, it has long been clear that section 351 would embrace this type of transaction. The Fifth Circuit Court of Appeals justified the nonrecognition result on the ground that,

instead of the transaction having the effect of terminating or extinguishing the beneficial interest of the transferors in the transferred property, after the consummation of the transaction the transferors continue to be beneficially interested in the transferred property and have dominion over it by virtue of their control of the new corporate owner of it.

It may be, however, that it is the "business readjustment" justification more than the mere change of form rationale that is really at work in cases involving incorporations by previously unrelated individuals.

It must also be noted that the mere change in form rationale is modified in part by section 351's boot provision. If the other requirements of section 351 are met, a transaction will not be disqualified simply because one or more of the transferors of property receive cash or other property in addition to stock and securities. Rather, section 351(b) provides that the recipient of such "boot" will simply recognize his realized gain to the extent of the "boot" received.

In the cases involving post-formation sales by P of more than 20 percent of Newco's stock to C, courts have attempted to justify their disqualification of the transaction under section 351 by reference to this mere change in form rationale. For example, in *Intermountain Lumber Co. v. Commissioner*, the Tax Court said:

We note . . . that the basic premise of section 351 is to avoid recognition of gain or loss resulting from transfer of property to a corporation which works a change of form only. Accordingly, if the transferor sells his stock as part of the same transaction, the transaction is taxable [i.e., the entire transaction is taxable, not just P's sale of stock to C] because there has been more than a mere change in form.

The quoted statement from *Intermountain* is, however, no justification at all from a policy viewpoint. The Court never states just what it is about P's sale of more than 20 percent of his stock to C that makes the transaction more than "a mere change of form", thereby justifying taxing P on all of his realized gain up front, rather than only on that gain realized on the sale of stock to C. It cannot simply be that P himself ends up with less than 80 percent of Newco's stock. As previously

---

92. *See Bittker & Eustice, supra note 17, § 3.01, at 3-5.*
93. *American Compress and Warehouse Co. v. Bender, 70 F.2d 655, 667 (5th Cir. 1934).*
94. *I.R.C. § 351(b).*
95. *See, e.g., cases cited supra note 4.*
96. 65 T.C. 1025 (1976).
97. *Id. at 1033-34.* In *Intermountain*, it was the transferee corporation arguing that the initial transfer was taxable under § 351, so that it could take a higher basis in the transferred assets for depreciation purposes.
noted, where there are other persons transferring property to Newco in
the same transaction, P might end up with a minute part of Newco’s
stock, and yet, recognize no gain on the transaction. 98 Moreover, the
mere fact that P received some cash in the exchange cannot, by itself,
justify forcing P to recognize all of his gain. Congress, as we have seen,
assumed in its boot provision that a transferor of property might receive
some cash without disqualifying a transaction from section 351
treatment. 99

Finally, the fact that the cash P received in the transaction (representing
more than 20 percent of his total consideration for the property
transferred) originated in the hands of C, rather than as “old and cold’
cash sitting in the corporation, cannot alone justify the disqualification
of the transaction as being more than a mere change in form. As previ-
ously discussed, the Service has specifically ruled in Revenue Ruling 79-
194 100 that a post-formation sale of more than 20 percent of P’s stock to
C would not disqualify a transaction from section 351, so long as C had
also made a more than de minimis direct contribution of cash or property
to the corporation in exchange for stock. It seems impossible to argue
that P has experienced a greater change in the form of his investment
when he sells 21 percent of his stock to a person who has also made a
transfer directly to Newco, than he has when he sells, for example, 50
percent of his stock to a person who has also made a direct contribution
to the corporation for stock. Yet, in the former case, P would recognize
100 percent of his realized gain, while in the latter, he would recognize
only 50 percent.

Justifying the disqualification of a P-C transaction as more than a
“mere change of form” is, therefore, a red herring. It is no more or less
a change of form for the transferors than are many other transactions
that clearly qualify under section 351. If, then, such disqualification can
be justified at all, it can only be that the end results of P-C transactions
are somehow not the type of “business readjustments” Congress wanted
to facilitate. The following section will demonstrate, however, that such
is simply not the case. In fact, the current disqualification of P-C trans-
actions seems to run directly contrary to Congress’ purpose in enacting
the predecessor of section 351: to eliminate all disincentives to the in-
corporation of new and existing businesses.

3. The Facilitation of Business Readjustments

As earlier stated, the announced purpose of the Congress in enact-
ing the predecessor of section 351 in 1921 was to “facilitate business
readjustments.” 101 Congress wanted to remove any disincentives to the
incorporation of existing or new businesses. 102 Not only would al-

98. See supra text accompanying notes 92-93.
99. See supra text accompanying note 94.
100. 1979-1 C.B. 145. See supra text at notes 39-46.
101. See supra text at notes 88-91.
102. See id.
allowing the P-C transaction to qualify under section 351 not undermine this purpose, but failure to do so would be clearly antagonistic to this announced Congressional policy. This can be illustrated by a few simple hypotheticals.

Consider, for example, a situation in which P, a sole proprietor, is considering selling a one-half interest in his business to C for $50,000. The parties agree that a corporation will be formed to own the assets previously owned individually by P, with P receiving $50,000 cash from C, and P and C each ending up owning a 50 percent stock interest in the new corporation. If the plan is in fact carried out, P would be required, under existing law, to recognize all of his realized gain on the transfer of his proprietorship assets. Section 351 would not be available to him. This apparently would be true, as we have seen, whether P and C, in forming the corporation, followed the Post-Formation Sale of Stock route, the Pre-Formation Sale of Property route, or the Boot Transaction route.103

If P and C had been willing to form a partnership instead of the corporation, however, P's taxable income from the transaction would have been reduced by one-half. P would then have recognized the realized gain only on the one-half interest in the assets effectively sold to C.104 Surely, the increased gain to P upon forming a corporation would, contrary to the stated legislative intention, be a clear disincentive to the incorporation of P's business. Congress could not have wanted to encourage persons in P and C's position to form a partnership rather than a corporation; yet, that is precisely what disqualifying the P-C transaction from section 351 does.

The problems become more acute where third parties are involved. Assume, for example, that both P and Q own sole proprietorships worth $100,000. P and Q would like to combine their previously unrelated proprietorships into a single corporate entity ("Newco"). P, however, also wants at the time of incorporation to receive $50,000 cash, which Individual C is willing to pay him to obtain a 25 percent stock interest in Newco. If the entire transaction (in which Q ends up owning 50 percent of the Newco stock, while P and C each end up owning 25 percent) is integrated, it will not qualify under section 351. The courts would conclude that only P and Q were transferors of property, and together they owned only 75 percent of the Newco stock immediately after the exchange.105 Both P and Q would, therefore, be required to recognize all

103. See supra text accompanying notes 33-75.
104. There is no control requirement on the formation of a partnership. See I.R.C. § 721(a). On the problem of classifying a partnership formation as a post-formation sale of a partnership interest, a pre-formation sale of property or a boot transaction, see Tax Reform Act of 1984, § 73, amending I.R.C. § 707(a).
105. But see BITTHER & EUSTICE, supra note 17, § 3.10, at 3-32. Professors Bittker and Eustice have conceded the possibility that under certain circumstances even a binding obligation by one of a number of transferors to resell the stock received on incorporation to a third party should not necessarily disqualify a transaction under section 351. Id. But their concession applies only to a situation in which the post-formation sale was not, in their words, "an integral part of the whole transaction." Id. at 3-36. They give this example:
of their realized gain in the transaction, and again a desirable business adjustment might not come about.

The irrationality from a policy perspective of disqualifying the P-C-Q transaction from section 351 treatment seems obvious. P, Q and C appear to be doing precisely what Congress wanted to encourage by enacting section 351. These three persons are joining their assets together in a plan to form a new corporation. The contributions to be made, as well as the stock interests to be received by each, are determined in advance. The plan is then carried out expeditiously, with Q, P, and C becoming owners of all of the corporation's stock; yet, if C ends up with more than 20 percent of the Newco stock, and all of C's cash contribution ends up in the hands of P, section 351 is inapplicable. Surely the result more consistent with the policy of section 351 is to allow the section to apply, but to require P to recognize gain to the extent he received cash.

The lack of rationality of the result in the above hypothetical becomes even more pronounced when one observes that, under Revenue Ruling 79-194, Q himself could have paid P the $50,000 cash for the 25 percent interest in Newco without disqualifying the transaction from section 351 treatment. What possible policy goal is advanced by requiring P and Q to recognize all of their accrued gain on their proprietorship assets simply because the $50,000 cash that wound up in P’s pocket came from third party C, rather than from Q?

4. What is Left of the Immediately After the Exchange Requirement?

To argue that Congress did not intend the phrase “immediately after the exchange” to be used to disqualify a post-formation sale of stock or pre-formation sale of property transaction does not leave the

---

[T]wo equal partners in a going business form a corporation in order to limit their liability; one of them, in need of funds to discharge debts of a personal nature, agrees in advance of the exchange to sell half of his stock to a third person. If the agreement to sell must be taken into account, the two transferors of property will own only 75 percent of the stock “immediately after the exchange” with the result that both must recognize gain or loss on the exchange, even though one of them may not have even known of the other’s commitment to sell part of his stock.

Id. at 3-36. Surely, the author’s conclusion that section 351 should apply to the facts of the example is correct. But they limit their conclusion by casting it in terms of the post-formation sale not being an “integral part of the whole transaction.” In the situation hypothesized, rational tax policy demands that section 351 apply without regard to the determination of whether the post-formation transfer was or was not an “integral part of the whole transaction.”

106. See Reg. § 1.351-1(a)(1). The Regulation section is quoted and discussed infra in the text at note 111.


108. There is nothing in the legislative history to indicate that Congress was thinking of the post-acquisition sale situation when it used the words “immediately after the exchange.” The only reference to the possibility that the “immediately after the exchange” phrase may have something to do with post-acquisition loss of control transactions is in the legislative history accompanying the passage in 1954 of § 351(c). S. Rep. No. 1622, 83rd Cong., 2d Sess. 265 (1954). Section 351(c) provides that, “in determining control, the fact that a corporate transferor distributes stock received in the exchange to its shareholders, shall not be taken into account.” The Senate Report on the 1954 Code states that
phrase without any meaning.

