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TAX-FREE TRANSFERS TO CONTROLLED CORPORATIONS*

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The federal income tax statutes which are especially pertinent to this subject are set out below.[1] It is suggested that they be read before considering the following discussion.

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[1] INTERNAL REVENUE CODE

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.
(a) *Computation of Gain or Loss.* The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in Section 113(b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.
(b) *Amount Realized.* The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.
(c) *Recognition of Gain or Loss.* In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this chapter, shall be determined under the provisions of section 112.
SEC. 112. RECOGNITION OF GAIN OR LOSS.
(a) *General Rule.* Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.
(b) *Exchanges Solely in Kind.*

* * * * *

(5) *Transfer to Corporation Controlled by Transferor.*
No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange. Where the transferee assumes a liability of a transferor, or where the property of a transferor is transferred subject to a liability, then for the purpose only of determining whether the amount of stock or securities received by each of the transferors is in the proportion required by this paragraph, the amount of such liability (if under subsection (k) it is not to be considered as "other property or money") shall be considered as stock or securities received by such transferor.
(c) *Gain from Exchanges Not Solely in Kind.*
(1) If an exchange would be within the provisions of subsection (b)(1), (2), (3), or (5), or within the provisions of subsection (1), of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph or by subsection (1) to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.
(e) *Loss from Exchanges Not Solely in Kind.* If an exchange would be within the provisions of subsection (b)(1) to (5), inclusive, or (10), or within the provisions of subsection (1), of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such

I. General Rule—Realization and Recognition of Gain or Loss

As a general rule, the receipt of stock or securities as consideration for the transfer of property constitutes an exchange upon which any gain or loss realized is recognized for income tax purposes.[2]

It is important to distinguish between the *realization* and *recognition* of gain or loss. Gain or loss must be both realized and recognized in order for immediate tax consequences to follow.

Gain or loss is *realized* by a transferor as the result of such a transfer measured by the difference between the cost or other basis of the property transferred and the fair market value of the stock or securities received. Note that it is not a question of whether properties of equal present value are swapped:

Example: Property with basis of $10,000 but now worth $20,000 is exchanged for stock worth $20,000. Gain of $10,000 is realized by the recipient of the stock.

If there is no difference between the basis of the propery transferred and the value of the stock or securities received, then no gain or loss is realized and no question of recognition arises. Sometimes, however, gain may be realized by reason of a good will factor in a going business:

Example: A and B are partners operating a business. They organize a new corporation and transfer the business to it for stock. The basis of the assets, other than good will, is equal to the present fair market value of such assets. However, there is a good will factor in the business which has a zero basis and which is fairly worth $10,000. A $10,000 gain is realized as a result of the transfer.

If gain or loss is realized, it is *recognized* under the income tax law unless specifically excepted. Several such exceptions are contained in Section 112 of the Internal Revenue Code. Our concern is with Section 112(b)(5).

II. Non-recognition of Realized Gain or Loss on Transfers to Controlled Corporations

Section 112(b)(5) is based upon the premise that, even though gain or loss may be realized upon the transfer of property for stock or securities, it should not be recognized for income tax purposes if the

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paragraph to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized.

(h) *Definition of Control.* As used in this section, the term "control" means the ownership of stock possessing at least 80 per centum of the total combined voting power of all classes of stock entitled to vote and at least 80 per centum of the total number of shares of all other classes of stock of the corporation.

[2] Int. Rev. Code §111.

result of the exchange is that the transferor retains in substance the same property ownership although revised in form. The purpose of the section is not perpetually to exempt gains or forever to prevent the deduction of losses, but rather to postpone the recognition of gains or losses for tax purposes until the disposition of the stock or securities received as consideration for the property.

Section 112(b)(5) begins by providing that no gain or loss shall be recognized if certain conditions are met. These conditions will be separately examined below in some detail.

A. *"if property is transferred to a corporation."*

1. *"property"*: Any kind of property, real or personal, tangible or intangible, is included. It may, for instance, include real estate,[3] a patent,[4] corporate stock,[5] partnership assets,[6] or cash.[7] For a time, the Commissioner of Internal Revenue refused to recognize that cash was property within the meaning of the statute. This cast doubt upon the effect of bringing in cash capital for the purpose of infusing new capital at the time of incorporation of a business, since the requisite control (discussed below) might not rest in the transferors of property other than cash. However, the Commissioner has agreed that cash is property.[8] Even though services may be valid consideration for the issuance of stock under local law, they do not constitute property.[9]

2. *"corporation"*: The question of whether the transferee is technically a corporation will hardly arise, although the term is defined in I. R. C. Section 3797(a)(3). Nearly always, the section is used in connection with newly formed corporations. It may, however, relate to transfers to old corporations.[10]

B. *"by one or more persons."*

There may be only one transferor or any larger number of transferors.

