

**SECTION 351
TRANSACTIONS AND RELATED ISSUES**

by

R. DAVID WHEAT, *Dallas*
Thompson & Knight LLP

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CHAPTER 3

Biography

R. David Wheat
Thompson & Knight LLP
1700 Pacific Avenue, Suite 3300
Dallas, Texas 75201
(214) 969-1468
E-mail: david.wheat@tklaw.com

David Wheat is a senior partner in the Dallas office of Thompson & Knight LLP. He has an L.L.M. in Taxation from NYU. He is Past Chair of the ABA Corporate Tax Committee. He is also a former Chair of the Dallas Bar Tax Section and the State Bar of Texas Tax Section. David Wheat has been voted by his peers as one of the Best Lawyers in Dallas in his field and has been selected one of the Best Lawyers in America. His practice focuses primarily on federal income taxation, with an emphasis on corporate and partnership tax, financing transactions and mergers and acquisitions.

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TAX PLANNING FOR SECTION 351 TRANSACTIONS

by R. David Wheat, Thompson & Knight LLP¹

I. NUTS AND BOLTS OF SECTION 351

A. Legislative History and Rationale of Section 351

In the absence of Section 351, a person who transfers property to a corporation in exchange for a corporation's stock recognizes gain under Section 1001 equal to the difference between the fair market value of the stock received and the adjusted tax basis of the property transferred. Section 351(a) provides an exception to this general rule. Under Section 351(a), no gain or loss is recognized by a transferor of property to a corporation in exchange solely for common stock and certain types of preferred stock if the transferors are in control of the transferee corporation (within the meaning of Section 368(c)) immediately after the transfer.

A version of Section 351 has been included in the Internal Revenue Code since the Revenue Act of 1921.² In 1989, Congress amended Section 351 to repeal non-recognition treatment for securities received by a transferor in the exchange. In 1997, Congress amended Section 351 to exclude the receipt of nonqualified preferred stock from non-recognition treatment.

The rationale of non-recognition treatment under Section 351 is that the transfer of property is not a closed transaction because a transferor has not economically cashed in its position in the transferred property. Rather, the transferor continues to indirectly own the transferred property through its ownership of the transferee corporation's stock and thus, there has been a mere change in the form of ownership.³

B. Overview of Requirements

Section 351 provides non-recognition treatment only if the following statutory requirements are satisfied:

1. There must be a transfer of "property" to a corporation;
2. The transferors must receive solely common stock or preferred stock that is not nonqualified preferred stock of the transferee corporation; and
3. Immediately after the transfer, the transferors must be in control of the transferee corporation within the meaning of Section 368(c).

C. Tax Consequences to Transferors and Transferees

1. General Tax Consequences to Transferors

If all of the Section 351(a) requirements are satisfied, the transferor will not recognize any gain or loss on the transfer of property to the corporation. The transferor's basis in the stock received will equal the basis of the property transferred, and the transferor's holding period in the property transferred will carry over to the stock received.⁴

If, as part of the transaction, the transferor receives boot (i.e., other consideration in addition to the transferee corporation's common stock or preferred stock that is not nonqualified preferred stock), Section 351(b) requires the transferor to recognize gain equal to the lesser of: (1) the gain that would be recognized under Section 1001 if the transferor were treated as selling the property transferred and (2) the fair market value of the boot received. The character of any gain recognized generally is determined to be ordinary or capital, long-term or short-term, based on the property contributed. Section 351(b)(2) prohibits the recognition of any realized loss. The transferor's basis in the boot received is equal to its fair market value and the stock is given a basis equal to the basis of the property transferred, subject to adjustments discussed below.⁵ If the transferor contributes more than one property and receives both stock and boot, the boot received is apportioned among the property transferred based on their relative fair market values to determine the amount of gain realized.⁶

The transferor's basis in the stock received is reduced by the amount of money and fair market value of property received and increased by the amount of gain recognized.⁷ The transferee corporation's assumption of liabilities generally is treated as money received and thus, the transferor's basis in the stock received is reduced by the amount of liabilities assumed.⁸ Nonetheless, liabilities the payment of which would give rise to a deduction ("Section 357(c)(3) liabilities") are not treated as money received, and thus, generally do not reduce the transferor's basis in the stock received.⁹ Section 358(h) contains an exception, however, in cases where the basis of the property contributed exceeds its fair market value. In that situation, the transferor's basis in the stock received is reduced by the amount of the Section 357(c)(3) liabilities assumed but not below the fair market value of the contributed property.

2. Definition of “Nonqualified Preferred Stock”

An exchange of property qualifies under Section 351(a) only if the transferor receives the transferee’s common stock or its preferred stock that is not “nonqualified preferred stock.” Although nonqualified preferred stock should count favorably to determine the “control immediately after” requirement, the receipt of nonqualified preferred stock is treated as boot. Nonqualified preferred stock is preferred stock having any of the following four characteristics:

- (1) The holder has the right to put the stock to the issuer or a related party within 20 years of the issue date,
- (2) The stock is subject to a mandatory redemption by the issuer or a related party within 20 years of the issue date,
- (3) The issuer or a related party has the right to call the stock and, as of the issue date, it is more likely than not, that the right will be exercised within 20 years of the issue date, or
- (4) The dividend rate varies in whole or in part (directly or indirectly) by reference to interest rates, commodity prices, or other similar indices, regardless of whether such varying rate is provided as an express term of the stock (e.g., adjustable rate stock) or as a practical result of other aspects of the stock (e.g., auction rate stock).

“Preferred stock” is stock that “is limited and preferred as to dividends and does not participate in corporate growth to any significant extent.”¹⁰ The legislative history of Section 351(g) states that “in no event will a conversion privilege into stock of the issuer automatically be considered to constitute participation in corporate growth.”¹¹ Apparently this language was added to make clear that only a meaningful conversion privilege will constitute participation in corporate growth. That is, the conversion provision must be such that there is a reasonable possibility that the conversion will occur. Further, the legislative history makes clear that conversion must be into stock of the issuer rather than stock of the issuer’s parent or another related party.¹²

Based on the foregoing, taxpayers seeking to receive preferred stock tax-free in a Section 351 transaction should consider adding a meaningful conversion privilege to the stock or other features such that the holder has an opportunity to participate in the “upside” of the corporation. Alternatively, the parties could make the stock perpetual (i.e., not redeemable or callable) or very long-term preferred stock (subject to a put or call right that is exercisable more than 20 years from the issue date).

Generally a redemption or put right will not cause preferred stock to be treated as nonqualified preferred

stock when the stock received is not publicly traded and the put right or redemption right may be exercised only upon the death, disability or mental incompetence of the holder.¹³ Further, a redemption or put right will not cause stock to be treated as nonqualified preferred stock in the case of a right or obligation to redeem preferred stock transferred in connection with the performance of services or if the right may be exercised only on the holder’s separation from service.¹⁴

3. Securities

Before Congress amended Section 351(a) in 1989, an exchange of property for the transferee corporation’s securities could be accomplished tax-free.¹⁵ Since 1989, however, securities are treated as boot, and thus, a transferor will recognize gain equal to the fair market value of any securities received in a Section 351 exchange, unless the installment method is available under Section 453.

4. Stock Warrants and Stock Rights

Warrants and rights to acquire the transferee corporation’s stock are treated as boot, and thus, cannot be received tax-free in a Section 351 exchange.¹⁶

5. Put Rights - Rev. Rul. 69-265

The IRS in Rev. Rul. 69-265 concluded that certain put rights are boot.¹⁷ Situation 1 of Rev. Rul. 69-265 involved a triangular C reorganization where the target shareholders received parent corporation stock plus the right to convert their parent stock into grandparent stock at any time after five years from the date of the reorganization by presenting their parent stock to grandparent who would directly issue its stock to the shareholders. The IRS concluded in Rev. Rul. 69-265 that such a put right was property separate from the transferee corporation’s stock, and thus, constituted boot.

By contrast, in Situation 2 of Rev. Rul. 69-265, the grandparent would contribute its shares to parent at the time of the conversion and the shareholders would put their parent stock to parent in exchange for grandparent stock. The IRS did not treat this put-redemption right as boot. Instead, the IRS viewed the conversion as a distribution of grandparent stock in redemption of parent stock that is subject to the provisions of Section 302.

Therefore, if the transferee corporation distributes its stock to the transferors in a Section 351 exchange but gives the transferors the right to exchange their transferee corporation stock for stock of the transferee’s parent, such right will be treated as boot if the right is exercisable against the parent.

6. Contingent Stock - Rev. Proc. 84-42

The term “stock” for purposes of Section 351 may include stock whose receipt by the transferor is contingent upon some future event such as future income targets of the transferee corporation if the following requirements are satisfied:¹⁸

- (1) All of the contingent stock must be issued within five years from the date of the transaction.
- (2) There must be a valid business purpose for not issuing all of the stock immediately.
- (3) The maximum number of shares that may be issued must be stated.
- (4) The contingent right must not be assignable, except by operation of law, or if the agreement does not prohibit assignments, must not be evidenced by a negotiable certificate, and must not be readily marketable.
- (5) The contingent right must give rise only to the receipt of additional stock of the transferee corporation.
- (6) At least 50% of the maximum number of shares of each class of stock that may be issued must be issued at the time of the initial transaction.
- (7) The stock issuance must not be triggered by an event the occurrence or nonoccurrence or which is within the shareholders’ control.
- (8) The issuance of the contingent stock rights must not be triggered by the results of an IRS audit either with respect to the transaction or certain parties related to the transaction.
- (9) The event for determining whether the contingent shares are to be issued and the number of shares to be issued must be objective and readily ascertainable.