The phrase is necessary in section 351 to make it clear that, as a general rule, chronologically separate transfers cannot be combined in looking at control. Thus, if A transfers property for all 100 shares of Newco’s stock in 1979, and B transfers property to Newco in 1984 for an additional 100 shares of stock, B’s 1984 transfer does not qualify under section 351, since B alone does not have control “immediately after [his] exchange” with Newco. A’s 1979 transfer is “old and cold” and his shares are, therefore, irrelevant with respect to B’s qualification.

The one point in the Treasury Regulations in which the “immediately after the exchange” language is discussed is in section 351-1(a)(1), which provides that certain chronologically separate, though factually related transfers may be viewed together in determining control “immediately after the exchange”:

The phrase “immediately after the exchange” does not necessarily require the simultaneous exchanges by two or more persons, but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure.

There is no hint in the Treasury Regulations that the “immediately after the exchange” language was intended to disqualify transactions involving post-formation stock sales to third parties.

E. Conclusion and Summary

Under existing law, it appears that section 351 will never apply to a transaction in which, as part of a scheme that is capable of being integrated for step-transaction purposes, Newco ends up with P’s property, P ends up with C’s cash, and P and C end up owning all of Newco’s stock in less than an 80/20 ratio. Where the Post-Formation Sale of Stock route is formally followed, the courts conclude that P, as the only transferor of property, is not in control of Newco “immediately after the exchange.” Moreover, if P and C formally use the Pre-Formation Sale of Property route or the Boot Transaction route, the courts will apparently first recast the form of the transaction as a Post-Formation Sale of Stock (so that C is not a transferor of property), and then proceed to disqualify the transaction from section 351 as before.

This part of the article has rejected these long-standing, but poorly justified results, and demonstrated that, regardless of the formal route followed, section 351 should apply to any P-C transaction as a matter

§ 351(c) was added because it was not clear under existing law whether such a distribution would prevent qualification under § 351. Id. at 265. Section 351(c), however, “does not shed any light on the meaning of the phrase “immediately after the exchange” in circumstances to which it is not applicable.” Bittker & Eustice, supra note 17, § 3.10, at 3-38.

110. See id.
111. Id.
112. By treating section 351 as always applicable in the P-C hypothetical, regardless of
of rational tax policy. A court could technically achieve this result in one of three ways:

1. A court could allow the form of the route chosen to determine tax consequences, but decide, as the First Circuit did in *Portland Oil Company v. Commissioner*, that even where the Post-Formation Sale of Stock route was formally used, section 351 should apply. This would require a court to interpret the "immediately after the exchange" language as requiring no more than momentary control by P, and disregarding for control purposes any post-formation stock sales by P, even if made under a binding commitment.

2. All transactions, regardless of the formal route followed, could be recast by a court as if the Pre-Formation Sale of Property route had been used. If that were done, section 351 would always apply to the P-C transaction since both P and C would be transferors of property and together would have 100 percent control "immediately after the exchange".

In the gift cases, P is the only formal contributor of property to the venture, but C, P's donee, ends up with more than 20% of the outstanding stock.

Until recently, it was thought that in the gift cases P could determine whether or not section 351 applied by the formal route followed. See id. If P wanted section 351 to apply, he would follow one of two routes: he would either give an interest in the underlying property to C prior to the incorporation, *Edlund Co. v. United States*, 288 F.2d 17 (2d Cir. 1961), discussed supra at text accompanying notes 59-67; or he would, under no binding obligation to do so, give C a stock interest immediately after the incorporation. See, e.g., *Wilgard Realty Co. v. Commissioner*, 27 F.2d 514 (2d Cir. 1942). If, on the other hand, P wanted to disqualify the transaction from section 351, he would have the corporation directly issue more than 20 percent of the stock to C. See, e.g., *Faha v. Florida Machine and Foundry Co.*, 168 F.2d 957 (5th Cir. 1948); *Mojonnier and Sons, Inc. v. Commissioner*, 12 T.C. 837 (1949).

Recent cases, however, take a more enlightened view that section 351 should apply to the gift-incorporation transaction regardless of the formal route followed. See *D'Angelo Associates, Inc. v. Commissioner*, 70 T.C. 121 (1978); *Stanton v. United States*, 512 F.2d 13 (3d Cir. 1975). In the *D'Angelo Associates, Inc.* case, for example, a dentist upon incorporating his practice, had the new corporation issue more than 20 percent of the outstanding stock to his children. The corporation subsequently claimed a stepped-up basis in the assets, based on its conclusion that section 351 was inapplicable because nontransferrors of property (the children) owned more than 20 percent of the stock immediately after the exchange. 70 T.C. at 132.

The Tax Court ruled, however, that gifts do not prevent the transferors from having control "immediately after the exchange" (and therefore qualifying under section 351) whatever the route followed.

If immediately prior to forming the corporation, five-sixths of the rental properties were given to the children and transferred to the corporation in return for the controlling interest . . . petitioner's basis would be the basis of Dr. . . . D'Angelo. Similarly, if the transfers were made directly to the corporation by Dr. . . . D'Angelo in return for stock and the stock then given to the children, petitioner does not seriously contend section 351 would be inapplicable. That this transaction has been squeezed into the seemingly nonexistent time intervals between these two situations surely cannot produce a different result.

Id. at 133 n.8.

Essentially, the reasoning in *D'Angelo Associates* is that, under the circumstances, regardless of the formal route followed, only one conclusion makes rational tax sense: that section 351 should apply. That is the same conclusion reached in this part where C pays consideration for his stock, with the only difference being that, in the transfer for value cases, there are tax consequences stemming from P's receipt of consideration from C.
3. Finally, all transactions, regardless of the formal route followed could be recast by a court as if the Boot Transaction route had been used, again with no possibility of disqualification under section 351.

In this Part I, where the only issue being discussed was the control issue, it made no difference which of the above three analyses a court used. All would lead to the same result: i.e., section 351's applicability. But in Part II, where the basis and gain and loss consequences to the parties will be examined, the analysis used by a court makes a major difference. In Part II, it is concluded that only by recasting all P-C transactions under the Boot Transaction route will appropriate tax consequences always be reached.

II. INCOME AND BASIS ISSUES: THE CASE FOR THE BOOT TRANSACTION ROUTE

A. INTRODUCTION

This part of the article assumes a P-C transaction to which section 351 applies, and discusses the amount and kind of gain or loss to be recognized by P, the basis to be taken by P in his stock, and the basis to be taken by Newco in the transferred property. The control issue is considered no longer to be at stake because (i) C ends up with 20 percent or less of the outstanding stock; (ii) C ends up with more than 20 percent of the stock but, because part of C's contribution to the venture remains with the corporation, C is considered part of the control group under Revenue Ruling 79-194;113 or finally (iii) C ends up with more than 20 percent of the stock (and P ends up with all the cash contributed to the venture by C), but for the reasons stated in Part I, section 351 is nevertheless considered to apply to the transaction.

Part II, therefore, has relevance even if one were to reject Part I's conclusions on the control issue. In other words, Part II's reasoning would still apply in determining the tax consequences of transactions which, under current law, do not result in loss of control.

For no clearly articulated reason, existing law would presumably tax a P-C transaction in which control was not at stake by applying the Post-Formation Sale of Stock route, regardless of the formal route actually selected. In other words, all gain and loss and basis consequences to P, C, and Newco would be determined as if P first transferred his property to the corporation in exchange for all of its stock, and then, in an unrelated transaction, sold some of that stock to C.114 The inappropriate-

114. That this is the result under current law where the Post-Formation Sale of Stock route is actually used is quite clear. See e.g., Rev. Rul. 79-194, 1979-1 C.B. 145, discussed supra in text accompanying notes 39-46. In situation I of that ruling, it will be recalled, section 351 was held to apply to a transaction in which P, in a post-formation sale, sold more than 20 percent of Newco's stock to C, since C had also contributed property to the corporation in exchange for stock. 1979-1 C.B. at 146. The Service specifically concluded, however, that "gain or loss to [P] upon the sale of the Newco stock will be determined and recognized under § 1001." Id. Similarly, in Portland Oil Co. v. Commissioner, 109 F.2d 479 (1st Cir. 1940), discussed supra in text accompanying notes 34-38, although
ness of that analysis will be demonstrated in this part, where it will be argued that the overall tax structure demands that the P-C transaction be taxed, regardless of the formal route adopted, as if the Boot Transaction route had been followed. That is, it should be taxed as if P received as boot from Newco the cash that C contributed to the corporation to acquire his stock.

B. Income and Basis Issues Where P Transfers Property Having a Basis in Excess of Fair Market Value

1. The Example

The problem with ever using the Post-Formation Sale of Stock route to determine tax consequences, and the case for always using the Boot Transaction route to do so seems clearest where the property being transferred to Newco has depreciated in value. The following example will be used to demonstrate this conclusion: Assume P owns land with a basis of $200,000 and a value of $80,000. C is willing to contribute $60,000 cash to the venture, $20,000 of which will remain in Newco and be used to improve the property, and $40,000 of which will end up in P’s hands. Thus, Newco will wind up with $20,000 cash and P’s land. The stock will be owned 40 percent (40 shares) by P and 60 percent (60 shares) by C. The section that follows compares the tax consequences to P, C, and Newco under each of the three formal routes, assuming that the formal route chosen is allowed to determine the tax consequences.

2. The Tax Consequences Under the Three Formal Routes

   a. The Post-Formation Sale of Stock Route

   If the Post-Formation Sale of Stock route is to be followed, Newco will initially be formed with C paying $20,000 for 20 shares of its stock and P exchanging his land (value = $80,000, basis = $200,000) for the remaining 80 shares. P would then (under a contractual commitment to do so) sell 40 shares of his Newco stock to C for $40,000, leaving the final stock ownership at 40 percent for P and 60 percent for C.