"Persons" includes individuals, trusts, or estates, partnerships and corporations.[11]

C. *"solely in exchange for stock or securities in such corporation."*

1. *"solely"*: Reading this section alone, one might conclude that an exchange would be entirely taxable (that is, the entire realized gain or

[3] U. S. Treas. Reg. 111, §29.112(b)(5)-1.
[4] Claude Neon Lights, Inc., 35 B. T. A. 424 (1937).
[5] G. C. M. 7285, IX-1 Cum. Bull. 181.
[6] Halliburton v. Comm'r., 78 F. 2d 265 (9th Cir. 1935).
[7] Halliburton v. Comm'r., *supra* note 6, Cyrus S. Eaton, 37 B. T. A. 715 (1938).
[8] G. C. M. 24,415, 1944 Cum. Bull. 219.
[9] See Columbia Oil and Gas Co., 41 B. T. A. 38 (1940).
[10] *Cf.* F. L. G. Straubel, 29 B. T. A. 516 (1933).
[11] U. S. Treas. Reg. 111, §29.112(b)(5)-1.

loss would be recognized) if anything other than stock or securities of the transferee corporation were received. However, another statute makes it clear that if an exchange would be within the provisions of Section 112(b)(5) except for the fact that money or other property is received in addition to stock or securities, the gain, if any, is recognized, but in an amount not in excess of the amount of money and the fair market value of the other property.[12] In such a situation, no loss is recognized.[13] This is sometimes called a "boot" provision. The receipt of such boot results in what is usually called a "partly taxable exchange."

Example: In an otherwise non-taxable exchange, A transfers property with a basis of $10,000 and now worth $20,000 to a newly formed corporation for stock worth $15,000 plus $5,000 in cash. A realizes a gain of $10,000, but only $5,000 of the gain is recognized (*i.e.*, the lower of the actual gain or the cash or non-exempt property received).

2. *"stock or securities"*: Stock is generally distinguished from securities in that stock represents a proprietary interest in the corporation whereas securities represent a creditor interest in the corporation. Looking at the statute alone, it would be concluded that a transferor could get either stock or securities or a combination of both without endangering the tax-free nature of the transfer. However, because of the requirement of a *continuity of proprietary interest* written into the corporate reorganization provisions by the United State Supreme Court,[14] it now appears that, in order for a transfer to be tax-free, each proprietor-transferor must at least receive a stock interest in the corporation which is substantial in relation to the value of the property transferred. Thus, such a transferor may receive only stock, or he may receive a combination of stock and securities, provided he receives a substantial amount of stock. If, however, he receives only securities, the exchange may be taxable. The law on this subject is not too clear but it should be assumed to be as stated in planning a tax-free incorporation.

Tax advantages which may accrue from the issuance of securities (as distinguished from stock) on incorporation may include: (a) deductibility of interest by the corporation, (b) minimization of the dangers of the penalty surtax on unreasonable accumulation of surplus under I. R. C. Section 102, and (c) avoidance of a tax on dividends under I. R. C. Section 115(g) upon payment of the securities (as contrasted with the tax which may be payable if stock is redeemed).[15]

[12] INT. REV. CODE §112(c).
[13] INT. REV. CODE §112(e).
[14] See LeTulle v. Scofield, 308 U. S. 415 (1940).
[15] Bernstein, *Tax Problems in the Formation and Operation of a Corporation*, 27 TAXES 558 (Jan. 1949).

But it is a precarious thing for proprietors to have securities issued to them in exchange for proprietary interests, and such an issuance should be undertaken only after careful study of the possible tax consequences.[16] Particular attention should be directed to the ratio of stock and securities to avoid an excessively heavy debt structure, and to the possibility that what is denominated a security may be held to be stock[17] or the equivalent of cash (see discussion below). This is an area of tax avoidance which may be expected to be narrowed by the courts or by Congress.