Even if all of the above requirements are not met, contingent stock rights may be treated as stock for purposes of Section 351 because case law generally does not require that all of the above requirements be satisfied.¹⁹

7. General Tax Consequences to Transferees

The transferee corporation recognizes no gain or loss upon the issuance of its stock for money or other property.²⁰ The corporation receives tax-free treatment even if the transaction does not qualify under Section 351. The corporation’s basis in the property received will be the same as the transferor’s basis in the transferred property increased by any gain recognized by the transferor.²¹ The corporation’s holding period in the property received includes the transferor’s holding period.²²

D. “Control Immediately After” Requirement

1. Overview

Non-recognition treatment applies only if the transferors control the transferee corporation within the meaning of Section 368(c) immediately after they transfer property to the transferee corporation. Section 368(c) control means:

[T]he ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

Thus, the control test under Section 368(c) is satisfied if the transferors own at least 80% of the total voting stock of the transferee corporation and at least 80% of each class of non-voting stock. No constructive stock ownership rules apply to determine whether the control test is met (except for consolidated groups) and thus, only stock directly owned is taken into account.

2. The Control Group

The Section 368(c) control test is applied on an aggregate basis and thus, can be satisfied by counting the stock received by multiple transferors even if no one transferor has the requisite control.²³ Multiple transferors can be treated as a control group even if they do not make simultaneous transfers of property, but the regulations require an agreement that defines the rights of the group and the agreement must be effected “with an expedition consistent with orderly procedure.”²⁴ Thus, although the transfers need not be simultaneous, they should be consummated without too long of a delay between transfers.

3. The “Immediately After” Requirement and the Application of the Step Transaction Doctrine

Section 351(a) is satisfied only if the transferors are in control of the transferee corporation “immediately after” the transfers. Thus, if a transferor disposes of stock and the disposition is integrated with the purported Section 351 transaction, the stock transferred likely will not count toward satisfaction of the “control immediately after” requirement.²⁵ In an important exception to this rule, however, a transfer of the transferee’s stock to a co-transferor will not prevent satisfaction of the control immediately after requirement.²⁶ Further, certain non-taxable transfers of the transferee corporation’s stock will not violate the “control immediately after” requirement, as discussed in more detail below.

The step transaction doctrine is critical in determining whether the “control immediately after” requirement is met. Courts have adopted three step transaction tests. The most restrictive test is the

binding commitment test, which will integrate a Section 351 transfer with a later transaction if there is a binding commitment at the time of the purported Section 351 exchange to do the subsequent transaction.²⁷ Under the end result test, perceived separate transactions are stepped together when it appears that they are component parts of a single transaction and each step was apparently intended to be taken to reach a specific end result.²⁸ Finally, purportedly separate transactions are integrated under the mutual interdependence test if the steps are so interdependent that the legal relationships created by one transaction would be useless without the completion of the entire series of transactions.²⁹

The extent to which any of these three tests applies is a subjective determination that depends on all of the facts and circumstances. Some of the factors to consider include the intent of the parties, the temporal proximity of the transactions, the existence of a binding commitment, and whether each transaction has substance by itself and has its own separate business purpose. Many practitioners believe that the binding commitment test is the operative test in Section 351 transactions.

4. Effect of Options on “Control” Test

The Section 351 control immediately after requirement may not be satisfied if there are outstanding options to acquire more than 20% of the transferee corporation’s stock. Similarly, a transferor that has an option to dispose of more than 20% of the transferee corporation’s stock may lack the requisite control to satisfy Section 351.

Several authorities are relevant to determine the effect of options on the control test. In *Ericsson Screw Machine Products Co. v. Commissioner*, an existing corporation (“ECLA”) transferred part of its assets to a transitory corporation for all of the transitory corporation’s stock.³⁰ The transitory corporation then consolidated with another corporation to form the taxpayer. Pursuant to this transaction, ECLA surrendered all of the stock of the transitory corporation and received 77 shares of the stock of the taxpayer. Moreover, ECLA gave an option to the shareholders of the other corporation (i.e., the corporation that consolidated with the transitory corporation) to purchase the 77 shares of the taxpayer for cash. The agreement with ECLA and the shareholders indicated the necessity that ECLA had for the cash. The parties intended all along that the shareholders of the other corporation would actually purchase the 77 shares of stock from ECLA for cash.

The issue was whether the transaction constituted a valid reorganization under former Section 112(g), which required the transferor or its shareholders to be in control of the corporation to which the assets were transferred. According to the Tax Court, the exercise

of the option and the surrender of the 77 shares by ECLA (which occurred approximately four months after the consolidation) was one of the steps essential and inseparable from the rest in accomplishing the result desired by the parties. Accordingly, ECLA had no stock interest in the transferred assets at the completion of the plan.³¹

A very different result was reached in *National Bellas Hess, Inc. v. Commissioner*.³² In that case, a predecessor corporation was in voluntary receivership for the benefit of all interested parties, including shareholders. Pursuant to a plan set forth in a court order, the corporation transferred properties to a corporation newly organized by a group of the predecessor’s key employees. In return, the predecessor received 300,000 of the 1.8 million authorized shares of common stock. The 300,000 shares were issued to the predecessor on or before July 30, 1932, and were the only shares outstanding. Pursuant to the court order, the predecessor’s receivers granted to the key employees a one-year option to purchase the 300,000 shares. The issue was whether the transaction constituted a valid reorganization within the meaning of Section 112(i)(1)(B) of the Revenue Act of 1932, which required the transferor or its shareholders or both to be in control of the corporation to which the assets were transferred. The Service argued that the required “control” was lacking. The Service relied on case law holding that if a transferor relinquishes control as a step in a plan of reorganization, and this step is inseparable from others and is essential to accomplish the entire purpose of the plan, the control requirement is not met.

The Tax Court rejected the Service’s argument.³³ According to the court, the predecessor’s ownership was real and lasting, rather than a momentary formality, and its subsequent relinquishment was not a part of the plan of reorganization or exchange. Considering the Service’s argument that from the beginning the predecessor was obligated to grant to the employee-organizers an option to purchase 300,000 shares, the court considered it “significant” that the predecessor was not obligated to do anything but grant the option.³⁴ The predecessor had not entered into a contract of sale or in any way divested itself of ownership. Moreover, the employee-organizers did not in fact exercise the option; rather, as a result of assignment and modifications, the receivers granted a different option to different parties.³⁵

Finally, a case that provides guidance is *Penn-Dixie Steel Corp. v. Commissioner*.³⁶ In this case, two corporations (Union and Continental) agreed to form a new corporation (“Newco”). Continental contributed cash and received 50% of the stock in Newco. Union contributed the assets and liabilities of one of its divisions and received 50% of Newco’s stock and a Newco debenture. Union received the right to put

Newco stock to Continental from August 1, 1970 through July 31, 1971. Similarly, Continental received a call option on Union's Newco stock essentially on the same terms from August 1, 1971 to July 31, 1972. In structuring the transactions, Continental would have preferred an outright purchase of Union's division, but Union rejected an outright sale in favor of the existing structure in order to avoid capital gains tax by qualifying for tax-free treatment under Section 351. Union exercised its put option on July 31, 1971.

The Tax Court considered whether this transaction constituted a sale to Continental of Union's entire interest in its old division. The taxpayer (the successor by merger to Continental) argued that the transaction was a sale for federal income tax purposes. The taxpayer wanted to collapse the transactions, such that Continental acquired all of the assets and liabilities of Union's division, which it then transferred to Newco in exchange for all of the Newco stock. In rejecting the taxpayer's argument, the court disagreed with the argument that Newco was subject entirely to the control of Continental.³⁷ Not only did the documents refer to a "joint venture," but also Union and Continental shared stock ownership, enjoyed equal representation on the board of directors, and shared Newco's earnings until Continental acquired full stock ownership.

In addition, the court was unimpressed with the assertion that the put and call options should be ignored. According to the court, there was not a sufficient certainty that the put and call would be exercised to find the existence of a sale.³⁸ Acknowledging that, at the time of the initial transaction, Continental intended to exercise its call if Union did not exercise its put, the court stated that "we are not convinced that such plans would not be subject to reevaluation in light of changing circumstances."³⁹ The court considered "it more than a remote possibility" that Newco might so prosper in its initial years that Union would not exercise its put, and that the economic outlet for the steel industry could then change sufficiently thereafter to lead Continental to decide not to exercise its call. In summary, "the put and call arrangements did not legally, or as a practical matter, impose mutual obligations on Union to sell and on Continental to buy."⁴⁰ Although neither party could unilaterally withdraw and prevent a sale, each party's obligation to act was contingent upon the exercise of the put or call, an event that might fail to occur.⁴¹ Thus, the Tax Court treated the incorporation of Newco as tax free under Section 351.

Based on all these authorities, outstanding options should not be counted for purposes of determining the "control immediately after" requirement under Section 351 if the exercise of the options is not integrated with the Section 351 transaction under the step transaction doctrine.

5. Prior Stock Ownership and Accommodation Transferors

Stock of the transferee corporation that is owned by preexisting shareholders who transfer property in the exchange generally is counted towards the 80% control test. Thus, existing shareholders of a corporation may make tax-free transfers of property to the transferee corporation in exchange for more stock of the transferee corporation so long as the shareholders retain control of the transferee corporation immediately after the transfer.

There is one important exception, however, for preexisting shareholders who receive only a small amount of the transferee corporation's stock relative to the value of the stock already owned and the preexisting shareholders are included in the control group only to enable the other members of the control group to satisfy the control test.⁴² Under these circumstances, the accommodation transferor doctrine disregards the stock owned by the existing shareholders to determine whether the control test is satisfied.