   Even under existing law, this transaction would qualify under section 351. Both P and C would, under Revenue Ruling 79-194,115 be treated as transferees of property and together they would be in control of Newco “immediately after the exchange.”116 Therefore, P would rec-

---

the First Circuit would not have disqualified a transaction involving a post-formation sale of more than 20 percent of Newco’s stock by P to C, it would have taxed the P to C sale in accordance with its form. 109 F.2d at 490.

There is little, if any, direct authority on the proper tax consequences of a P-C transaction not involving loss of control, which is cast by the taxpayers in either the form of a Pre-Formation Sale of Property or a Boot Transaction. However, in the analogous situation where on an incorporation stock is directly issued by Newco to C to repay a debt owed by P to C, the Regulations seem to indicate that regardless of the form used, the transaction will be treated as if P had first received all the stock and then transferred some of it to discharge his obligation to C. See Regs. § 1.351-1(b)(1), (2), Ex. 1. Part III of the Article deals with this situation involving Newco’s use of stock to discharge P’s liabilities.

116. See id.
ognize no loss on the initial exchange of his depreciated property for Newco’s stock.\textsuperscript{117} P’s basis in his 80 shares would, under section 358, be $200,000, the same basis he had in the property transferred.\textsuperscript{118} Upon the sale by P of the 40 Newco shares to C, P would recognize a loss of $60,000, \textit{i.e.}, the excess of his $100,000 carryover basis in the 40 shares sold,\textsuperscript{119} over the $40,000 paid to him for such stock by C. P’s basis in his remaining 40 shares would be $100,000.

 Yet, even though P recognizes a $60,000 loss on the transaction, the corporation’s basis would remain $200,000, the carryover basis it took under section 362(b)\textsuperscript{120} on the initial incorporation.\textsuperscript{121} If the corporation were to sell the property the next day for its $80,000 fair market value, it would recognize a loss of $120,000.

b. \textit{The Pre-Formation Sale of Property Route}

Here, P would first sell an undivided one-half interest in the property to C for $40,000. Newco would then be formed by P and C contributing to it their undivided interests in the property, and C contributing to it an additional $20,000 of cash. In exchange, P would receive 40 percent, and C 60 percent of Newco’s stock. P’s basis in his stock would be $100,000.\textsuperscript{122}

The pre-formation sale of the property interest by P to C would result in P’s recognizing a loss of $60,000 (the excess of P’s $100,000 basis in the one-half property interest sold over the $40,000 received from C on the sale).\textsuperscript{123} The incorporation of Newco that followed the sale of the property by P to C would be tax-free,\textsuperscript{124} with Newco taking a basis in the property transferred to it of $140,000. That represents C’s $40,000 cost basis in the one-half interest he contributed, plus P’s $100,000 basis in the remaining one-half interest contributed by him.\textsuperscript{125} Upon an immediate sale of the property for its $80,000 value, Newco would recognize a loss of $60,000.

c. \textit{The Boot Transaction Route}

Finally, using the Boot-Transaction route, Newco would be formed

\begin{itemize}
\item \textsuperscript{117} I.R.C. § 351(a).
\item \textsuperscript{118} I.R.C. § 358 provides, generally, that a transferor takes a basis in the stock and securities received in a section 351 exchange equal to the basis he had in the assets transferred.
\item \textsuperscript{119} One-half of his total carryover basis in the stock.
\item \textsuperscript{120} Under § 362(a)(1) a corporation takes a basis in property received in a § 351 transaction equal to the transferor’s basis in the property.
\item \textsuperscript{121} A shareholder’s sale of stock, of course, generally has no effect on the corporation’s basis in its assets. \textit{But see, e.g.}, I.R.C. § 338.
\item \textsuperscript{122} That represents one-half of his total basis in the land.
\item \textsuperscript{123} If, after the integrated transaction, P owned more than 50 percent of the corporation’s stock, P’s loss on the sale to C might be classified as an indirect sale by P to the corporation and, therefore, disallowed under § 267. \textit{See supra} text accompanying notes 101-103.
\item \textsuperscript{124} The two transferors, P and C, would have 100 percent control immediately after the exchange.
\item \textsuperscript{125} I.R.C. § 362(a)(1). \textit{See supra} note 120.
\end{itemize}
by having C contribute $60,000 cash to it for 60 percent of the stock, and having P contribute his property in exchange for the other 40 percent of the stock plus $40,000 cash boot.

Using this form, the tax results would be quite different since P would be unable to recognize any loss on the transaction. Under section 351(b)(2), no loss is recognized by a transferor on a section 351 exchange even if he receives boot in the transaction. P would hold his 40 percent stock interest with a basis of $160,000\(^{126}\) and a value of $40,000; and the corporation would hold the land worth $80,000, with a basis to it of $200,000.\(^{127}\)

d. Summary of Tax Consequences

Table 1 illustrates the dramatic differences between the three routes. In both the Post-Formation Sale of Stock route and the Pre-Formation Sale of Property route P recognizes a loss of $60,000. However, in the former route, the corporation's basis is not adjusted downward, as it is in the latter, by the loss recognized by P. If the Boot Transaction route is followed, no loss is recognized at all by P, and the corporation's basis in the property ($200,000) remains the same as it was in the hands of P.

<table>
<thead>
<tr>
<th>TABLE 1</th>
<th>Stock Ownership</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transfer of Loss Property</td>
<td>P's Loss</td>
</tr>
<tr>
<td></td>
<td>in Newco Stock</td>
</tr>
<tr>
<td>Form I The Post-Formation Sale of Stock</td>
<td>($60,000)</td>
</tr>
<tr>
<td>Form II Pre-Formation Sale of Property</td>
<td>($60,000)</td>
</tr>
<tr>
<td>Form III The Boot Transaction</td>
<td>None</td>
</tr>
</tbody>
</table>

3. The Case for the Boot Transaction

The Code assumes that two results are possible when a person transfers depreciated property to a less than 50 percent owned corporation:\(^{128}\) (i) the transferor recognizes loss, and the transferee-corpora-

---

\(^{126}\) Under § 358(a), P's basis in his stock is his original basis in the land exchanged ($200,000), decreased by the amount of money received ($40,000) in the transaction.

\(^{127}\) The corporation's basis in the land is, under § 362(a)(1), the same as P's basis in it ($200,000).

\(^{128}\) I.R.C. § 267 applies where depreciated property is transferred by a shareholder to
tion takes a stepped-down basis in the asset; or (ii) the transferor recognizes no loss under section 351, and the transferee-corporation takes a high carryover basis in the property under section 362. What the statute clearly does not contemplate is an integrated transaction in which the transferor recognizes loss on the exchange, and yet, the corporation continues to take the transferor's unadjusted carryover basis in the property. Yet, this is precisely the result that comes about if the Post-Formation Sale of Stock route is applied to determine tax consequences in the P-C hypothetical. On P's planned post-formation stock sale to C, P would recognize a $60,000 loss, and yet Newco would keep its $200,000 carryover basis in the asset transferred to it by P. Surely, this result is totally inconsistent with the overall tax structure.

The tax consequences obtained by following the Pre-Formation Sale of Property route are not nearly as outrageous as those obtained by following the Post-Formation Sale of Property route. They are, nevertheless, erroneous. If the Pre-Formation Sale of Property route were followed, P would again recognize a large loss, but now the corporation's basis in the property would be stepped down accordingly. In choosing between the Pre-Formation Sale of Property route and the Boot Transaction route, the question is, of course, whether the allowance of any loss in the P-C hypothetical is appropriate. Section 351(b)(2) tells us it is not. That section specifically reveals Congressional intention not to permit a transferor to recognize a loss in an incorporation transaction qualifying under section 351, even if the transferor ends up with both stock and cash. It is appropriate, therefore, for courts to recast the economically identical pre-formation asset sale as a boot transaction and disallow any loss to P.

If, in the described transaction, P had ended up with more than 50 percent of the corporation's stock, there would be an additional reason for rejecting the Post-Formation Sale of Stock route and adopting the Boot Transaction route. In that situation, section 267, as well as section 351(b)(2), would evidence a clear statutory intention to deny P an immediate loss deduction. Section 267 disallows, inter alia, a loss on direct or indirect sales or exchanges of property between shareholders and their more than 50 percent owned corporations. Thus, if the Boot Trans-

---

a more than 50 percent owned corporation in an otherwise taxable exchange. Under § 267, the shareholder would not be entitled to claim the loss and, in effect, the corporation would take a carryover basis for purposes of determining gain and a cost basis for determining loss. See infra text at notes 133-135.

129. See I.R.C. §§ 1001(a), 1001(c), and 1012.

130. For the possible application of § 267 to deny this loss on P's pre-formation sale of depreciated property to C, see infra text accompanying notes 133-135.

131. The corporation's basis would be $140,000. See supra text accompanying note 125.

132. I.R.C. § 351(b)(2) states that even where boot is received in a section 351 transaction, "no loss to [the transferor] shall be recognized." Id.

133. I.R.C. §§ 267(a)(1); 267(b)(2). See generally 4 B. Bittker supra note 1, § 78.1 - 78.3, at 78.1-1 to 78.1-18. Section 267(d), in effect, gives the transferee a cost basis for determining loss (and depreciation), and a carryover basis for determining gain. See Reg.
action route were followed, P's loss would be disallowed under two sections: 351(b)(2) and 267.

Moreover, the language in section 267 referring to indirect sales would certainly require a court to treat the pre-formation sale by P to C, followed by C's planned contribution of the property to the corporation, as an indirect sale of the property by P to his more than 50 percent owned corporation.

Thus, no loss would be allowed to P under the Pre-Formation Sale of Property route either. To allow a taxpayer to avoid the limits of section 267 if he formally structures a transaction as a post-formation sale of stock makes no rational tax policy sense, and courts should recast all such transactions as Boot Transactions in order to reach appropriate results.