3. *"securities":* Anything that is considered the equivalent of cash is not a security.[18] It is likely that any short-term obligations, whether notes, debentures, or bonds, will be held not to be securities.[19] Five-year bonds have been held not to be securities.[20] On the other hand, corporate notes having a maturity of twenty years have been held to be securities,[21] even though callable on any interest payment date more than two years after issuance.[22] It has been suggested that any obligation evidenced on paper which has a maturity of ten years or longer will probably qualify as a security.[23] If a transferor who realizes gain receives stock in the transferee corporation and obligations which are not considered to be securities (*e.g.*, short-term notes), the result will be at least a partly taxable exchange, since the obligations will qualify as "boot."

D. *"and immediately after the exchange such person or persons are in control of the corporation."*

1. *"immediately":* The exchange itself does not have to be completed immediately or simultaneously but only with reasonable expedition.[24] However, requisite control must exist immediately after the exchange is completed, which means that it need not exist for any particular length of time. Difficulty may be encountered where there exists at the time of the exchange some prearranged plan or obligation to dispose of stock after the exchange. It seems that the existence of a mere plan or purpose to dispose of stock will not be sufficient to destroy the necessary control. For instance, it has been held that a plan to give stock to relatives following the exchange will not cause an otherwise non-taxable exchange to be taxable.[25] On the other hand,

[16] See Schlesinger, *Thin Incorporations' Income Tax Advantages and Pitfalls*, 61 HARV. L. REV. 50, 58 (1947).
[17] *Cf.* Swoby Corp., 9 T. C. 887 (1947).
[18] Pinellas Ice & Cold Storage Co. v. Comm'r., 287 U. S. 462 (1933).
[19] Schlesinger, *supra* note 16, at 67; Weiss, *Notes as Securities Within Section 112(b)(3)*, 26 TAXES 228 (March 1948).
[20] Worchester Salt Co. v. Comm'r., 75 F. 2d 251 (2d Cir. 1935).
[21] Estelle Pardee Erdman, T. C. Memo. Op. Jan. 25, 1946.
[22] Mary N. Crofoot, T. C. Memo. Op. Jan. 25, 1945.
[23] Schlesinger, *op. cit. supra* note 16.
[24] U. S. Treas. Reg. 111, §112(b)(5)-1.
[25] Wilgard Realty Co. v. Comm'r., 127 F. 2d 514 (2d Cir. 1942); *cf.*, Roberts

the existence of a preexisting obligation to dispose of stock may prevent the existence of the requisite control.[26] If any transfer is contemplated of an interest in property or in a business which is about to be transferred to a corporation, it would seem better to transfer such interest well in advance of the transfer to the corporation (letting the transferee receive stock therefor), rather than to transfer stock shortly after the transfer to the corporation.

2. *"control":* Control is precisely defined by the law as meaning the ownership of stock possessing at least 80 per cent of the total combined voting power of all classes of stock entitled to vote and at least 80 per cent of the total number of shares of all other classes of stock of the corporation.[27] Control is based on ownership, not the actual exercise of control. The requirement is conjunctive—the transferor (or transferors as a group) must own stock possessing at least 80 per cent of the *voting power* of the corporation *and* at least 80 per cent of the total *number* of shares of all other classes of stock. It is not necessarily sufficient to own 80 per cent *in value* of the entire outstanding stock of the corporation.

E. *"but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange."*

1. *Two or more classes of stock issued:* If, for example, there are two transferors and voting common and non-voting preferred are issued, the proportionate interest requirement may be satisfied even though one transferor receives only common and the other transferor receives only preferred.[28]

2. *Stock and securities issued:* There is a difference of opinion about whether the proportion must be maintained with respect to each transferor separately (i) as to the stock and (ii) as to the securities.[29] To

Co., 5 T. C. 1 (1945); *but cf.*, Heberlein Patent Corp. v. United States, 105 F. 2d 965 (2d Cir. 1939) (prearranged transfers to donees held to take the transaction outside §112(b)(5)).

[26] Halliburton v. Comm'r., 78 F. 2d 265 (9th Cir. 1935); Hazeltine Corp. v. Comm'r., 89 F. 2d 513 (3d Cir. 1937); W. & K. Holding Corp., 38 B. T. A. 830 (1938).

[27] INT. REV. CODE §112(h).