The accommodation transferor doctrine prohibits a transferor from considering an existing shareholder's ownership to determine whether the transaction meets the Section 351 control requirement if the existing shareholder transfers relatively little value in comparison to its existing stock ownership.⁴³ For example, assume an existing shareholder (A) who already owns 800 shares of X transfers \$100 for one additional share of X in a transaction where B transfers property for 199 shares. B cannot receive tax-free treatment under Section 351 because B cannot count A's ownership to determine control. A is an accommodation transferor who gave up very little (\$100) compared to the value of what it already owned (*i.e.*, assuming a price per share of \$100, A's existing ownership is worth \$80,000). Without A, B does not own 80% or more of X. For ruling purposes, A must transfer property with a value at least equal to \$8,000 (*i.e.*, 10% of the value of the stock A already owns).⁴⁴

The IRS has extended the rationale of the accommodation transferor doctrine beyond situations that involve existing shareholders. For example, the IRS denied Section 351 treatment in Rev. Rul. 79-194 where a corporation (X) and a group of investors exchanged property for stock of Newco.⁴⁵ In Rev. Rul. 79-194, X exchanged property for 99% of Newco's stock and the investors exchanged property for the remaining 1% interest. X then sold 50% of its interest in Newco to the investors so that the investors held 51% of Newco and X held 49%. The IRS concluded that the investors were not transferors in the first instance and, therefore, X's transfer to them violated the "control immediately after" requirement. The IRS reasoned that the 1% of Newco stock the investors

initially received was of little value relative to the value of the 51% stock they ultimately held.

The IRS reached a different conclusion where B corporation initially received 94% of Newco and a group of investors received 6% of Newco and B subsequently sold 45% of its Newco interest to the investors so that the investors were the majority shareholders.⁴⁶ In that situation, the IRS concluded that the transaction qualified for Section 351 treatment. Thus, we know that a transferor must initially receive more than 1%, and maybe as much as 6%, of the transferee to qualify as a bona fide transferor.

6. Section 351(c)

Section 351(a) is satisfied only if the transferors of property control the transferee corporation immediately after the transfer. Therefore, if a transferor immediately transfers the stock received to someone outside the control group, the control immediately after requirement may not be satisfied. A corporate transferor, however, may distribute some or all of the stock received to its shareholders without violating the control immediately after requirement based on a special rule under Section 351(c). While a corporate transferor may distribute stock received from the transferee corporation and still qualify for Section 351 treatment, such a distribution may be taxable to both the shareholders and the distributing corporation.⁴⁷

Moreover, in the case of divisive transactions where the distributing corporation contributes property for stock in a Section 351 transaction and then distributes the stock of the transferee corporation in a Section 355 transaction, Section 351(c)(2) provides that the shareholders may dispose of all or part of the transferee corporation's stock without preventing the distributing corporation's Section 351 transaction from satisfying the "control immediately after" requirement.

7. Downstream Transfers of Stock

a. Consolidated Return Context

Members of a consolidated group may freely transfer stock received in a Section 351 exchange among themselves without disrupting the "control immediately after" requirement because each member of the group is treated as constructively owning the stock owned by other members of the group.⁴⁸

b. Outside Consolidated Return Context

Outside the consolidated return context, there is no special rule (such as Section 351(c)) that applies when a transferor transfers stock received in a Section 351 exchange downstream to a subsidiary pursuant to a plan. Fortunately, Rev. Rul. 2003-51 will protect many such downstream stock transfers, as discussed below.

Rev. Rul. 2003-51 addresses a transfer of property to a corporation followed by a transfer of the transferee corporation's stock to another corporation.⁴⁹ In that ruling, corporation W engaged in business A. Unrelated corporation X also engaged in business A through its wholly owned subsidiary, Y. W and X desire to consolidate their business A operations in a new holding company structure. To achieve this objective, W first transfers its business A assets to Z, a newly formed corporation for all of the Z stock (the "First Transfer"). Immediately afterwards, and pursuant to a prearranged binding agreement with X, W transfers the Z stock it received to Y for Y stock (the "Second Transfer") and X simultaneously contributes \$30X to Y to meet the capital needs of business A in exchange for additional Y stock (the "Third Transfer"). After the Second and Third Transfers, Y transfers the \$30X cash received from X and its business A assets to Z (the "Fourth Transfer").

Viewed separately, each of the First Transfer, the combined Second and Third Transfers, and the Fourth Transfer qualifies as a Section 351 exchange. However, if the First Transfer is integrated with the Second and Third Transfers, W would lose the control it obtained of Z in the First Transfer as a result of the Second and Third Transfers because Z would be owned by Y, not W.

The IRS ruled that the transfer of assets to Z by W is a valid Section 351 transaction notwithstanding the fact that pursuant to a binding agreement, W transferred the stock of Z to Y. The IRS reasoned that the control requirement may be satisfied in this case even if the Z stock is transferred pursuant to a binding commitment in place upon W's transfer of its business A assets to Z because "[t]reating a transfer of property that is followed by a nontaxable disposition of the stock received as a transfer described in § 351 is not necessarily inconsistent with the purposes of § 351." The rationale of non-recognition treatment under Section 351 is that the transfer of property is not a closed transaction because the transferor has not economically cashed out of its position in the transferred property. In Rev. Rul. 2003-51, W continues to indirectly own its business A assets transferred to Z through its ownership of the Y stock.

Rev. Rul. 2003-51 distinguishes Rev. Rul. 70-140, which involved a transfer of assets by a sole proprietorship to a wholly owned subsidiary followed by an exchange of the wholly owned subsidiary's stock for stock of an unrelated corporation that the IRS recast as a direct transfer of assets to an unrelated corporation in a taxable transaction.⁵⁰ Rev. Rul. 70-140 is distinguishable because the first transfer of assets to the wholly owned subsidiary was necessary to make the second transfer of the wholly owned subsidiary's stock to the unrelated corporation to qualify as a tax-free reorganization. By contrast, in Rev. Rul. 2003-51,

the First Transfer was not necessary for W and X to combine their business A assets in a holding company structure in a tax-free Section 351 transfer. Rather, W could have transferred its business A assets to Y as part of a plan that included X's transfer of \$30X to Y in a tax-free Section 351 exchange. Thereafter, Y could have transferred the business A assets to Z in a successive Section 351 exchange.

8. Gifts of Stock

Gifts of stock received in a Section 351 exchange normally should not violate the control immediately after requirement if the transferor has the power after the transfer to designate who will receive the stock and is under no binding obligation to give the stock to the donee.⁵¹ But there is some authority indicating that the transferee corporation should not directly transfer its stock to the donee. Rather, the transferee corporation should transfer the stock to the transferor who should then give the stock to the donee.⁵²

E. Transfers of "Property"

1. Statutory Exclusions

The non-recognition treatment afforded by Section 351(a) applies only if the transferors transfer "property" to the transferee corporation. Neither Section 351 nor the Treasury regulations define the term "property" except by providing three specific exclusions. First, the term "property" does not include the contribution of services to or for the benefit of the transferee corporation.⁵³ Second, an obligation of the transferee corporation that is not evidenced by a security is not considered "property" for purposes of Section 351(a).⁵⁴ Third, the forgiveness of interest on the transferee corporation's obligation that accrued while the obligation was held by the transferor is not considered property within the meaning of Section 351(a).⁵⁵

2. Case Law Definitions of Property

Although neither Section 351 nor the Treasury regulations define the term "property," the absence of a definition does not usually create problems. Generally, the term is broadly defined to include "anything of value that can be legally owned and transferred"⁵⁶ The issue arises most often where the taxpayer transfers intangible assets and a determination must be made as to whether the taxpayer transferred assets or services.⁵⁷

3. Impact on "Control Immediately After" Test

Only stock received by a transferor of "property" is included in the "control immediately after" determination. Thus, stock received by a transferor solely for services is not counted favorably toward the 80% control test. Interestingly, however, if a transferor transfers both property and services, all of the stock

received by such transferor counts favorably toward the 80% control test.⁵⁸

F. Business Purpose

1. General

A threshold question is whether a non-federal tax business purpose is required for a transaction to qualify under Section 351. Published IRS rulings certainly take the position that a business purpose is required under Section 351.⁵⁹ The cases, however, seem to be inconsistent, leaving some uncertainty as to whether a business purpose is required.⁶⁰ On balance, however, the better view is that a business purpose is required to qualify under Section 351.

2. Conduit Issues

The issue of business purpose often arises when a shareholder transfers an asset to its corporation and the corporation promptly sells the asset. Frequently, the asset has a built-in loss and the shareholder is attempting to assign the loss to the corporation.

The IRS may challenge the form of such a transaction under one or more interrelated concepts, including lack of business purpose, Section 482, or by applying step transaction principles. As discussed below, if such a challenge is successful, the loss is attributed to the shareholder rather than the corporation.

a. Lack of Business Purpose and Section 351

If there is no business purpose for transferring the asset to the corporation, the IRS and courts generally would treat the corporation as a mere conduit, and thus, a sale of the asset by the corporation would be ignored.⁶¹ Instead, the shareholder would be treated as selling the asset, and the loss realized on such sale would be sourced to the shareholder. Importantly, a short interval of time between the transfer of the asset to the corporation and its subsequent sale by the corporation may weaken an otherwise bona fide business purpose because the short time interval may show that the subsequent sale was preconceived.⁶²

As an alternative to treating the corporation as a conduit, the IRS might respect the transfer from the shareholder to the corporation but treat it as a failed Section 351 transaction. In that case, the shareholder would recognize a loss on the exchange of the asset for the corporation's stock.⁶³ This loss may be deferred under Section 267 and under the consolidated return regulations if the transferor and transferee are members of the same consolidated group.⁶⁴ The loss would then be recognized by the shareholder when the transferee corporation sells the asset to a party outside both the consolidated group and the controlled group (i.e., generally a less than 50% affiliate).⁶⁵

b. Section 482

The IRS may also invoke Section 482 to deny the corporation's loss deduction, particularly if the transaction is not motivated by a bona fide business purpose, but instead is undertaken to evade or avoid tax.