C. Income and Basis Issues Where P Transfers Property Having a Value in Excess of Basis

1. The Example

Where P is placing appreciated property into the venture, and ending up with both stock and cash, he will have to recognize some gain regardless of the formal route followed. However, both the amount and classification of that gain (as ordinary or capital), as well as P's basis in his stock and Newco's basis in the assets received turns on the way the transaction is analyzed.

The discussion in this part will again demonstrate that appropriate tax consequences are produced only if all P-C transactions are analyzed as if the Boot Transaction route were followed.

To illustrate the gain and loss and basis issues in this section, an example will again be used. In this example, C will invest $20,000 cash in the venture and will receive 20 percent of the stock, while P will put into the venture depreciable commercial real estate held by him for more than a year, and worth $100,000. In exchange, P will receive 80 percent of Newco's stock and $20,000 cash. It is assumed that P's commercial real estate has an adjusted basis of $20,000, was purchased by him for more than $100,000, and has been depreciated using ACRS depreciation. Therefore, if the property were sold by P to an unrelated third party for $100,000, P would recognize $80,000 ordinary income, representing full recapture of depreciation under section 1245.

§ 1.267(d)-1(a)(4), Ex. 1, Ex. 2. Only the original transferee, however, is entitled to the higher basis for determining gain. See Reg. § 1.267(d)-1(a)(4), Ex. 3.

134. I.R.C. § 267(a)(1) denies losses on such exchanges "directly or indirectly" between the specified related parties.

135. Sales of property to an unrelated party have been brought within § 267(a)(1) where related parties have entered into parallel transactions. For example, in McWilliams v. Commissioner, 5 T.C. 623 (1945), rev'd, 158 F.2d 637 (6th Cir. 1946), aff'd 331 U.S. 694 (1947), the Supreme Court held that losses incurred by the taxpayer from the sale of securities on the New York Stock Exchange were not allowable when on the same day his wife purchased the same number of shares of the same stock. The same rationale seems even clearer where the intermediary is one person.

136. The full recapture rules of section 1245 apply on the sale of commercial real es-
Since P ends up with 80 percent of the stock, control is not at issue even under existing law, and, therefore, section 351 will apply to the transaction regardless of the formal route followed. But as previously stated, what remains at stake is the amount and kind of gain to be recognized by P, as well as the basis to be taken by P in his stock, and by Newco in the real estate. These issues are considered below. The varying tax consequences that apply where form is allowed to govern are considered first. The case for following the Boot Transaction route regardless of the formal path followed is then set forth.

2. The Tax Consequences Under the Three Formal Routes
   
a. The Post-Formation Sale of Stock Route

In this formal route, P would first exchange the real estate, with a basis of $20,000 and a value of $100,000 for all of Newco’s stock in a transaction qualifying under section 351; he would then (under a binding agreement to do so) sell 20 percent of that stock to C for $20,000 cash.

Section 351 applies to the initial exchange between P and the corporation since, even under current law, P, who would be considered the only transferor of property, maintains 80 percent control “immediately after the exchange.” Therefore, P will recognize no gain upon the receipt of Newco’s stock, and will take a basis in that stock of $20,000.137 Similarly, Newco will take a $20,000 basis in the land.138

P’s sale of 20 percent of the stock to C will produce recognized gain for P in the amount of $16,000. That represents the $20,000 cash received from C less P’s $4,000 basis (20 percent of his entire basis) in the Newco stock transferred to C. P’s basis in his remaining shares will be $16,000. The gain recognized by P on his sale of stock will have no effect on Newco’s basis in the real estate, which remains at $20,000.139

P’s $16,000 gain will be long-term capital gain.140 This is so even though the gain on the stock sale is solely attributable to the depreciable real estate, which if sold would have produced only ordinary income.141 The stock received by P is a capital asset, and, under section 1223(1), its holding period includes the period that P held the real estate.142

---

137. I.R.C. §§ 1245(a)(1), (a)(5).
139. A corporation increases its basis in assets received in a section 351 exchange only by the gain recognized by the transferor on his transfer of the assets to the corporation. I.R.C. § 362(a)(1). Gain recognized on the transferor’s sale of stock does not affect the corporation’s basis in its assets.
140. The asset being sold is P’s stock, a capital asset in his hands. While the stock received derives its basis, see I.R.C. § 362(a)(1), and its holding period, see infra note 142, from the transferred properties, “capital asset status (or the lack of it) for the stock . . . is not a characteristic that is inherited from the property exchanged therefor.” Bittker & Eustice supra note 17, § 3.12; at 3-48.
141. See supra note 140.
142. Under § 1223(1), a shareholder receiving stock in a § 351 transaction has a holding period in such stock which includes the period during which he held the transferred
b. *The Pre-Formation Sale of Property Route*

Here, P first sells an undivided 20 percent interest in the land to C for $20,000 cash, and then P and C contribute their land interests to Newco in exchange for an 80 percent and 20 percent stock interest in the company, respectively. P again recognizes $16,000 gain, this time on the sale of the property to C.\textsuperscript{143} Now, however, because of the depreciation recapture rules, the recognized gain will all be ordinary.\textsuperscript{144}

No further gain will be recognized under section 351 on P and C’s exchange of their real estate interests for Newco stock. As in the Post-Formation Sale of Stock route, P will take a $16,000 basis in the stock received, i.e., the same basis he had in his remaining 80 percent interest in the real estate contributed to Newco. Newco, however, will have a greater basis than it did in the post-formation stock sale example. There Newco’s basis was $20,000. Here it will be $36,000, representing the combined carryover bases of P ($16,000) and C ($20,000 cost basis) in their real estate interests.\textsuperscript{145}

c. *The Boot Transaction Route*

If the Boot Transaction route were followed (and allowed to govern for tax purposes), the tax consequences would change once again for both P and Newco. Upon transferring the real estate (basis = $20,000 and value = $100,000), in exchange for 80 percent of the corporation’s stock plus $20,000 cash (the cash just contributed by C), P would, under section 351(b), recognize $20,000 of gain. This is $4,000 more than he recognized under the two formal routes. This $20,000 gain recognized would all be ordinary income.\textsuperscript{146}

Newco would, under section 362, take a $40,000 basis in the land, representing P’s carryover basis in the property plus the $20,000 gain recognized by P on the incorporation.\textsuperscript{147}

d. *Summary of Tax Consequences*

Table 2 below reflects the varying tax consequences in this no loss of control example under the three formal routes.

---

property, provided the transferred property is either a capital asset or a § 1231 asset. In the hypothetical, P’s real estate is a § 1231 asset.

143. P allocates $4,000 of his basis (20 percent of his total $20,000 basis in the real estate) to the 20 percent interest sold to C for $20,000.

144. *See supra* note 136.

145. *See supra* § 362(a)(1).

146. When gain is recognized because “boot” is received in a § 351 exchange, the character of the assets transferred (including a consideration of the potential depreciation recapture on such assets) will determine whether the gain is ordinary income or capital gain, and, if capital gain, whether long-term or short term gain. *See Bittker & Eustice supra* note 17, § 3.06, at 3-21 to 3-22.

147. *See supra* § 362(a)(1).
TABLE 2
NO LOSS OF CONTROL: P REALIZES GAIN

<table>
<thead>
<tr>
<th>Stock Ownership</th>
<th>P's Loss in Newco Stock</th>
<th>C's Basis in Newco Stock</th>
<th>Newco's Basis in Property</th>
<th>P</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Form I</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Post-Formation</td>
<td>$16,000</td>
<td>$16,000</td>
<td>$20,000</td>
<td>80%</td>
<td>20%</td>
</tr>
<tr>
<td>Sale of Stock</td>
<td>Capital Gain</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Form II</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pre-Formation</td>
<td>$16,000</td>
<td>$16,000</td>
<td>$36,000</td>
<td>80%</td>
<td>20%</td>
</tr>
<tr>
<td>Sale of Property</td>
<td>Ordinary Income</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Form III</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>The Boot</td>
<td>$20,000</td>
<td>$20,000</td>
<td>$40,000</td>
<td>80%</td>
<td>20%</td>
</tr>
<tr>
<td>Transaction</td>
<td>Ordinary Income</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Even though there is no possibility of loss of control in this example, Table 2 indicates that the various routes produce widely differing tax results. For example, the Boot Transaction route produces greater gain for P than do the other two routes; moreover the gain that is recognized will be entirely capital under the Post-Formation Sale of Stock route, but entirely ordinary under both the Boot Transaction and Pre-Formation Sale of Property routes. Finally, and of considerable significance, is the fact that only in the Post-Formation Sale of Stock route does the gain recognized by P not lead to an increase in Newco's $20,000 carryover basis in the property. In both of the other routes, Newco's $20,000 carryover basis in the real estate is directly or indirectly increased by the gain recognized by P on the overall transaction.

3. The Case for the Boot Transaction Route

a. Effect of Transaction on Newco's Basis in the Property

P's basis in his transferred property was $20,000. If the Boot Transaction route were followed, P would recognize $20,000 gain, and the corporation's basis in the property would be $40,000. Under the Pre-Formation Sale of Property route, P's gain would be $16,000, and the corporation's basis $36,000. But, where the Post-Formation Sale of Stock route is followed, although P's gain is $16,000, the corporation's basis remains $20,000.

In enacting sections 358 and 362, Congress intended to create a system in which any gain realized but unrecognized by a transferor in a section 351 transaction would be deferred by him until his stock was
sold.\textsuperscript{148} The basis mechanism of section 358 achieves this result. Moreover, there was to be a mirror image of the shareholder's deferred gain at the corporate level. That is, the same amount of gain deferred by the shareholder would also be recognized by the corporation if it immediately sold, for fair market value, the property transferred to it.\textsuperscript{149} Section 362(b) produces this result by giving the corporation a carryover basis in the property received.