[28] *Cf.* Mather & Co., 7 T. C. 1440 (1946), *aff'd*, 171 F. 2d 864 (3d Cir. 1949), *cert. denied*, 69 Sup. Ct. 1049 (1949); F. L. G. Straubel, 29 B. T. A. 516 (1933). The control requirement discussed above would be satisfied, since the two transferors own all of the stock. It may be important to determine whether the value of what each receives is in proportion to his interest in the property before the transfer, and this will be affected by the value of the stock received.

[29] *E.g.*, if A and B each owns one-half interest in a business and common stock and long-term bonds are issued by the transferee corporation, must each receive one-half of the stock and one-half of the bonds? *Cf.* MERTENS, LAW OF FEDERAL INCOME TAXATION, §20.44 at 167; George P. Skouras, 45 B. T. A. 1024 (1941).

be on the safe side, the stock taken separately and the securities taken separately should each be issued in proportion to the property interests.[30]

3. *Measuring differences in proportion:* There is presently a division of authority about the proper way to measure differences in proportion between the value of the interests transferred and the value of the stock or securities received.

The weight of authority supports the so-called "relative value" test.[31] Under this test, the dollar value of the interest transferred by each transferor is compared with the value of the stock or securities received by him. This comparison may give a certain amount of gain or loss. The ratio of this gain or loss to the value of the interest transferred is then obtained. The "spread" between the ratio of the transferor having the greatest gain and the ratio of the transferor having the greatest loss is then determined.[32]

The other test is the so-called "control" test.[33] Under this test, the ratio of the interest of each transferor in the property transferred is compared with the ratio of his interest in the stock or securities received.

An example showing the difference in results under the two methods follows:

Example: A transfers property worth $190,000 to newly formed corporation X, receiving stock worth $189,000, and B transfers property worth $10,000, receiving stock worth $11,000.

	Value of Assets Transferred		*Value of Stock Received*		(e) *Gain or Loss*	(f) *Diff. between (b) and (d)*	(g) *Ratio of gain or loss (e) divided by (a)*
	(a) *Amount*	(b) *% to total*	(c) *Amount*	(d) *% to total*			
"A"	$190,000	95%	$189,000	94.5%	—$1000	—0.5%	— 0.53%
"B"	10,000	5%	11,000	5.5%	+$1000	+0.5%	+10.00%
Tot.	$200,000	100%	$200,000	100%	$ 0		

The so-called "relative value" test shows a spread between the gain and loss ratios of more than 10 per cent (column (g)). The so-called "control" test shows a spread of only one per cent (column (f)).

Having determined the spread, it is necessary to decide whether or not it is too great to fulfill the substantial proportion requirement. In the example given, it seems clear that the spread is too great under the relative value test, but not too great under the control test. A spread

[30] Schlesinger, *op. cit. supra* note 16, at 68.

[31] United Carbon Co. v. Comm'r., 90 F. 2d 43 (4th Cir. 1937); Bodell v. Comm'r., 154 F. 2d 407 (1st Cir. 1946).

[32] In the Bodell case, *supra*, it appeared that all of the transferors realized losses, and the spread between the greatest loss and the least loss was determined.

[33] Mather & Co. v. Comm'r., 171 F. 2d 864 (3d Cir. 1949), *cert. denied*, 69 Sup. Ct. 1049 (1949).

of more than 2 or 3 per cent will likely be held to exceed the maximum allowable.[34]

F. *"Where the transferee assumes a liability of the transferor, or where the property of a transferor is transferred subject to a liability, then for the purpose only of determining whether the amount of stock or securities received by each of the transferors is in the proportion required by this paragraph, the amount of such liability (if under subsection (k) it is not to be considered as 'other property or money') shall be considered as stock or securities received by such transferor."*

The regulations give the following simple illustration of the operation of this provision:

Example: A and B, individuals, each owns property with a fair market value of $100,000 on July 1, 1942. There is a purchase money mortgage on A's property of $50,000. On July 1, 1942, A and B organize the X Corporation, to which they transfer the property above described for the entire capital stock of the X Corporation and the assumption by the X Corporation of A's purchase money mortgage. The X Corporation's capital stock is divided as follows: $50,000 to A and $100,000 to B. Nevertheless, for the purpose of determining whether the transferors received stock or securities substantially in proportion to their interests in the properties transferred, as required by Section 112(b) (5), A is deemed to have received stock or securities to the extent of $100,000, since his $50,000 purchase money mortgage, assumed by the X Corporation, is also to be treated as stock or securities received by him. Accordingly, under the facts as stated, the proportions required by Section 112(b) (5) exist.