Section 482 authorizes the IRS to allocate gross income, deductions, credits, or allowances between two or more commonly controlled businesses if such allocation is necessary to "prevent evasion of taxes or to clearly reflect the income" of any such business. The Section 482 regulations authorize an allocation even if a transaction otherwise qualifies for non-recognition treatment under Section 351.⁶⁶ The Treasury regulations provide the following example:

In Year 1, USP, a United States corporation, bought 100 shares of UR, an unrelated corporation, for \$100,000. In Year 2, when the value of the UR stock had decreased to \$40,000, USP contributed all 100 shares of UR stock to its wholly-owned subsidiary in exchange for subsidiary's capital stock. In Year 3, the subsidiary sold all of the UR stock for \$40,000 to an unrelated buyer, and on its U.S. income tax return, claimed a loss of \$60,000 attributable to the sale of the UR stock. USP and its subsidiary do not file a consolidated return.

In determining the true taxable income of the subsidiary, the district director may disallow the loss of \$60,000 on the ground that the loss was incurred by USP.⁶⁷

This example cites the seminal Section 482 case, *National Securities Corp. v. Commissioner*.⁶⁸ In *National Securities*, a parent corporation transferred depreciated stock of another corporation to its wholly owned subsidiary. The transferred stock further declined in value in the subsidiary's hands, and the subsidiary sold the transferred stock in the same tax year and reported a loss. The IRS argued that the subsidiary was entitled to deduct a loss only for the decline in value that occurred while the subsidiary held the stock, which suggests that the IRS conceded that the Section 351 transfer was otherwise valid.

The Third Circuit concluded that the transaction did not clearly reflect income because the subsidiary reported a loss that was in fact incurred by the parent. In addition, the court indicated that the transfer may have been made for the purpose of tax avoidance. Therefore, the court, upholding the application of Section 482, held that the loss should be allocated to the parent.⁶⁹ *National Securities* is often cited as a "tax avoidance case."⁷⁰ Therefore, a Section 482 allocation may be upheld where the "challenged transaction was

arranged solely to avoid taxes and without a valid business purpose."⁷¹

Even in the absence of tax avoidance, the IRS has successfully used Section 482 to reallocate income in a Section 351 transaction to clearly reflect the income of the parties.⁷² These situations typically have involved a mismatch of income and expense. For example, in *Rooney v. United States*, a shareholder incorporated a business by transferring a mature farming crop and related assets.⁷³ The newly formed corporation reported the proceeds from the sale of the crop and deducted the expenses incurred to grow the crop after its transfer. The transferor deducted the expenses to grow the crop before its transfer, resulting in a net operating loss. The court upheld the IRS's reallocation of all the expenses to the transferee to "clearly reflect income."

Arguably, gain or loss from the sale of transferred property in an otherwise valid Section 351 transaction should not be reallocated under Section 482 to clearly reflect income because distortion of income is inherent in a Section 351 transaction (i.e., economic gain or loss to the transferor is not recognized in such a transaction).⁷⁴ This argument suggests that Section 482 will only apply to a purported Section 351 exchange if there is some element of tax evasion or avoidance (e.g., lack of business purpose).

c. Step Transaction Doctrine

Although there are arguments to the contrary, there is some risk that the IRS may apply some variation of the step transaction doctrine to integrate into a single transaction the contribution by the shareholder and the sale of the asset by the corporation.⁷⁵ The step transaction doctrine combines a "series of individually meaningless steps into a single transaction . . . if such steps are in substance integrated, interdependent, and focused toward a particular result."⁷⁶

If the IRS successfully applies the step transaction doctrine to the shareholder's proposed transfer of property to the corporation and the corporation's sale of that property, the shareholder, rather than the corporation, would be treated as the seller. Under those circumstances, any loss recognized on such sale would be attributed to the shareholder, not the corporation.

The IRS should not be able to reorder the steps of a transaction if there are equally direct routes to achieve the same result. The shareholder has at least two alternative routes, each composed of two steps, to dispose of its property: it could sell the property outright and contribute the sales proceeds to the corporation or it could contribute the stock to the corporation and the corporation could sell the property. It is clear that a taxpayer may plan its tax affairs to minimize taxes.⁷⁷ Therefore choosing between equally

direct, alternative sequences of steps, none of which reverses the effect of prior steps, to minimize the tax cost of a transaction, should not be barred, at least if the transaction has substance and is otherwise motivated by a valid business purpose.⁷⁸

G. Investment Company

Section 351 non-recognition does not apply to transfers of property to an investment company.⁷⁹ A transfer of property will be considered a transfer to an investment company if (1) the transfer results, directly or indirectly, in diversification of the transferors' interests, and (2) the transferee is a corporation where more than 80% of the value of its assets are held for investment and are money, stocks, or securities.⁸⁰ For purposes of (2) above, stock of certain subsidiaries is disregarded and the transferee corporation is treated as owning its ratable share of its subsidiaries' assets. A corporation is considered a subsidiary if the transferee corporation owns 50% or more of (1) the combined voting power of all classes of stock entitled to vote or (2) the total value of shares of all classes of stock outstanding.

A transfer ordinarily results in the diversification of the transferors' interests if two or more persons transfer nonidentical assets to a corporation in exchange for the corporation's stock.⁸¹ Stock and cash are nonidentical assets.⁸² But a transfer is disregarded if it is an insignificant part of the total value of the assets transferred.⁸³ The IRS may consider a transfer representing 5% or less of the total value of the assets transferred to be insignificant.⁸⁴ On the other hand, a transfer representing 11% of the total value of the assets transferred likely would be considered significant.⁸⁵ In addition, diversification will not occur if each transferor transfers an already diversified portfolio of stocks.⁸⁶ A portfolio is diversified if not more than 25% of the value of the total assets is invested in the stock of any one issuer and not more than 50% of the value of the total assets is invested in the stock of five or fewer issuers.⁸⁷

H. Integration of Public Offering or Other Subsequent Sales With Original Section 351 Transaction

1. In General

A public offering or sale of a transferee corporation's stock after an initial Section 351 transaction may cause the initial exchange to fail to qualify under Section 351 if the two transactions are integrated. In general, cases decided under Section 351 indicate that a public offering or other sale of stock after an initial Section 351 transaction should not be considered part of the initial Section 351 transaction where there is no binding agreement at the time of the initial transfer to the corporation that requires the

corporation or the initial transferors to issue or transfer such stock to others.

For example, in *American Bantam Car Co. v. Commissioner*, the Tax Court held that sales made pursuant to a public offering conducted shortly after property was transferred to a corporation in exchange for stock under Section 351 should not be integrated with the initial Section 351 transaction for purposes of determining whether the initial transferees had the requisite "control" of the transferee corporation.⁸⁸ The transferors contributed assets to a new corporation for 300,000 shares of common stock. Five days later, the corporation executed a written contract with underwriters for a selling order of 90,000 shares of the corporation's convertible preferred stock. Concurrently with this contract, the initial transferors agreed to deliver up to 100,000 shares of common stock endorsed in blank to the underwriters. Thereafter, the underwriters sold several thousand shares of the transferee corporation's stock to the public.

At issue was whether the transaction by which the transferee corporation received assets in exchange for its stock qualified under Section 112(b)(5) of the Revenue Act of 1936.⁸⁹ In discussing whether the transferors had "control" over the newly formed corporation immediately after the transfer, the court noted that on June 3, 1936, the initial transferors received absolutely and unconditionally 300,000 shares of no-par common stock. On June 8, no other common stock had been issued, and a contract regarding possible future assignment of the 300,000 shares already issued had not yet been executed. No preferred stock had been issued on June 3, and there was no contract for its sale until June 8. According to the court, the statutory words "immediately after the exchange" require control for no longer period.⁹⁰

On the other hand, the courts of appeals in *Hazeltine Corp. v. Commissioner*⁹¹ and *Bassick v. Commissioner*⁹² integrated subsequent transactions with the initial Section 351 transaction to establish the necessary degree of "control" where agreements entered into before incorporation provided for the sale to third parties of stock originally issued by the new corporation to the initial transferors or the issuance of additional shares of stock by the newly formed corporation.