This mirror image continues even if a shareholder recognizes some gain under section 351(b) because of his receipt of boot in the transaction.\textsuperscript{150} To the extent of the gain recognized by the shareholder on the transaction (and thus not deferred by him), the corporation receives an increased basis in the property under section 362(b). Where the Pre-Formation Sale of Property route is chosen, the corporation indirectly achieves an increased basis also.\textsuperscript{151}

Clearly, then, Congress did not intend that an incorporation transaction could result in a transferor's recognizing gain, without a concomitant increase in the corporation's basis in the transferred assets. Yet, that is precisely the effect of a literal adherence to the Post-Formation Sale of Stock route in our P-C hypothetical. P's post-formation sale of Newco stock to C, though clearly an integral part of the entire incorporation transaction, is treated as if it were a totally unrelated sale of stock by P to C, resulting in no basis adjustment at the corporate level.

b. Character of Gain Recognized by P

In the P-C example, the character of the gain recognized by P would also differ if form were allowed to govern. P would recognize only capital gain under the Post-Formation Sale of Stock route, and only ordinary income under the other two routes.\textsuperscript{152}

There seems to be no question that any gain recognized on an incorporation transaction involving boot is taxed as ordinary income whenever the asset transferred is an ordinary asset (or is subject to recapture of depreciation).\textsuperscript{153} This will also be the result under the Pre-Formation Sale of Property route. Since the Post-Formation Sale of Stock route is economically identical to the other two routes, underlying considerations of Code structure and consistency should convince a court to recast a taxpayer's formal use of the Post-Formation Sale of Stock route as either a pre-formation sale of property or as a boot trans-

\textsuperscript{149} See id. at 484-85.
\textsuperscript{150} See id. at 485-86.
\textsuperscript{151} The increased basis comes because C's pre-formation purchase of P's asset (which results in gain recognition to P), gives C a cost basis, which is carried over by § 362(a)(1) to the corporation.
\textsuperscript{152} See supra text accompanying notes 140-142, 144, and 146.
\textsuperscript{153} See supra note 146. The gain is also ordinary when § 1239 applies. See infra text accompanying notes 157-159.
action. The kind of gain recognized will, thus, be the same without regard to the formal route adopted by the taxpayer.

Where P is transferring a single asset to the venture, both the Boot Transaction route and the Pre-Formation Sale of Property route seem equally acceptable with regard to the characterization of income issue. Whichever of these routes is used, the character of the asset transferred determines whether the gain recognized will be ordinary or capital. If, however, more than one asset were being contributed to the venture by P, then only the Boot Transaction route would produce appropriate results in all cases.

For example, assume P is going to contribute to the venture two assets, Asset I and Asset II, each with a basis of zero and a value of $50,000. C is going to contribute $20,000 cash. In P's hands, Asset I is a capital asset held for more than a year, while Asset II is an ordinary asset. Under the Boot Transaction route, P would be deemed to have contributed both assets to the corporation for 80 percent of the stock plus $20,000 cash. P would, therefore, recognize $20,000 of gain, one-half of which would be ordinary income, and the other half capital gain. P should not be able to avoid this result by, for example, formally combining a pre-contribution sale of Asset I (the capital asset) to C, with a contribution of Asset II (the ordinary asset) to Newco solely in exchange for stock. If such a scheme were effective, P would still recognize $20,000 gain (on the sale of Asset I to C), but all the gain would be capital. By following the Boot Transaction route, the possibility of changing ordinary income into capital gain would be eliminated.

The conclusion as to the propriety of using the Boot Transaction route is further reinforced by the existence of section 1239, which provides that gain recognized on a direct or indirect sale or exchange of depreciable property between, inter alia, an individual and an 80 percent controlled corporation, constitutes ordinary income even if the gain would otherwise be taxed as capital gain. Thus, in the P-C hypothetical, even if the recapture rules had been inapplicable to P's transfer of the real estate (as they would have been, for example, if P had depreciated the real estate on a straight line basis), the gain recognized to P on the receipt of the boot would have all been ordinary income under section 1239. Moreover, as was the case with section 267, the pre-formation sale of the real estate by P to C, followed by C's contribution of the property to the corporation, would seem to be an indirect sale by P to his controlled corporation. As such, P would recognize only ordinary income.

154. It is doubtful that in a boot transaction the shareholder could assign the stock received to the ordinary asset and the boot to the capital asset. See Bittker & Eustice supra note 17, § 3.06, at 3-23 to 3-25; Rev. Rul. 68-55, 1968-1 C.B. 140. See generally Rabinoivitz, Allocating Boot in Section 351 Exchanges, 24 Tax L. Rev. 337 (1969).
155. Cf. Bittker & Eustice supra note 17, § 3.06, at 3-24 to 3-25.
156. See generally 2 B. Bittker supra note 1, § 54.11, at 54-75.
157. If commercial or residential real estate is depreciated using the straight-line method, there is no recapture of depreciation on its sale. I.R.C. §§ 1250(a); (b).
income, under section 1239, on the sale to C.\textsuperscript{158} It seems entirely inap-
propriate to allow a taxpayer to so easily avoid the reach of section 1239 
by his formal use of the Post-Formation Sale of Stock route.

c. \textit{Amount of Gain Recognized by P}

In the P-C hypothetical, P would recognize $16,000 of gain under 
the Post-Formation Sale of Stock and the Pre-Formation Sale of Prop-
erty routes, and $20,000 under the Boot Transaction route. Looking 
only at this amount of gain issue, it is difficult to justify P's recognizing 
$20,000 rather than $16,000 gain in the transaction. The general justifi-
cation for allowing no basis recovery in a boot transaction is that by 
requiring all realized gain to be recognized to the extent of boot, the 
need to value the property transferred or the stock received is elimi-
nated.\textsuperscript{159} In the P-C hypothetical, however, this problem is resolved by 
C's arm's length agreement to pay $20,000 for 20 percent of the stock. 
That agreement tells us that the property is worth $100,000. Neverthe-
less, if the Boot Transaction route is to be used to determine the kind of 
gain recognized by P, and the corporation's basis in the property re-
ceived, then, as a matter of consistency, it must be used to determine the 
amount of gain recognized.

D. \textit{Summary}

This part has shown that only the tax results obtained by following 
the Boot Transaction route are consistent with the statutory scheme 
dealing with section 351 transactions (i.e., sections 351, 358, and 362), 
as well as those dealing with sales between related parties (sections 267 
and 1239).

Moreover, the conclusions reached in this part add further weight 
to Part I's argument that the P-C transaction should never result in loss 
of control. If it is appropriate to recast all P-C transactions as Boot 
Transactions for purposes of determining gain and loss and basis conse-
quences to the parties where control is not at stake, it seems unlikely 
that Congress could have intended the opposite result once control be-
came an issue. In other words, it would be odd indeed to recast all P-C 
transactions as Boot Transactions so long as C ended up with 20 percent 
or less of the Newco stock, but to then, in effect, recast them as Post-
Formation Stock sales once C's ownership exceeded 20 percent.

\textsuperscript{158} The rationale is the same as in a section 267 transaction. \textit{See supra} note 135; 
Meyer, \textit{Avoiding Adverse Tax Consequences in the Operation of a Closely Held Corporation}, 32 

\textsuperscript{159} \textit{See Rabinowitz supra} note 154, at 356 n.51.
III. THE TAX CONSEQUENCES OF AN INCORPORATION TRANSACTION IN WHICH NEWCO ISSUES STOCK TO C TO DISCHARGE P'S PRE-EXISTING INDEBTEDNESS TO C

A. INTRODUCTION: THE CONTROL ISSUE IN THE DISCHARGE OF INDEBTEDNESS SITUATION

This part deals with a situation quite similar to the P-C transactions described in Parts I and II, except here C is not paying cash to acquire newly issued Newco stock, but rather is agreeing, as an integral part of the incorporation of Newco, to accept Newco stock in discharge of a pre-existing indebtedness owed to him by P.

With respect to the question of control immediately after the exchange, little needs to be added to Part I's discussion of the issue. If C ends up with more than 20 percent of the Newco stock, it is assumed under existing law that section 351 will be inapplicable whether, as in Part I, C has paid cash for such stock,160 or, as in this part, he has accepted the stock in discharge of an obligation owed to him by P.161 In both cases, P is treated as the only transferee of property, and he alone is not considered to be in control of Newco immediately after the integrated exchange.162 This part rejects that conclusion in the creditor situation as it did in the cash transaction. Whether C receives his greater than 20 percent stock interest in Newco for cash or in discharge of P's indebtedness to him, rational tax policy demands that section 351 apply. The stated Congressional goals of facilitating business readjustments and creating no disincentives to the incorporation of existing businesses163 demands section 351's application in both situations.

In fact, if anything, the Congressional policy applies even more clearly to the discharge of indebtedness situation than it does to the cash transaction. An incorporation transaction which combines a transfer of stock interest to a creditor is a more likely occurrence than the combined incorporation-cash bailout situation. Moreover, Congress, in en-

160. See supra text accompanying notes 23-25 and 33.
161. See BITTKE & EUSTICE supra note 17, ¶ 5.03, at 5-12 to 5-13.
An example is the individual proprietor who incorporates his business, taking part of the stock himself and directing that the rest be issued to an employee as compensation for services performed in years past. Such a transaction is to be treated as though all the stock had been issued first to the proprietor in exchange for the assets of his business, with part of it being used by him to pay his debts. The incorporation would qualify under § 351 if the proprietor retained at least 80 percent of the stock, and even if he retained less than 80 percent, it might qualify if the loss of "control" (as defined in § 368(c)) was not an integral part of the transaction.

162. See supra note 161.
163. See supra text accompanying notes 88-91.
acting the predecessor of section 357(a),\textsuperscript{164} clearly recognized that the incorporation of an existing business would often involve the assumption by Newco of the liabilities of that business.\textsuperscript{165} Section 357(a) generally allows such assumption of liabilities to take place without the transferor of property recognizing any gain.\textsuperscript{166} Given this concession in section 357(a), would Congress have then desired the total disqualification of the transaction under section 351(a), if Newco, in effect, paid off those assumed liabilities in stock? It seems unlikely.