In other words, where a liability of a transferor is assumed, the amount of the assumed liability is added to the stock or securities received by the transferor in determining whether the proportionate interest requirement is met.

Liabilities assumed may be of a joint nature, which is usually the case where a partnership is incorporated.

A limitation of yet undetermined scope on the operation of the assumption of liability provision is contained in Subsection (k) of Section 112. This limitation is to the effect that if it appears that the principal purpose of the taxpayer with respect to the assumption of a liability (or acquisition of property subject to a liability) was to avoid federal income tax on the exchange, or was not a bona fide business purpose, then the amount of the liability will be treated as if it were money received by the taxpayer. (This would mean that, if the other

[34] *Cf.* Ared Corp. 30 B. T. A. 1080 (1934); Bodell v. Comm'r., 154 F. 2d 407 (1st Cir. 1946); see also 495 CCH Std. Fed. Tax. Rep., ¶8718.

statutory conditions were met, any gain realized on the exchange would be recognized to the extent of the liability.)

Does this mean that a sole proprietorship cannot be incorporated tax-free if the principal purpose is to avoid federal income taxes on future business income? Rather obviously the answer should be in the negative, for the statute refers not simply to the avoidance of federal income taxes, but to the avoidance of federal income taxes *on the exchange.* The type of transaction which was probably envisaged was one where one tries to convert what is in substance a sale into a tax-free exchange.

Example: A owns a valuable office building which is unencumbered. He borrows on it to the hilt, and then immediately transfers it to a newly formed corporation for its stock, subject to the liability. The amount of the liability would in all likelihood be treated as money received by A.

The question of what is a bona fide business purpose within the meaning of Subsection (k) is more uncertain.[35] Does this mean that the liability must be a business liability? Upon the incorporation of a partnership, may the transferee corporation assume personal income tax liabilities of the partners arising out of the prior operation of the business? The Commerce Clearing House Standard Federal Tax Reports state that such liabilities may rightly be assumed—that the assumption need not be confined to business liabilities.[36] However, the Commissioner may not agree. In view of the existent uncertainty, the taxpayers would do well to be careful about the assumption of any liabilities other than those arising out of the prior operation of the business which is incorporated, or those which were placed on the property transferred well in advance of the transfer. Certainly, it would be inadvisable for the corporation to assume purely personal liabilities of the transferor, such as liabilities for rent, grocery or medical bills.[37]

III. Basis of Transferred Property and Stock or Securities Received

The statutory purpose of postponing the recognition of gain or loss until a better day is given vital aid by the basis provisions of Section 113. The applicable provisions are outlined below.

[35] See Halperin, *Issuance of Obligations Upon Incorporation*, 25 Taxes 450 (May 1947).

[36] 492 CCH ¶751G.01.

[37] There is a broader question of whether the general independent or corporate business purpose requirement, applicable to corporate reorganizations generally, applies to Section 112(b)(5). One author argues convincingly that it does not apply. Schlesinger, *op. cit. supra* note 16, at 59. See also W. & K. Holding Corp., 38 B. T. A. 830 (1938).

A. *Entirely tax-free exchange:*

1. *Transferred assets:* Retain the same basis in the hands of the transferee corporation that they had in the hands of the transferor, irrespective of whether liabilities are assumed (or the assets are transferred subject to liabilities) or whether the stock or securities were the sole or only part of the consideration for the transfer.[38]

2. *Stock or securities received:* Take the same basis which the property transferred had in the hands of the transferor, except that if any liabilities were assumed (or if property was transferred subject to any liabilities) the basis is reduced by the amount of the liabilities.

B. *Partly taxable exchange:*

1. *Transferred assets:* Basis is the same as the basis in the hands of the transferor immediately before the transfer, increased by the amount of any gain or reduced by the amount of any loss recognized to the transferor upon the transfer.

2. *Stock or securities received:* Basis is the same as the basis of the property transferred, decreased by the amount of money received by the transferor or transferors, and increased by the amount of any gain or decreased by the amount of any loss recognized to the transferor upon the transfer.[39] If the transferor received stock or securities permitted to be received without the recognition of gain, and, in addition, received other property, the basis determined as aforesaid must be allocated between the several properties (other than money) and for this purpose the other property is taken at its fair market value at the date of the exchange.