Hazeltine and *Bassick* are distinguishable from *American Bantam*. First, there was no written contract in *American Bantam* binding the transferors to transfer stock to the underwriters. At most, there was an informal oral understanding of a general plan contemplating the organization of a new corporation, the exchange of assets for stock and the marketing of preferred stock of the new corporation to the public. Second, when the underwriting agreement was reduced to a formal contract, the underwriters in *American*

Bantam received no absolute right to ownership of the common stock, but only when, as, and if, certain percentages of preferred stock were sold. Finally, the necessity of placing 300,000 shares in escrow with a bank indicated that complete ownership of the stock rested with the initial transferors following the exchange.⁹³ According to the Tax Court in *American Bantam*, the standard required by the courts to determine that a series of steps are “interdependent” and thus should be viewed as a single transaction did not exist.⁹⁴ The contemplated arrangement for the sale of preferred stock to the public “was entirely secondary and supplemental to the principal goal of the plan — to organize the new corporation and exchange its stock.”⁹⁵ The understanding with the underwriters for disposing of the preferred stock, though important, was not a *sine qua non* in the general plan, without which no other step would have been taken.⁹⁶ Accordingly, the exchange of assets for stock between the transferors and the newly formed corporation in *American Bantam* was a distinct and completed transaction, so that the initial transferors were in control of the taxpayer immediately after the exchange.⁹⁷

It is true that, in applying the step transaction doctrine in other contexts, courts have used a variety of tests to determine whether to integrate a series of transactions. The existence of a binding agreement is not always necessary to integrate transactions. Notably, the Tax Court in *American Bantam* did not look solely to the non-existence of a binding agreement to sell, but considered whether the series of steps were “interdependent” based upon all the facts.⁹⁸ Indeed, in a non-Section 351 context, the United States Court of Appeals for the Fifth Circuit opined that the invocation of the step transaction doctrine should not depend exclusively on whether there is a “binding commitment” to take subsequent steps in a series of transactions; rather, both the “end result” test⁹⁹ and the “interdependence” test should guide the application of the step transaction doctrine.¹⁰⁰ Nonetheless, in the context of Section 351 transactions, the authorities indicate that the absence of an agreement to sell or issue additional stock at the time of an initial Section 351 transaction is an extremely important factor indicating that subsequent transactions should not be integrated with an initial Section 351 transaction for purposes of applying the Section 351 “control” requirement.

2. Effect of Underwriting Contract If Transactions Are Integrated

If a Section 351 exchange is integrated with a public stock offering (because, for example there is a binding agreement to sell or issue additional stock at the time of the initial Section 351 transaction), it is necessary to determine whether those who purchase

stock in the public offering should be considered “transferors” of property for purposes of applying the Section 351 “control” requirement.

If the parties acquire their stock from an underwriter, whether such parties are “transferors” depends upon whether the underwriting is a “qualified underwriting transaction.” For purposes of Section 351, a person who acquires stock from an underwriter in a “qualified underwriting transaction” is treated as transferring cash directly to the corporation in exchange for stock of the corporation, and the underwriter is disregarded. A qualified underwriting transaction is a transaction in which a corporation issues stock for cash in an underwriting in which either the underwriter is an agent of the corporation or the underwriter’s ownership of the stock is transitory.¹⁰¹

Relying on the qualified underwriting transaction regulation, the IRS in Rev. Rul. 2003-48 concluded that an initial Section 351 contribution of stock to a corporation was integrated with a subsequent public offering of the transferee corporation’s stock where the stock offering was pursuant to the same plan as the initial Section 351 transfer.¹⁰²

I. **Successive Section 351 Transfers**

Section 351 non-recognition treatment applies only if the transferors directly own at least 80% of the total voting power and at least 80% of the total number of non-voting shares of the transferee corporation immediately after they transfer property to the transferee corporation. Except in the context of consolidated groups, no constructive ownership rules apply to determine whether the transferors have the requisite control of the transferee corporation.

The IRS has ruled that successive transfers of property are viewed separately to determine whether each transfer qualifies under Section 351. For example, in Rev. Rul. 77-449, the parent corporation transferred property to its wholly owned first-tier subsidiary for stock, the first-tier subsidiary then transferred the property to its 50% owned subsidiary who then transferred the property to its wholly owned subsidiary for stock.¹⁰³ The IRS viewed each transfer separately and concluded that each transfer separately satisfied the requirements of Section 351. The same result occurs even if the parent corporation transferred property to its 80% subsidiary who then transferred the same property to its 80% subsidiary even though the parent corporation owned only a 64% interest in the second-tier subsidiary.¹⁰⁴ Moreover, successive asset transfers should each independently qualify under Section 351 even if the subsidiary first receiving the property in the purported Section 351 exchange is left with no assets¹⁰⁵ or is dissolved within a year after the transfer.¹⁰⁶

The IRS in Rev. Rul. 83-156 approved of a successive transfer of property from a corporation (P)

to its wholly owned subsidiary (S) and from S to a newly formed partnership in which S and its wholly owned subsidiary (S1) were partners as a Section 351 transfer followed by a Section 721 transfer.¹⁰⁷ Citing Rev. Rul. 77-449, the IRS treated each transfer separately and thus, no gain or loss was recognized pursuant to Sections 351 and 721.

In certain situations, the IRS treats a direct transfer of property that bypasses intermediate corporations as successive Section 351 transfers. For example, in PLR 200031039 (May 5, 2000), a first-tier subsidiary of a common parent corporation transferred assets subject to liabilities directly to a fourth-tier subsidiary. If multiple transfers were undertaken, transfer taxes would have been incurred and regulatory consents would have been required. The IRS treated the direct transfer down the chain for federal income tax purposes as successive Section 351 transfers from the first-tier subsidiary to the second-tier subsidiary for a constructive exchange of additional shares of the second-tier subsidiary's stock, followed by a transfer of the assets from the second-tier subsidiary to the third-tier subsidiary and finally, from the third-tier subsidiary to the fourth-tier subsidiary.¹⁰⁸

This approach is consistent with Rev. Rul. 64-73.¹⁰⁹ In Rev. Rul. 64-73, a parent corporation (L) owned 100% of a first-tier subsidiary (M), which owned 100% of a second-tier subsidiary (N). L acquired all of the assets of X, an unrelated party, for L voting stock in a C reorganization. The plan of reorganization provided that X would transfer some of its assets to L and other assets directly to N, rather than through L and M. The IRS treated L as first acquiring all of X's assets in a C reorganization and then subsequently dropping down some of X's assets to N in successive Section 351 transactions.

Rev. Rul. 2003-51 offers an alternative to the "cause to be directed" approach of Rev. Rul. 64-73. For example, suppose that P owned 100% of both S1 and S2. P desires to make S2 a second-tier subsidiary and to transfer a directly-held asset to S2, but P does not want to successively transfer the asset to S1 and then to S2. P could first transfer the S2 stock to S1 in a Section 351 transfer and then P could transfer the asset directly to S2, and rely on the "cause to be directed" approach of Rev. Rul. 64-73 to treat the asset as first being contributed to S1 by P and then by S1 to S2. Another approach would be to transfer the asset to S2 and then transfer the stock of S2 to S1. This second approach is tax-free under Rev. Rul. 2003-51, in which the IRS ruled that a transfer of property to a corporation followed by a transfer of the transferee corporation's stock to another corporation was a valid Section 351 exchange.¹¹⁰

II. SECTION 351 AND REORGANIZATIONS

A. Section 351 as an Acquisition Vehicle - Rev. Rul. 84-71

Section 351 is a useful alternative to the reorganization provisions when the percentage of target shareholders seeking tax-free reorganization treatment is relatively small. For example, suppose 85% of the target shareholders wish to receive cash but 15% of the shareholders (possibly management or a significant shareholder) wish to receive acquiring corporation stock and, therefore, tax-free rollover treatment. This transaction would not qualify as a tax-free reorganization because the requisite continuity of interest (only 15%) would be lacking. In such a case, however, taxpayers have been able to achieve a tax-free result using Section 351.

The leading authority on acquisitive Section 351 transactions is Rev. Rul. 84-71.¹¹¹ In that ruling, 14% of T's stock was held by A, president and chairman of the board, and 86% was held by the public. P, an unrelated, publicly-held corporation, wished to acquire all of the stock of T. All of the T shareholders except A, who wished to avoid recognition of gain, were willing to sell their T stock for cash.

To accommodate A's wishes, the following transactions were carried out as part of an overall plan. First, P and A formed a new corporation, S. P transferred cash and other property to S solely in exchange for all of S's common stock. A transferred its T stock to S solely in exchange for all of S's preferred stock. These transfers were intended to be tax-free under Section 351. Second, S organized a new corporation, D, and transferred to D the cash it had received from P in exchange for all of the D common stock. Third, D was merged into T under state law. As a result of the merger, each share of T stock, except those shares held by S, were surrendered for cash equal to the stock's fair market value and each share of D stock was converted into T stock.

The IRS concluded that the fact that "larger acquisitive transactions," such as those described above, fail to meet the requirements for tax-free treatment under the reorganization provisions of the Code does not preclude the applicability of Section 351(a) to transfers that are a part of such larger transactions, as long as either alone or in conjunction with other transfers, the transfers meet the requirements of Section 351(a).

The transaction structure in Rev. Rul. 84-71 is very similar to that used by Unilever to acquire National Starch.¹¹² Thus, this structure is often referred to as a "National Starch" transaction.

B. Double Dummy - The Right Way and the Wrong Way

Acquisitive Section 351 transactions frequently are structured using what is known as the "double

dummy” technique. The double dummy technique is often used for a merger of equals and is a practical method of implementing a Section 351 transaction where one or more of the target corporations is publicly traded.

For example, suppose that corporation X and Y are two large publicly-traded companies that would like to combine their operations for valid business reasons. To do so, X and Y form Newco. Newco forms two transitory dummy subsidiaries, X1 and Y1. Next, Newco causes X1 and Y1 to merge into X and Y respectively with X and Y surviving. In the merger, the public shareholders of X and Y receive solely common stock in Newco. The dummy subsidiaries are disregarded for federal income tax purposes because they are transitory.¹¹³ Thus, the overall transaction will be treated as if the public shareholders transferred their stock in X and Y to Newco in exchange for Newco common stock in what should be a valid Section 351 transaction.