Even the mere change of form rational, referred to earlier,\textsuperscript{167} seems more apt in the creditor situation than in the cash bailout transaction. In Part I’s transaction, P and C were unrelated individuals prior to the incorporation. In the discharge of indebtedness transaction, however, that is not the case. In the latter transaction, C, as creditor, would often have had a pre-existing interest in the assets of the unincorporated business (or individual assets) which he simply exchanged for an equity interest in the incorporated business.

Finally, the literal language of the statute again creates no problems. If the “immediately after the exchange” language is seen to require only momentary control in the property transferor,\textsuperscript{168} then there will, of course, be no control problem in the discharge of indebtedness transaction. In addition, as in the cash transaction, C, the creditor, could be treated as having transferred property to the corporation\textsuperscript{169} (in this case, the property would be C’s existing rights against P),\textsuperscript{170} thereby making both P and C transferors who together are in total control of the corporation immediately after the exchange.

B. GAIN, LOSS AND BASIS CONSEQUENCES: THE CASE FOR THE ASSUMPTION OF LIABILITY ROUTE

1. Treatment of Liabilities Assumed in a Section 351 Transaction

To understand the conclusions reached in this part with respect to the gain, loss, and basis consequences of the P-C discharge of indebtedness transaction, it is first necessary to review the general rules regarding the tax treatment of liabilities assumed by a corporation as part of an otherwise qualifying section 351 transaction. Section 357(a) provides the basic rule that the assumption of a liability by the acquiring corporation, or the corporation taking property subject to a liability, is not boot to the transferor in a section 351 exchange.\textsuperscript{171} In enacting the prede-

\textsuperscript{164} See infra note 171 and accompanying text.
\textsuperscript{165} See infra text accompanying notes 172-173.
\textsuperscript{166} See infra note 171 and accompanying text.
\textsuperscript{167} See supra text accompanying notes 92-100.
\textsuperscript{168} See supra text accompanying notes 34-38.
\textsuperscript{169} See supra text accompanying note 32.
\textsuperscript{170} Even if C’s rights against P were considered property for section 351 purposes, the assignment of income doctrine could apply to cause C to recognize income if his rights against P were, for example, for unpaid salary. However, it is only the approach of treating P as the sole transferor who is in control of the corporation “immediately after the exchange” that is consistent with the Assumption of Liability route set forth in this part.
\textsuperscript{171} I.R.C. § 357(a). Under this section, the amount of the liability is considered in
cessor of section 357, it was perceived by Congress “that if gain was to be recognized upon [an] . . . incorporation whenever the transferee assumed a liability of the transferor or took property subject to a liability, the usefulness of [section 351] . . . would be seriously impaired.”

Thus liabilities do not generally constitute boot but rather simply reduce the shareholder’s basis in his stock.

One exception to this rule is found in section 357(b), which treats a corporation’s assumption of a transferor’s liability as boot if the principal purpose of the assumption was to avoid Federal income tax, or was not for a bona fide business purpose. This exception applies most clearly to a transaction in which the transferor has the corporation assume his personal liability, i.e., a liability unrelated to the business or assets being transferred.

If section 357 did not exist, and a corporation’s assumption of liabilities in a section 351 transaction were simply treated as boot to the transferor, no discussion beyond that set forth in Part II would be necessary here. We would again simply apply the Boot Transaction analysis to determine gain and loss and basis consequences to the parties. In fact, the Boot Transaction is precisely the analysis that should be applied to a case in which the liability owed by P to C (which is being discharged with Newco stock) is totally unrelated to the assets being transferred to the corporation by P. In that situation, section 357(b) would, in fact, treat the assumed liability as boot, and the Boot Transaction route would be appropriate in the P-C discharge of indebtedness transfer.

computing the amount of gain or loss realized on the exchange but is disregarded in ascertaining the amount of the realized gain which is to be recognized. As a concomitant to the enactment of § 357(a), Congress enacted the basis rule of § 358(d). That section states that, solely for the purpose of computing the shareholder’s basis in his stock and securities, liabilities are to be treated as money received in a § 351 exchange. In other words the corporation’s assumption of liabilities, while not causing the stockholder to recognize gain, does cause him to reduce the basis in the stock and securities he receives. This is necessary if § 357(a) is to result in the deferral and not the exemption of gain.

172. Bittker & Eustice, supra note 17, § 3.57, at 3-25 to 3-26.


174. If any of the liabilities were assumed by the corporation for a forbidden purpose, then all of the liabilities assumed, including those assumed for good business purposes, are treated as boot. Reg. § 1.357-2(a).

175. I.R.C. § 357(b) is normally applied in one of two situations: first, when a transferor has his controlled corporation assume his personal expenses, and second, when the transferor borrows on business property in anticipation of the incorporation, uses the borrowed funds for personal purposes, and has the corporation assume the liability. See Burke & Chisholm, Section 357: A Hidden Trap in Tax Free Incorporations, 25 Tax L. Rev. 211, 215-26 (1970); Greiner, Behling & Moffet, Assumption of Liabilities and the Improper Purpose—A Re-examination of Section 357(b), 92 Tax Law. 111, 117-26 (1978).

176. In the discharge of indebtedness situation, the Boot Transaction route would involve C’s transferring his rights against P to Newco in exchange for Newco stock. At the same time, P would transfer property in exchange for Newco stock, plus boot in the form of the discharge of P’s obligation to C—which is now owned by Newco. When all the smoke cleared, P would recognize gain, under § 351(b), equal to the value of the debt discharged. See supra note 170.

177. For an explanation of how the Boot Transaction analysis would apply in these circumstances, see supra note 176.
Where, however, P's liability to C is of the type that would come within the general rule of section 357(a) if assumed by the transferee corporation, another route, referred to here as the Assumption of Liability route, seems the appropriate one. This route is explained, and its use justified in the sections that follow.

2. The Case for the Assumption of Liability Route Where the Liability Being Discharged Is of a Nondeductible Variety

a. The Example

To illustrate the special issues that arise where C accepts stock in discharge of P’s pre-existing indebtedness to him, the following simple example will be used: Assume P owns undeveloped land with a basis to him of $50,000, and a value of $100,000. The property has been mortgaged to secure a $20,000 recourse liability that P owes to C. It is decided between P and C that a corporation (“Newco”) will be formed to own the land. P will end up with 80 percent of the Newco stock and C will own 20 percent. Moreover, when the transaction is completed, P’s liability to C will have been discharged.

b. The Various Paths Available

There are three economically equivalent forms in which P and C’s deal might be carried out. First, P could transfer the land to Newco in exchange for all of its stock, worth $100,000, and then, under a binding obligation to do so, transfer 20 percent of that stock to C to discharge his indebtedness to C. This is the equivalent form to the one referred to in Parts I and II as the Post-Formation Sale of Stock route.

Second, P might first transfer a 20 percent interest in the land to C to discharge his indebtedness, with P and C then transferring their undivided interests in the land to Newco for an 80 percent and 20 percent stock interest respectively. This is equivalent to the Pre-Formation Sale of Property route and will not be discussed further in this part.178

Finally, there is a third route available in which P would first transfer the land to Newco in exchange for all of Newco’s stock worth $80,000, plus Newco’s assumption of P’s $20,000 obligation to C. Newco would then (under a binding obligation to do so) issue $20,000 of new stock to C to discharge the assumed liability. This formal transaction is referred to here as the Assumption of Liability route.179

c. The Tax Consequences Under the Post-Formation Sale of Stock Route and the Assumption of Liability Route Compared

If the Post-Formation Sale of Stock route were followed, section

178. As the rest of Part III illustrates, the real choice is between the two extremes: the Post-Formation Sale of Stock route and the Assumption of Liability route.

179. See Bitter & Eustice, supra note 17, § 3.03, at 3-13 (describing what is here called the Assumption of Liability route as an alternative to the Post-Formation Sale of Stock route). See infra note 187.
351 would apply to P’s initial transfer of the land to Newco in exchange for all of its stock. P would, therefore, recognize no gain on the incorporation, and would take a $50,000 basis in his stock. His transfer of 20 percent of his shares (with a basis of $10,000 and a value of $20,000) to his creditor, C, would result in P’s recognizing gain of $10,000. Newco’s basis in the land would be $50,000, the same basis P had in it. The corporation’s basis would not be affected by the fact that P recognized gain on his transfer of stock to C.

If the Assumption of Liability route were followed, and the form not recast as a Post-Formation Sale of Stock, P would still recognize no gain on the incorporation. Under section 357(a), Newco’s assumption of P’s $20,000 liability to C would not be treated as boot in the transaction. Moreover, Newco’s subsequent discharge of that assumed liability by the issuance of stock to C should, similarly, have no tax effect on P. Under existing case law it appears that a transaction is still treated as an assumption of liability under section 357(a) even if the corporation makes a prompt or even a prearranged payment of that liability to the creditor. In summary, then, P would recognize $10,000 of gain under the Post-Formation Sale of Property route but none under the Assumption of Liability route.

---

180. Since C ends up with only 20% of Newco’s stock, even under existing law, P alone remains in control of Newco “immediately after the exchange.”

181. I.R.C. § 358(a). P’s basis in his stock is the same as his basis in the land transferred.

182. P’s carry-over basis in all of his stock under § 358(a) would be $50,000, and the allocation to 20 percent of that stock would, therefore, be $10,000.

183. See, e.g., Schults v. Commissioner, 59 T.C. 559, 565 (1973) (transfer of property to satisfy pecuniary debt is treated no differently than “if the debtor issued his check to the creditor in payment of the debt and then received the creditor’s check in payment for the property.”).


185. See supra text accompanying notes 171-173. P’s basis in his stock would, however, be reduced from $50,000 to $30,000 by the $20,000 liability assumed by the transferee corporation. See I.R.C. § 358(d)(1); supra note 171.