Example: A, the owner of a manufacturing plant, transferred it to B corporation in exchange for all of B's stock, the assumption of a $30,000 mortgage on the plant and an interest-bearing 2-year debenture of $25,000 (worth face value). The property transferred had a basis to A of $175,000. The stock received had a fair market value of $300,000. In determining the basis to A of the stock and note, A's recognized gain must first be determined, since recognized gain serves to increase the basis. This gain is computed as follows:

A received:	$300,000 in stock
	30,000 liability assumed
	25,000 debenture
Total	$355,000
Less	175,000 basis of property transferred
	$180,000 A's *realized* gain

[38] INT. REV. CODE §113(a)(8).

[39] For this purpose, a liability assumed, or property taken subject to a liability, is considered to be money received by the transferor in the amount of the liability.

In determining recognized gain, the liability assumed is not considered to be money or other property. However, the short-term debenture not being a "security," is treated as other property. Hence, A's *realized* gain of $180,000 is recognized to the extent of $25,000. A's aggregate basis for the stock and debentures is:

	$175,000	basis of property transferred
Less	30,000	liability assumed, considered for basis purpose as money received
	$145,000	
Plus	25,000	recognized gain
Total	$170,000	basis of stock and debenture

In allocating the aggregate basis between the stock and debenture, the latter is taken at its fair market value, $25,000, leaving as the basis of the stock $145,000. The basis of the property to B corporation is the basis of the property transferred, $175,000, plus A's recognized gain, $25,000, or a total basis of $200,000.

IV. Advisability of Making Exchange Taxable

In some instances it may be advisable purposely to make an exchange taxable.

Where property has a low basis when compared with its present value, it may be desirable to "step up" the basis of this property, and correspondingly the basis of the stock received, by causing immediate recognition of the gain realized on the transfer. The price is the payment of an immediate tax by the transferor, which, however, may be taxable in whole or in part at long-term capital gains rates. In the case of depreciable property, the benefits derived will include a higher basis for the purpose of depreciation of the property in the hands of the transferee corporation. In the case of depreciable or non-depreciable property, the transferee corporation will have a higher basis for the purpose of computing gain or loss on any subsequent sale of the property. Likewise, the transferor will have a higher basis for the stock received. Where a future sale of the property or the stock is contemplated, such higher basis (particularly in the case of property likely to increase substantially in value), will tend to prevent the pyramiding of gains in one taxable year.[40]

Where property has a high basis when compared with its present value, it may be assumed that the exchange should be purposely made taxable so that the transferor can deduct the loss realized on the exchange. Such an assumption should be examined carefully. If the

[40] Note that this pyramiding factor may be subject to a limit in the case of capital assets, such as stock, subject to the long-term capital gains rates.

property transferred is a capital asset, any loss realized would be a capital loss, the deductibility of which is subject to rather severe limitations. Moreover, any realized loss of an individual transferor could not be deducted if the transferee corporation should qualify as a "related taxpayer"; that is, a corporation in which the transferor owned, directly or indirectly, more than 50 per cent of the stock. For this purpose, an individual is considered to own stock owned by members of his family or by his partner.[41] Finally, the the basis of the property in the hands of the transferee corporation would be reduced by the amount of any loss recognized to the transferor.[42]

In net result, it is probable that the instances where taxpayers purposely make transfers taxable, where they could otherwise be made taxfree, are rare.

V. Steps in the Incorporation of a Partnership

A tax-free incorporation of a partnership may be accomplished by either of two methods:

(1) The partnership assets are transferred to the partners (usually subject to the partnership liabilities) and the partners transfer the parnership assets (subject to the partnership liabilities) to the corporation in exchange for stock; or

(2) The partnership assets (usually subject to the partnership liabilities) are transferred directly to the corporation in exchange for the stock of the corporation, and the partnership then distributes the stock to the partners. A short cut often taken here involves the distribution of the stock directly to the partners from the corporation.

In either event, it is essential that the partners receive stock, or stock and securities, in proportion to their net interests in the business. By reason of differences in withdrawals, the agreed capital ratio may not have been maintained. It is probably preferable that this ratio be restored either by contributions to or withdrawals from capital before making the transfer to the corporation.[43] If the ratio is restored the stock should be issued in this ratio. If it is not restored, the stock should be issued to accord with the interests as they may appear at the time of the transfer.