In this example, each of the mergers should also qualify as tax-free reverse subsidiary mergers under Section 368(a)(2)(E) and as reorganizations under Section 368(a)(1)(B). Suppose, however, that the consideration paid to the public shareholders of X and Y included Newco securities as well as Newco common stock. Assume also that X and Y were each required to spin off a significant portion of their business before the combination. The foregoing facts prevent Newco’s acquisition of X and Y from qualifying as a reorganization. The receipt of consideration other than voting stock (i.e., the Newco securities) prevents the transaction from qualifying as a reorganization under Section 368(a)(1)(B). Also, the spin-off violates the substantially all requirement and prevents the mergers from qualifying as reverse subsidiary mergers under Section 368(a)(2)(E). In such a case, it is critical that the overall transaction qualify under Section 351 or the public shareholders will be taxed upon receiving the Newco common stock.¹¹⁴

It is important to note that the direction of the subsidiary mergers may be critical. While a reverse subsidiary merger is treated as if the target shareholders transferred their stock to Newco, a forward subsidiary merger would not be treated in this manner. Thus, a merger of X into X1 with X1 surviving would not be treated as a transfer by the X shareholders of their stock to Newco and the stock issued by Newco to such shareholders would not count favorably for purposes of the 80% control test under Section 351. In such a case, if the X shareholders owned more than 20% of Newco after the transaction, the Y shareholders would be taxed on a transfer of Y stock to Newco in exchange for Newco’s stock (because Section 351 would not apply) unless the transaction qualified as a reverse subsidiary merger (or,

if there were no boot at all in the transaction, possibly as a type B reorganization).¹¹⁵

C. Rev. Rul. 70-140 Problem

The IRS in Rev. Rul. 70-140 disregarded a transfer of assets by an individual to a newly formed corporation where the stock of the transferee corporation was to be acquired by another corporation in a B reorganization pursuant to a prearranged, integrated plan.¹¹⁶ In Rev. Rul. 70-140, A owned a business in the form of a sole proprietorship. Pursuant to an agreement between A and Y, an unrelated corporation, A transferred all the assets of the sole proprietorship to X in exchange for all of the X stock. A then transferred all his X stock to Y solely in exchange for voting common stock of Y, which was widely held. The two steps of the transaction were part of a pre-arranged integrated plan. The IRS ruled that A’s receipt of X stock in exchange for the sole proprietorship assets was transitory and without substance for tax purposes since it was apparent that the assets of the sole proprietorship were transferred to X to enable Y to acquire such assets without the recognition of gain to A. Thus, the transfer of the sole proprietorship assets to X was treated as a sale of the assets by A to Y followed by a transfer of such assets by Y to the capital of X.

Similarly, the Tax Court in *West Coast Marketing Corp. v. Commissioner* disregarded a purported Section 351 transaction followed by a purported B reorganization where a taxable exchange was contemplated at the time of the purported Section 351 transaction.¹¹⁷ Because the purported Section 351 transaction was disregarded, the transferor was treated as selling the transferee corporation’s assets in a taxable exchange. To the contrary, however, the Tax Court in *Weikel v. Commissioner* respected an incorporation transaction and a subsequent tax-free reorganization that were about three months apart as two separate transactions.¹¹⁸

III. ANTI-LOSS DUPLICATION AMENDMENTS TO CODE SECTION 362

Section 836 of the American Jobs Creation Act, Pub. Law 108-357 (the “AJCA”), amended Section 362 to prevent the duplication of built-in loss in both the assets transferred and the stock received in Section 351 transactions.

A. Background

In a Section 351 transaction, the transferee corporation’s basis in the property acquired is the same as it was in the hands of the transferor, increased by the amount of gain recognized by the transferor in the transaction. IRC § 362. Also, the transferor’s basis in the stock received in the transaction is the same as that of the property exchanged in the transaction, adjusted

for any gain or loss recognized by the transferor in the transaction, and decreased by the amount of any money or other property received by the transferor. IRC § 358. Thus, built-in gain or loss in the transferred assets is “duplicated” in the stock received.

B. AJCA Amendments to Section 362

The AJCA made two key amendments to Section 362 in order to limit loss duplication. The first added Section 362(e)(1) that applies to cross border Section 351 transactions or reorganizations. In particular, it applies where the transferor is not subject to US tax but the transferee is and the transferred property has an aggregate built-in loss immediately after the transaction. In the case of such “loss importation”, the basis of each transferred property is reduced to its fair market value.

The AJCA also added Section 362(e)(2) which is a broader provision. Section 362(e)(2) generally provides that if property is transferred in a Section 351 transaction and the transferee’s aggregate adjusted bases of the property transferred in the transaction exceeds the fair market value of the property immediately after the transaction, then the transferee’s aggregate adjusted bases of the property transferred is limited to the fair market value of the property immediately after the transaction (i.e., the basis is “stepped down”). The aggregate basis reduction is allocated among the property transferred in proportion to their respective built-in losses immediately before the transaction. Instead of limiting the basis of the property transferred in the transaction, the transferor and transferee can irrevocably elect to limit the transferor’s basis in the stock received in the exchange to the fair market value of the property immediately after the transaction. The election must be included with the return for the taxable year in which the transaction occurs.

C. Effective Date

The amendments made by Section 836 of the AJCA apply to transactions after the date of enactment of the AJCA (October 22, 2004).

IV. SECTION 351 AND THE PROPOSED “NET VALUE” REGULATIONS

A. Overview of Proposed “Net Value” Regulations

In March 2005, the IRS and Treasury proposed the so-called “net value” regulations to address the application of several non-recognition provisions of the Code to transactions involving insolvent corporations. The centerpiece of the proposed regulations is the addition of an “exchange of net value” requirement to Sections 332, 351 and 368. In the preamble to the proposed regulations, the IRS and Treasury explain that a “net value” requirement is appropriate because a transfer of property in exchange for the assumption or

satisfaction of liabilities resembles a sale and should not be afforded non-recognition treatment.

B. Application of Proposed “Net Value” Requirement to Section 351

For purposes of Section 351, the proposed regulations provide that stock will not be treated as issued for property unless:

1. The fair market value of the property transferred to the corporation exceeds the sum of the liabilities that are assumed by the transferee in connection with the transfer plus the amount of cash and other property (other than stock permitted to be received under Section 351 without the recognition of gain) received by the transferor (i.e., there is a “net surrender of value”); and
2. The fair market value of the assets of the transferee corporation exceeds the amount of its liabilities immediately after the transfer (i.e., there is a “net receipt of value”). Prop. Treas. Reg. § 1.351-1(a)(1)(iii).

For example, suppose an individual, Mr. X, transfers real estate with a fair market value of \$150, subject to non-recourse debt of \$200, to his wholly-owned corporation, Y, in exchange for additional shares of Y’s stock. Suppose Y is solvent immediately after the exchange. Under the proposed regulations, there has been no “net surrender of value” because the fair market value of the real estate does not exceed the amount of the liabilities assumed by Y. Since there is no net surrender of value, the stock of Y is not considered to be issued in exchange for property. Therefore, Mr. X’s transfer of the real estate to Y is not subject to Section 351. Prop. Treas. Reg. § 1.351-1(a)(2), Example 4.

Importantly, the proposed regulations do not provide the tax consequences to the parties absent the application of Section 351. Since no non-recognition provision applies, Mr. X could be treated as recognizing gain to the extent that the non-recourse debt exceeds his basis in the property. Alternatively, the transaction could be treated as a Section 301 distribution by Y to Mr. X to the extent that the debt assumed exceeds the value of the property transferred. Further, the regulations are silent as to the basis that Y takes in the real estate. Thus, the proposed regulations tell us very little about this type of transaction other than that Section 351 does not apply to it.

V. ASSUMPTION OF TRANSFEROR LIABILITIES

A. Section 357 Generally

Under Section 357(a), the transferee corporation’s assumption of the transferor’s liabilities generally is

not treated as boot in a Section 351 transaction. The transferee corporation assumes a recourse liability if, based on all the facts and circumstances, it agrees or is expected to satisfy the liability or a part of a liability whether or not the transferor has been relieved of the liability.¹¹⁹ The transferee corporation generally is treated as assuming a nonrecourse liability if the asset received is subject to the nonrecourse liability.¹²⁰ If, however, the transferred assets are cross-collateralized with other assets that the transferor retains, the amount of the nonrecourse liability that the transferee corporation is treated as assuming is reduced by the lesser of (1) the amount of the nonrecourse liability that the transferor agrees to, and is expected to, satisfy or (2) the fair market value of the cross-collateralized assets retained by the transferor.¹²¹

B. Section 357(b)

Notwithstanding the general rule under Section 357(a) that the transferee corporation's assumption of the transferor's liabilities is not treated as boot in a Section 351 transaction, this rule does not apply if the principal purpose of the assumption is to avoid federal income tax on the exchange or if a bona fide business purpose does not exist for the assumption.¹²² If such an improper motive exists or a bona fide business purpose is lacking, Section 351(b) provides that the total amount of liabilities assumed in the transaction (and not just the amount of "tainted" liabilities) is treated as boot.¹²³ Gain is recognized, however, only to the extent that gain is realized in the Section 351 transfer.

For example, suppose A transfers property worth \$100,000 and with a basis of \$50,000 to the transferee corporation. At the time of the transfer, the property is subject to a \$50,000 liability that the transferee corporation assumes. If the principal purpose of the assumption was to avoid federal income tax on the exchange or if a bona fide business purpose did not exist for the assumption, \$50,000 would be treated as boot under Section 357(b) that would trigger taxable gain because \$50,000 of gain is realized in the overall transaction. If, on the other hand, the basis of the transferred property equaled \$100,000, A would recognize no gain even though the transferee corporation assumed the \$50,000 liability because there was no realized gain in the transaction.