186. In the § 351 context, the question, as posed by Bittker & Eustice, supra note 17, § 3.07, at 3-26 to 3-27, is as follows:

[I]f the transferor’s liability is discharged on the transfer (by payment, or by novation between the creditor and the corporate transferee), would this event fall outside § 357(a), on the ground that the transferee neither assumed the debt nor took property subject to it, and generate taxable boot or cancellation of indebtedness income to the transferor? (emphasis in text).

Bittker & Eustice conclude that § 357(a) should cover this situation. They note that the Supreme Court decision in United States v. Hendler, 303 U.S. 564 (1938) specifically included “a prompt (and no doubt prearranged) payment of the assumed liabilities by the transferee corporation.” Hendler had treated the assumption as boot but Congress immediately responded by enacting the predecessor of § 357(a) to overrule Hendler.

The analogous question has arisen in the corporate reorganization area where the treatment of the liability as cash boot can lead to the disqualification of the transaction. See Bittker & Eustice, supra note 17, § 14.55, at 14-176 to 14-177. Courts have generally held that the prompt payment of assumed liabilities by the acquiring corporation does not affect the qualification of the transaction as a reorganization. Stockton Harbor Indus. Co. v. Commissioner, 216 F.2d 658 (9th Cir. 1954), cert. denied, 349 U.S. 904 (1955); Peabody Hotel Co. v. Commissioner, 7 T.C. 600 (1946), aq. 1946-2 C.B. 4; New Jersey Mortgage & Title Co. v. Commissioner, 3 T.C. 1277 (1944), aq. 1945 C.B. 5.
d. The Case for the Assumption of Liability Route

Under existing law, it is apparently the Post-Formation Sale of Stock analysis that would be used to determine tax consequences regardless of the form actually followed to carry out the transaction. Yet, the policy expressed by Congress in enacting the predecessor of section 357 seems to pull in the other direction, i.e., towards the use of the Assumption of Liability route in all cases.

As earlier noted, Congress, in enacting the predecessor of section 357, recognized the business necessity in many incorporations for the transferor to transfer assets subject to liabilities. If a corporation's assumption of (or taking subject to) such liabilities was to result in boot to a transferor, the transferor would be required to pay tax at a time when he was receiving no cash. This surely would be a disincentive to incorporators, and, therefore, contrary to the overall Congressional purpose in enacting section 351.

This statutory purpose behind section 357's enactment seems equally applicable whether the pre-existing business related liability formally assumed by Newco is to be discharged by Newco's cash payment or by its issuance of stock. In neither case will P be receiving any cash in hand with which to pay his taxes. Requiring P to pay tax would, there-

---

187. See BITTNER & EUSTICE, supra note 17, 3.05, at 3-12 to 3-13. The authors state that "such a transaction is to be treated as though all the stock had been issued first to the proprietor in exchange for the assets of his business, with part of it being used by him to pay his debts." Id. As authority, the authors cite §§ 1.351-1(b)(1) and (b)(2) of the Treasury Regulations. Id. at 3-12 n.28. The relevant passages from those regulation sections are as follows:

(b)(1) Where property is transferred to a corporation by two or more persons in exchange for stock or securities ... it is not required that the stock and securities received by each be substantially in proportion to his interest in the property immediately prior to the transfer. However, where the stock and securities received are received in disproportionate to such interest, the entire transaction will be given tax effect in accordance with its true nature, and in appropriate cases the transaction may be treated as if the stock and securities had first been received in proportion and then some of such stock and securities had been used ... to pay compensation ... or to satisfy obligations of the transferor of any kind. (emphasis added)

(b)(2) Example (1). Individuals A and B, father and son, organize a corporation with 100 shares of common stock to which A transfers property worth $8,000 in exchange for 20 shares of stock and B transfers property worth $2,000 in exchange for 80 shares of stock. No gain or loss will be recognized under section 351. If B had rendered services to A (such services having no relation to the assets transferred or to the business of the corporation) and the disproportionate in the amount of stock received constituted the payment of compensation by A to B, B will be taxable upon the fair market value of the 60 shares of stock received as compensation for services rendered, and A will realize gain or loss upon the difference between the basis to him of the 60 shares and their fair market value at the time of the exchange.

Despite the apparent requirement of Reg. §§ 1.351-1(b)(1) and (b)(2), Ex. 1, that the Post-Formation Sale of Stock route be used, Bittker and Eustice, after discussing that Treasury Regulation example, state that "in the alternative, the transaction might be regarded as a transfer of property by the proprietor in exchange for stock and an assumption of his indebtedness by the corporation, followed by a payment of the debt by the corporation." BITTNER & EUSTICE supra note 17, § 3.05, at 3-13.

188. See supra text accompanying notes 171-173.

189. See supra text accompanying notes 101-107.
fore, in both cases tend to discourage necessary business readjustments. This rationale is further expanded in the section that follows, involving the incorporation of a cash basis business.

3. The Case for the Assumption of Liability Route Where the Assumed Liability Would Have Been Deductible Had it Been Paid by the Transferor

   a. The Incorporation of a Cash Basis Business

Comparing the results reached by the Post-Formation Sale of Stock route with the Assumption of Liability route in an incorporation involving Newco's assumption of a liability which would have been deductible had it been paid by the transferor, the case for adoption of the Assumption of Liability route is strengthened. Historically, there were a variety of problems raised where a cash basis proprietorship (or partnership) was incorporated. Most important, for purposes of this article, was the proper tax treatment to be accorded the transfer of zero basis trade accounts receivable to Newco, and Newco's assumption of the proprietorship's deductible trade payables. After years of struggling with these issues, the Service conceded in a 1980 revenue ruling that, as a general rule, the acquiring corporation should simply step into the shoes of the cash basis proprietorship with respect to both the receivables and payables. The corporation should report the collection of the receivables as ordinary income, and deduct the trade payables when it paid them. The justification for the treatment of trade accounts receivable was explained by a former Chief Counsel of the Internal Revenue Service as follows:

It would seem that the basic policy of section 351 is to recognize that the new corporation represents a substantial continuation of the business formerly conducted by the transferor. This policy would suggest the transferor should not be taxed on the accounts receivable and the new corporation should be taxed

---

190. See generally Keller, supra note 148.

191. Id. at 490-95. With respect to accounts receivable, the problem concerned whether the transfer of zero-basis trade accounts receivable to a controlled corporation in exchange for its stock or securities resulted in the recognition of income to the transferor, either at the time of the incorporation transfer or at the later date when the accounts receivable were collected by the transferee corporation. See Hempt Bros., Inc. v. United States, 490 F.2d 1172 (3d Cir. 1974), cert. denied, 419 U.S. 826 (1974). See generally Keller, supra note 148, at 490-95. With respect to trade payables, the question was which party, if either, received a deduction for those payables. See generally id. at 495-98. This problem also involved the effect of the corporation's assumption of a deductible liability on the transferor's basis, including the possibility that the assumption of liabilities might result in gain to the transferor under § 357(c). See generally id. at 495-96. These latter questions were resolved by the enactment, in 1978, of I.R.C. §§ 357(c)(3) and 358(d)(2), which state that assumed obligations which would have been deductible had they been paid by the transferor, are not liabilities for purposes of §§ 357 or 358.


193. These rules may not apply if there is no business purpose for the transfer or the transferor had either accumulated the accounts receivables or prepaid any of the accounts payable in anticipation of the incorporation. Id. at 115. See Keller, supra note 148, at 526-537. See also infra text accompanying notes 195-96.
when it collects them.\textsuperscript{194}

The reason for consistently treating the assumption of cash basis trade payables was clearly set forth by the National Office of the Internal Revenue Service in a 1978 technical advice memorandum.\textsuperscript{195} Because of its significance to the issue under discussion, the bulk of that memorandum's analysis is set forth below:

The Service has long maintained that section 351 of the Code encompasses the transfer of unrealized receivables unless the transaction lacks a business purpose, artificially produces losses, or otherwise distorts the transferor's income. That position is based in large part on the early legislative history of section 351 which indicates that Congress intended by its enactment to eliminate the impediments to business readjustments involving mere changes in form. See H. Rept. No. 350, 67th Cong., 1st Sess. 10 (1921); S. Rept. No. 998, 68th Cong., 1st Sess. 17 (1924). In view of the past and current Service position with respect to unrealized receivables it has been determined that an unrestricted application of the rationale set forth in \textit{Holdcroft Transportation Co. v. Commissioner}, 153 F.2d 323 (8th Cir. 1946) [which denied corporate deduction for assumed payables] is unacceptable.

The same legislative history which we considered as support for the present Service position with respect to accounts receivable also supports a conclusion that the transferee corporation should be accorded the right to deduct expenses of the business, which if not assumed by the transferee would have been deductible by the transferor, if the section 351 transaction is business motivated, does not artificially produce losses for the transferee and does not distort the income of the transferor or transferee.

An example of a distortion of income would be a transfer of accounts receivable to the corporation by a retention by the transferor of expenses payable. Splitting the receivables and payables in this manner results in an artificial creation of losses on behalf of the transferor. The practical effect of present Service position, which considers the splitting of accounts receivable from expenses payable as a distortion of income, is to force transferors to either hold back both the receivables and payables or transfer both to the corporation. Although retaining the receivables and payables would be the safest course from a tax standpoint, from a business point of view it may be economically unsound if the corporation will require working capital.