Although the amount of stock to be issued for the partnership assets is immaterial for tax purposes so long as the proportionate interest requirement is met, it is fairly customary to issue stock, the aggregate par value of which is equal to the net book value (or net worth per books) of the assets transferred to the corporation.

[41] Int. Rev. Code §24(b).
[42] In this connection, it should be remembered that no loss is recognized on a partly taxable exchange. Int. Rev. Code §112(e).
[43] See Fink, *Exchanging Property for Stock*, 24 Taxes 1069 (Nov. 1946).

The published position of the Bureau of Internal Revenue, as indicated by G. C. M. 20,251[44] and I. T. 2010,[45] is to the effect that on the complete liquidation of a partnership (a) the aggregate basis of the partnership interests is allocated among the assets received in proportion to the respective values of the assets received, and (b) if cash as well as other property is received, the basis of the partnership interests is first reduced by the cash and the remaining basis is allocated among the other property. Tax commentators have pointed out that the consequent reshuffling of basis of partnership assets which will in all probability occur under the Bureau's published position if method (1) above is used may have undesirable effects upon the basis of the assets in the hands of the corporation to which they are transferred by the partners—as, for example, a stepped-down basis for inventory and a stepped-up basis for fixed assets or good will. By the same token, however, it is stated that a selective transfer of assets to the corporation may result in tax advantages through a stepped-up basis of assets. It has been surmised that, in any event, a reallocation of basis may be avoided by following the direct transfer route under method (2) above.

Knowledge is becoming fairly widespread that the Bureau in practice does not follow the published position stated in the preceding paragraph. Reliable information has come to light that G. C. M. 20,251, *supra*, has been overruled by *unpublished* G. C. M. 23,415. The result is that the Bureau, following the joint ownership rather than the entity theory of partnership, would hold that ordinarily there is no reallocation of basis upon the complete liquidation of a partnership. Hence, on a tax-free incorporation of a partnership, the basis of the assets in the hands of the partnership carries over unchanged in the hands of the corporation, irrespective of which method is followed in incorporating the partnership.

Based upon the published position of the Bureau, a warning has been issued that a taxable gain may be recognized as a result of a partnership liquidation by the distribution of cash, if the assets intended to be transferred to the corporation (or the stock received by the partnership in exchange for such assets) are distributed to the partners *before* (a) conversion of non-cash assets by the partnership which are intended to be reduced to cash and (b) distribution of that and other withheld cash.[46] In other words, the warning is to the effect that cash to be retained by the partners should be distributed to them no later than

[44] 1938-2 Cum. Bull. 169.
[45] III-I Cum. Bull. 46.
[46] Schlesinger, *op. cit. supra* note 16; Schlesinger, *Caveat Reiterated: Planning Partnership Liquidations to Avoid Risk of Capital Gain*, 27 TAXES 731 (Aug. 1949).

simultaneously with the distribution of the other partnership assets (or stock for which the assets have been exchanged). However, it is understood that the practice of the Bureau[47] is not to recognize any gain on the liquidation of a partnership unless a partner receives more than his allocable share of the cash, or possibly unless the partners take specific assets for their interest in the business rather than undivided shares in all of the assets. In such latter events, the partners are deemed to have made taxable sales or exchanges of all or part of their partnership interests, upon which any gain realized will be recognized. (Presumably in the cash situation a "boot" rule might be followed in determining the recognized gain—*i.e.*, gain recognized to the extent of the lesser of the gain or cash.) Also in such events, changes of basis of the assets would be indicated.

In view of the published and unpublished Bureau positions and the warning mentioned, what is the safest route to take in incorporating a partnership in order to avoid taxable gain and a reshuffling of basis? It would seem that method (2) above should be followed; that if any cash is to be retained by the partners, the distribution timing indicated by the warning should be observed; and that each partner should receive only his proportionate share of the cash (or any other assets) to be retained by the partners.[48]

[47] *Cf. unpublished*, G. C. M. 23, 415, *supra*.

[48] The retention of cash or other property by the partners may be desirable in order to avoid the imposition of any penalty surtaxes under INT. REV. CODE §102. See Schlesinger, *op. cit. supra* note 46.