A tax avoidance motive is more likely to be found if the transferor borrows against the transferred property shortly before transferring the encumbered property to the transferee corporation and the transferee corporation assumes the liability because the result is substantially the same as if the transferee corporation transferred cash boot to the transferor.¹²⁴ Section 351(b) is also more likely to apply to liabilities incurred to pay personal, rather than ordinary business, expenses.¹²⁵

C. Section 357(c)

1. In General

Section 357(c) provides another exception to the general rule under Section 357(a). Gain is recognized under Section 357(c) to the extent that the sum of the liabilities assumed exceeds the transferor's basis in the property transferred.¹²⁶ It is possible that both Section 357(b) (relating to tax avoidance purpose) and Section 357(c) could both apply in one transaction. In that case, Section 357(b) applies instead of Section 357(c).¹²⁷

Certain categories of liabilities are not treated as liabilities assumed for purposes of Section 357(c) and thus, do not cause gain recognition. Specifically, Section 357(c)(3) excludes liabilities the payment of which would either give rise to a deduction or payments made to a retiring or deceased partner's successor in interest as described in Section 736(a). Items in the first category include trade accounts payable, interest, and taxes to the extent the transferor would be entitled to a deduction if it had paid the liability. The rationale for excluding these types of liabilities is to prevent inappropriate gain recognition where the transferor has not yet received a corresponding deduction or other tax benefit.

It is unclear how contingent liabilities are treated for purposes of Section 357(c). The issue from the transferor's perspective is whether a liability is treated as a transferor liability that is assumed by the transferee (which implicates Section 357(c)) or is instead treated as a transferee liability that arose after the Section 351 exchange (which would not implicate Section 357(c)). From the transferee's perspective, the issue is whether the transferee can deduct the contingent liability once it becomes fixed.

The IRS in Rev. Rul. 95-74 has ruled that if a transferee assumes environmental liabilities associated with contaminated property contributed to the transferee in a Section 351 exchange, the transferee steps into the transferor's shoes to determine whether the environmental cleanup costs are deductible.¹²⁸ In Rev. Rul. 95-74, P operated a manufacturing plant located on land that P had purchased many years ago in an uncontaminated state. The land became contaminated, however, as a result of plant operations. P contributed all the assets associated with its manufacturing business including the manufacturing plant and the contaminated land to S in exchange for all of the stock of S and for S's assumption of the liabilities associated with the manufacturing business in a Section 351 exchange. Two years after the Section 351 exchange, S incurred costs to remediate the contaminated land and attempted to deduct these costs.

The IRS ruled that the contingent environmental liabilities assumed from P are deductible as business expenses by S as if S owned the land for the period and in the same manner as it was owned by P. The IRS

reasoned that the legislative intent of Section 351(a) to provide for a tax-free incorporation would be frustrated if S were unable to deduct the environmental remediation costs.

In Rev. Rul. 95-74, the IRS specifically declined to follow the Eighth Circuit's decision in *Holdcroft Transportation Co. v. Commissioner*.¹²⁹ *Holdcroft* involved a Section 351 exchange where the transferee attempted to deduct payments to settle the transferor's liabilities. The Eighth Circuit held that the payments were not deductible even though the transferor would have been entitled to a deduction because the assumed liabilities did not arise as an operating expense of the transferee, but were part of the cost of acquiring the transferor's property.

Under the "step into the shoes" approach adopted in Rev. Rul. 95-74, the contingent liability is ignored at the time of the Section 351 transfer and the transferee would be able to deduct an otherwise deductible liability when permitted under its normal method of accounting. Another approach to deal with contingent liabilities assumed in a Section 351 transaction is known as the "look back approach." Under the look back approach, the contingent liability is ignored at the time of the Section 351 transfer, but Sections 357 and 358 would be reapplied when the liability later becomes fixed by treating the transferor as making a deemed payment to discharge the liability.¹³⁰

2. Character Issues

Section 357(c) provides that the "excess shall be considered as gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be." Thus, the characterization of any gain depends on the character of the underlying assets. If more than one item of property is transferred, Treas. Reg. § 1.357-2(b) by way of example provides that the total recognized gain shall be allocated ratably over the various items transferred in accordance with their relative fair market values.

3. Lessinger/Peracchi Debate

There has been much debate about whether a transferor can create basis by transferring a personal unsecured promissory note to the transferee corporation and consequently avoid Section 357(c) gain recognition. This approach has been approved of by the Second Circuit in *Lessinger v. Commissioner* and by the Ninth Circuit in *Peracchi v. Commissioner*.

The transferor in *Lessinger* contributed all the assets and liabilities of its sole proprietorship to a newly formed corporation.¹³¹ The sum of the liabilities assumed exceeded the adjusted basis of the assets transferred. The transferee corporation treated the excess of liabilities over the adjusted basis of the assets as a note receivable from the transferor. The Second Circuit reversed the Tax Court and allowed the

shareholder to avoid Section 357(c) gain recognition by treating the personal promissory note as having a basis equal to its face amount.¹³² While the Tax Court reasoned that the promissory note had a zero basis in the hands of the shareholder and thus, had a zero basis in the hands of the transferee corporation, the Second Circuit interpreted "adjusted basis" in Section 357(c) to mean the adjusted basis of the note in the hands of the transferee corporation, which the court determined to be equal to its face amount.

In *Peracchi v. Commissioner*, a shareholder contributed real estate encumbered by recourse liabilities to his wholly owned corporation, and the liabilities exceeded the basis of the real estate transferred by more than \$500,000.¹³³ The shareholder transferred an unsecured promissory note with a face amount of \$1,060,000 to the corporation. The Ninth Circuit held that the shareholder had a basis in the promissory note equal to its face amount. As a result, the shareholder did not have to recognize Section 357(c) gain because the basis of the assets contributed (including the promissory note) exceeded the liabilities assumed.

Lessinger and *Peracchi* were both decided before the enactment of Section 357(d). Under Section 357(d)(1)(A), if the transferor remains personally liable for recourse debt, it can avoid Section 357(c) gain.¹³⁴

4. Liability Tax Shelters

Notice 2001-17 treats the assumption of certain contingent liabilities in Section 351 transactions as tax shelters.¹³⁵ Notice 2001-17 addresses a transaction where the transferor contributes an asset whose basis is roughly equal to its fair market value for the transferee corporation's stock and the transferee corporation's assumption of a liability that the transferor has not yet taken into account for federal income tax purposes. The amount of the liability nearly equals the basis or fair market value of the transferred asset.

These types of arrangements can accelerate or duplicate tax deductions. Under Section 351, the transferor's basis in the transferee corporation's stock equals the basis of the asset transferred unreduced by the assumed liability.¹³⁶ If the transferor sells the stock, it will recognize a loss equal to the present value of the assumed liability and the transferee corporation is able to claim a deduction as it makes payments on the liability.

Notice 2001-17 disallows losses for transfers after October 18, 1999 to the extent that Section 358(h) reduces the transferor's basis in the transferee corporation's stock. Section 358(h) reduces the basis of the stock received in a Section 351 transaction if the basis of stock received exceeds the fair market value of the stock. The amount of the basis reduction is equal to the amount of any liability that is assumed by another as part of the exchange that did not otherwise

reduce the transferor's basis in the stock by reason of the assumption under Section 358(d).¹³⁷

D. Section 357(d)

Section 357(d) addresses the amount of a liability a transferee of property is treated as assuming in connection with a transfer of the property and the tax consequences that result when the transferee assumes the liability. Congress enacted Section 357(d) because it was concerned that if multiple transferees were treated as assuming the same liability, taxpayers might assert that the basis of multiple assets reflects the assumption of the same liability in a manner that is inconsistent with the underlying economics of the transfer.¹³⁸ For example, suppose a parent corporation (P) owns three assets that together secure a \$60 nonrecourse liability. Each asset has a basis and fair market value of \$20. P transfers one asset to each of its three wholly owned subsidiaries and there is no agreement by P or any of the subsidiaries to retain a portion of the nonrecourse liability. Before the enactment of Section 357(d), each subsidiary would be treated as assuming the entire \$60 nonrecourse liability, which increased its basis under Section 362 by \$60.¹³⁹

Section 357(d) distinguishes between the assumption of recourse and nonrecourse liabilities. A recourse liability is treated as assumed if "based on all the facts and circumstances, the transferee has agreed to, and is expected to, satisfy such liability (or portion), whether or not the transferor has been relieved of such liability."¹⁴⁰ By contrast, the default rule is that a nonrecourse liability is treated as assumed by the transferee of any asset subject to such liability.¹⁴¹ The amount of the assumption is reduced, however, by the amount that the transferor of assets subject to that liability has agreed, and is expected to, satisfy, up to the fair market value of the assets subject to the liability that are retained by the transferor.¹⁴² Section 362(d) limits the basis increase resulting from the assumption to the fair market value of the asset. Thus, in the example set forth above, the entire \$60 nonrecourse liability is treated as assumed by each subsidiary under Section 357(d) but the basis in each transferred asset would be limited to \$20 under Section 362(d).

The IRS is concerned that Section 357(d) does not always produce appropriate results. In the above example, it is questionable whether each subsidiary should be treated as assuming the entire \$60 nonrecourse liability. To address this concern, the IRS is considering publishing a notice of proposed rulemaking. On May 5, 2003, the IRS issued an advance notice of proposed rulemaking to solicit specific comments regarding various aspects of Section 357(d).¹⁴³ The types of issues the IRS is considering addressing in regulations include:

- Assumptions of nonrecourse liabilities
- The amount of nonrecourse liability assumed absent an agreement
- Subsequent transfers of property subject to nonrecourse liabilities
- Identifying the amount of liabilities assumed by agreement
- Accounting for liabilities
- Requirements for an agreement to satisfy a liability
- Acts constituting satisfaction of a liability
- Collateral consequences of satisfying a liability

VI. ZERO BASIS ISSUES

A. Overview

When one corporation (the "issuing corporation") transfers its stock to another corporation (the "acquiring corporation") in a Section 351 transaction, the acquiring corporation's basis in the issuing corporation stock received is determined under Section 362. Under Section 362, the acquiring corporation's basis in the issuing corporation stock is the same as it would be in the hands of the issuing corporation. A corporation's basis in its own stock is zero.¹⁴⁴ Consequently, the acquiring corporation takes a zero basis in the issuing corporation stock, and thus, could recognize gain when it ultimately disposes of the stock.