If the transferor finds it necessary for business reasons to transfer the accounts receivable to the corporation and, in order to clearly reflect income, if he also causes the corporation to assume the expenses payable, it would be anomalous to then create a distortion of income by requiring the corporation to


capitalize the assumed expenses when paid. Income is clearly reflected when the accounts receivable are matched with the expenses payable; the income and expenses are no more matched if the expenses must be capitalized than if the transferor had held back the payables and transferred only the receivables.196

As the following subsections demonstrate, the justification for having the corporation report the collection of accounts receivable and deduct the payments of accounts payable applies equally to a situation in which the corporation discharges the deductible liability by the issuance of its stock, as where it discharges those liabilities with cash. Yet, under existing law, the tax consequences will apparently be entirely different in the two cases.

b. The Example

To illustrate the appropriateness of applying the Assumption of Liability route in a situation in which Newco stock is used (as an integral part of a corporation transaction) to discharge a deductible liability owing by P or P’s proprietorship to C, the following hypothetical facts will be assumed: P’s cash basis proprietorship, with assets worth $100,000 and a basis of $50,000 is to be incorporated. The proprietorship’s assets include $40,000 worth of zero basis trade receivables. The only liability of the cash basis proprietorship is a $20,000 obligation owed to employee C for back wages. It is agreed between P and C that Newco will be formed to own the proprietorship’s assets; that P will own 80 percent and C 20 percent of the Newco stock; and that P’s $20,000 liability to C will be discharged.

c. The Tax Consequences Under the Assumption of Liability Route and the Post-Formation Sale of Stock Route Compared

If the Assumption of Liability route is applied to these facts, the transaction will be taxed as if P had transferred all of the assets to Newco in exchange for $80,000 worth of its stock, and Newco’s assumption of P’s $20,000 deductible obligation to C; and in a separate transaction, Newco had issued $20,000 of its stock to C in discharge of the obligation owed to him.

On these facts, P would recognize no gain and would be entitled to no deductions.197 The corporation would report $40,000 of ordinary income on the collection of the receivables, and would be able to claim a $20,000 deduction on the payment of the payables.198 C would, of course, be required to report $20,000 of ordinary income on receiving the salary payment.199 These are the same tax consequences that would

196. Id.
198. Id.
have resulted had Newco discharged the debt to C in cash rather than stock, the only difference being that where the debt is discharged in stock, C would take a basis of $20,000 in that stock.\footnote{200}

These tax consequences, which would be reached by following the Assumption of Liability route, seem the only rational ones; yet, they are not the results reached under existing law. Under current law, the Post-Formation Sale of Stock route would be applied.\footnote{201} The transaction would presumably be treated as if P first transferred the proprietorship assets (not subject to any liabilities) to the corporation in exchange for all of the corporation’s stock, and then used part of that stock to discharge his obligation to C.\footnote{202} Thus, the fact that C’s debt was discharged by Newco’s issuance of stock rather than its payment of cash would lead to dramatically different tax consequences for both P and the corporation.

Under this Post-Formation Sale of Stock analysis, P (since he continued to own 80 percent of the outstanding stock) would recognize no gain or loss in the initial section 351 transaction; but on the post-formation transfer of 20 percent of his stock (with a basis of $10,000)\footnote{203} to discharge his $20,000 salary obligation to C, P would recognize a $10,000 gain, and would be entitled to an ordinary business deduction in the amount of $20,000.\footnote{204} Yet, while P would be claiming the $20,000 business deduction, the corporation would still be reporting the $40,000 of ordinary income on the collection of the receivables.\footnote{205}

Table 3 below compares the tax consequences resulting from the Post-Formation Sale of Stock and the Assumption of Liability routes.

\footnote{200} The value of the stock received is reported as income. See Reg. § 1.61-2(d)(2).
\footnote{201} See supra note 187.
\footnote{202} Id.
\footnote{203} See id. P’s total basis in all of the shares received in the incorporation would be $50,000, the same basis he had in the proprietorship assets. I.R.C. § 358(a). Consequently, his basis in the 20 percent of the shares transferred would be $10,000.
\footnote{204} When a taxpayer uses appreciated property to discharge a deductible debt, he receives a deduction equal to the fair market value of the property transferred, but must recognize his realized gain on the property. See, e.g., International Freighting Corp. v. Commissioner, 135 F.2d 310 (2d Cir. 1943). Thus, P would be entitled to a $20,000 § 162 business deduction and would recognize $10,000 gain on the disposition of the property.
\footnote{205} See supra text accompanying notes 193-95. Thus, by treating this transaction as a Post-Formation Sale of Stock, the IRS is creating the very results—income at the corporate level, deductions at the shareholder level—that it was trying to eliminate in Rev. Rul. 80-198, 1980-1 C.B. 113. In fact, if the taxpayer purposefully created this situation, the Service would presumably allocate the income to the transferor or the deduction to the transferee. Id. at 115. See Keller, supra note 148, at 956-37.
TABLE 3

<table>
<thead>
<tr>
<th>Post-Formation Sale of Stock Route</th>
<th>Newco's Deduction Upon the Trade Receivables</th>
<th>Newco's Income Upon the Discharge of the Indebtedness to C</th>
<th>P's Deduction Upon the Discharge of the Indebtedness to C</th>
<th>P's Basis in Stock</th>
<th>Newco's Basis in Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>$40,000\textsuperscript{206}</td>
<td>none</td>
<td>$10,000</td>
<td>$20,000</td>
<td>$40,000\textsuperscript{207}</td>
<td>$50,000\textsuperscript{208}</td>
</tr>
<tr>
<td>$40,000\textsuperscript{209}</td>
<td>$20,000</td>
<td>none</td>
<td>none</td>
<td>$50,000\textsuperscript{210}</td>
<td>$50,000\textsuperscript{211}</td>
</tr>
</tbody>
</table>

\(\textit{d. The Case for the Assumption of Liability Route}\)

The numbers in the chart clearly reveal the case for the Assumption of Liability route. Under existing law (The Post-Formation Sale of Stock route), Newco would report $40,000 of ordinary income upon the collection of the trade receivables, but it would be P (if anyone) who would be entitled to the $20,000 business deduction for paying C's salary. This is precisely the result that the Service acknowledged was incorrect in its 1980 ruling.\(\textsuperscript{212}\) Using the Assumption of Liability route, on the other hand, both the income and deduction would be in the corporation. Moreover, under the Post-Formation Sale of Stock route, P would recognize gain on the transaction. As explained earlier, any gain recognition to P in the transaction would be contrary to the underlying policy of section 357.\(\textsuperscript{213}\)

\(\textit{C. Summary}\)

In any integrated P-C incorporation transaction in which C is accepting Newco stock in discharge of a liability owed by P to C, (and which liability is related to the assets being transferred), the transaction should be analyzed as if Newco first assumed P's liability to C, and then,

\(\textsuperscript{206}\) This represents 80 percent of P's $50,000 carry-over basis in the assets transferred. See I.R.C. § 358(a). P has transferred one-fifth of his shares to C.

\(\textsuperscript{207}\) This represents P's $50,000 carry-over basis in the assets transferred. See I.R.C. § 358(a). The basis is not reduced by the deductible liability to C assumed by the corporation. See I.R.C. §§ 358(d)(2), (c)(3).

\(\textsuperscript{208}\) The corporation takes the same basis in the assets that the proprietorship had in them. See I.R.C. § 362(a). The basis is not increased by the gain recognized on P's stock sale to C. The generally accepted rule is that the transferee corporation steps into the shoes of the transferor, preserving intact the old basis of each asset received in the exchange. P.A. Birren and Son v. Commissioner, 116 F.2d 718 (7th Cir. 1940). Thus, for example, the corporation will take the $40,000 of trade accounts receivables with a zero basis, and report the entire $40,000 collected as income.

\(\textsuperscript{209}\) See supra note 208. The corporation's basis is not affected by its assumption of liabilities of the transferor unless the assumption causes gain to the transferor under § 357. See BITTNER & EUSTICE, supra note 17, § 3.12, at 3-49.

\(\textsuperscript{210}\) See supra text accompanying notes 192-96.

\(\textsuperscript{211}\) See id.

\(\textsuperscript{212}\) Rev. Rul. 80-198, 1980-2 C.B. 113; Ltr. Rl. 7830010 (4/14/78), quoted supra in text accompanying note 196. See supra note 205.

\(\textsuperscript{213}\) See supra text accompanying notes 187-89.
in a separate transaction, discharged that liability by issuing stock to C. The application of this Assumption of Liability route will mean that section 351 will always be applicable to the transaction, that P will recognize no gain on the transaction, and that the corporation will be entitled to claim a deduction when it issues stock to discharge the indebtedness to C, if the debt to C would have been deductible had it been paid by C.

SUMMARY AND CONCLUSION

When an individual (P) decides to incorporate his existing business, or to transfer property to a newly formed corporation (Newco) in order to start up a new business, he may find that to be an opportune time to dispose of a partial interest in the pre-existing business or assets to a third party (C) for cash, or to discharge a liability owed by him to C.

Under existing law, however, the entire incorporation transaction will generally be removed from the non-recognition treatment of section 351, if, as part of an overall transaction which can properly be integrated for step transaction purposes, C ends up with more than 20 percent of the Newco stock. Regardless of the formal route used by the parties to achieve their end results, current law will treat the transaction as if P first received all of the stock of Newco and then transferred more than 20 percent of it to a nontransferor of property, C, thereby losing control of the corporation "immediately after the exchange." This article has demonstrated that this well seasoned result is neither required by the literal language of the Code nor justified by the policy objectives of section 351.

Moreover, the article has demonstrated that the current law's application of the Post-Formation Sale of Stock route in cases not involving loss of control always leads to erroneous tax and basis consequences for P and Newco. To reach rational and consistent tax results, whenever P winds up with C's cash and C ends up with Newco stock, the transaction should be taxed in accordance with what the article has called the Boot Transaction route: *i.e.*, it should be taxed as a transaction in which Newco is initially formed by P's transfer of property and C's transfer of cash, with P and C each receiving stock of Newco in the exchange and P receiving as "boot" from the corporation the cash amount just contributed to the corporation by C.

Where, however, C is receiving the Newco stock in discharge of an obligation owed to him by P, the transaction should be taxed using the Assumption of Liability route; that is, it should be taxed as if P first formed the corporation in exchange for all of Newco's stock, plus Newco's assumption of his liability to C, and then Newco, in a separate transaction, issued stock to C in discharge of the liability to C.