The IRS has issued regulations to avoid this zero-basis problem in certain situations. The regulations adopt a cash purchase model to provide relief from gain recognition. Under the cash purchase model, the acquiring corporation is treated as purchasing the issuing corporation's stock for the stock's fair market value using cash contributed by the issuing corporation.¹⁴⁵ This model eliminates the zero-basis problem because the acquiring corporation's basis in the issuing corporation stock will equal the stock's fair market value.

The cash purchase model is modified when the acquiring corporation or some other party actually pays cash for some portion of the issuing corporation stock. Under those circumstances, the amount of cash deemed contributed by the issuing corporation to the acquiring corporation is reduced by the amount of cash actually paid for the issuing corporation stock.¹⁴⁶

An acquiring corporation recognizes no gain or loss when it disposes of the stock of another corporation if, pursuant to a plan to acquire money or other property:¹⁴⁷

- (1) the acquiring corporation directly or indirectly acquires the issuing corporation stock from the issuing corporation in a transaction in which the acquiring corporation's basis in the stock is determined

based on the issuing corporation's basis in its stock;

- (2) the acquiring corporation immediately transfers the issuing corporation stock for money or other property (the "immediacy requirement");
- (3) no party receiving the issuing corporation stock receives a substituted basis in the stock within the meaning of Section 7701(a)(42); and
- (4) the acquiring corporation does not exchange the issuing corporation stock for stock of the issuing corporation. Otherwise, an acquiring corporation could selectively recognize loss by immediately swapping issuing corporation stock for other issuing corporation stock, which it could hold long term with a cost basis.

B. Immediacy Requirement

The recast under the final regulations reaches the same result as if the issuing corporation directly exchanges its own stock for property and contributes that property to the acquiring corporation. In particular, the basis of property acquired by a corporation for its stock would be equal to the stock's fair market value, provided the property is acquired in a taxable transaction.¹⁴⁸ The acquiring corporation's basis in the property transferred from the issuing corporation would be equal to the issuing corporation's basis in the property, which in this case, would equal the stock's fair market value.

The results are consistent, however, only if the acquiring corporation immediately transfers the issuing corporation stock for money or other property. Otherwise, there is a possibility that the value of the issuing corporation stock will fluctuate while the stock is in the hands of the acquiring corporation. Consequently, the regulations apply only if the acquiring corporation immediately transfers the issuing corporation stock after receiving it.¹⁴⁹

Absent an immediacy requirement, one of two alternatives would be necessary. First, the cash purchase model could apply, as it does under the final regulations, at the time the acquiring corporation obtains the issuing corporation stock. This approach may make it difficult to determine the value of the stock without a related transaction to assist in the valuation. In addition, this approach facilitates selective loss recognition because the acquiring corporation could hold on to the issuing corporation stock until its value decreases, and then sell the stock and recognize a loss.¹⁵⁰

The second alternative is to apply the cash purchase model when the acquiring corporation actually disposes of the issuing corporation stock. This

alternative, however, would allow the acquiring corporation to avoid recognizing gain on the appreciation of the issuing corporation stock. Because both alternatives cause inappropriate results, the IRS refused to create exceptions to the immediacy requirement.

C. Using Parent Stock to Compensate Subsidiary Employees

Before the zero-basis regulations, the IRS saw fit to protect a subsidiary from the zero-basis dilemma in connection with the transfer of its parent stock to compensate subsidiary employees.¹⁵¹ Without the protection of Rev. Rul. 80-76, the parent would be treated as contributing its zero-basis stock to its subsidiary, and the basis of the stock in the hands of the subsidiary would be determined with respect to the parent's basis in the stock, which is zero.

The Section 1032 regulations preserve the zero-basis relief afforded by Rev. Rul. 80-76 by applying the cash purchase model to the use of a parent's stock to compensate a subsidiary's employees, provided the subsidiary immediately transfers the parent's stock. Because the regulations address the same issue as Rev. Rul. 80-76, the final regulations obsoleted the ruling.¹⁵²

Several examples in the final regulations address the use of a parent's stock to compensate its subsidiary's employees. For instance, example 4 illustrates the base case where parent transfers some of its shares to an employee of the subsidiary.

In example 5, the employee is offered an option to purchase parent shares with a fair market value of \$100 for a strike price of \$80. The employee transfers \$80 and the subsidiary transfers \$10 to the parent. The amount of cash that the parent is deemed to contribute to the subsidiary under the cash purchase model is equal to the difference between the fair market value of the stock and the fair market value of money or other property received by the parent as payment from the employee or the subsidiary.

Examples 6 and 7 involve stock subject to a substantial risk of forfeiture where the employee does not make a Section 83(b) election. In example 6, the parent retains the reversionary interest. In example 7, the subsidiary retains the reversionary interest. Example 8 involves a nonstatutory stock option. Finally, example 9 addresses the identical facts of Rev. Rul. 80-76 (*i.e.*, a majority shareholder of parent transfers some of its parent stock to a subsidiary employee).

1 This outline is the joint effort of David Wheat and Michelle Kwon. They both practice in the corporate tax group at Thompson & Knight LLP in Dallas, Texas.

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- 2 Section 202(c)(3) of Revenue Act of 1921.
- 3 *Portland Oil Co. v. Comm'r*, 109 F.2d 479 (1st Cir. 1940). *See also* S. Rep. 67-275 (1921).
- 4 I.R.C. § 358(a) (basis) and Treas. Reg. § 1.358-1(a) (same). I.R.C. § 1223(1) (holding period).
- 5 I.R.C. § 358(a)(1); Treas. Reg. § 1.358-1(a).
- 6 Rev. Rul. 85-164, 1985-2 C.B. 117; Rev. Rul. 68-55, 1968-1 C.B. 140.
- 7 I.R.C. §§ 358(a)(1) and (2).
- 8 Treas. Reg. § 1.358-3(a).
- 9 I.R.C. § 358(d)(2).
- 10 I.R.C. § 351(g)(3)(A).
- 11 H. Conf. Rep. No. 105-220, 105th Cong., 1st Sess., *reprinted in* 1997 U.S.C.C.A.N. 1129, 1357 (1997) (emphasis added).
- 12 *Id.*
- 13 I.R.C. § 351(g)(2)(C)(i)(I).
- 14 I.R.C. § 351(g)(2)(C)(i)(II).
- 15 Section 351(a), amended by Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7203(a).
- 16 Treas. Reg. § 1.351-1(a)(1). *See also Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194 (1942) (stock warrants were not “stock” for purposes of Section 368(a)(1)(B)).
- 17 Rev. Rul. 69-265, 1969-1 C.B. 109.
- 18 Rev. Proc. 84-42, 1984-1 C.B. 521, *amplifying* Rev. Proc. 77-37, 1977-2 C.B. 568.
- 19 *Hamrick v. Comm'r*, 43 T.C. 21 (1964), *acq.*, 1966-1 C.B. 2; *Carlberg v. United States*, 281 F.2d 507 (8th Cir. 1960).
- 20 I.R.C. § 1032.
- 21 I.R.C. § 362(a).
- 22 I.R.C. § 1223(2).
- 23 Rev. Rul. 2003-48, 2003-19 I.R.B. 863; Treas. Reg. § 1.351-1(a)(3).
- 24 Treas. Reg. § 1.351-1(a)(1).
- 25 Rev. Rul. 79-194, 1979-1 C.B. 145.
- 26 *Id.*
- 27 *See, e.g., Comm'r v. Gordon*, 391 U.S. 83 (1968); *S. Klein on the Square, Inc. v. Comm'r*, 188 F.2d 127 (2d Cir. 1951); *Intermountain Lumber Co. v. Comm'r*, 65 T.C. 1025 (1976); *Hazeltine v. Comm'r*, 89 F.2d 513 (3d Cir. 1937).
- 28 *See, e.g., Culligan Water Conditioning v. United States*, 567 F.2d 867 (9th Cir. 1978); *King Enterprises, Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969).
- 29 *See, e.g., Redding v. Comm'r*, 630 F.2d 1169 (7th Cir. 1980); *American Bantam Car Co. v. Comm'r*, 11 T.C. 397 (1948), *aff'd per curiam*, 177 F.2d 513 (3d Cir. 1949).
- 30 14 T.C. 757 (1950).
- 31 *Id.* at 764.
- 32 20 T.C. 636 (1953), *aff'd*, 220 F.2d 415 (8th Cir. 1955).
- 33 20 T.C. at 646-48.
- 34 *Id.* at 646-47.
- 35 In addition, the court held that ownership and control were not negated by the fact that the predecessor planned to sell capital stock to the general public and the predecessor did not intend to indefinitely retain the stock transferred to it. *Id.* at 647.
- 36 69 T.C. 837 (1978).
- 37 *Id.* at 843.
- 38 *Id.* at 843-44.
- 39 *Id.* at 844.
- 40 *Id.*
- 41 *Id.*
- 42 Treas. Reg. § 1.351-1(a)(1)(ii). *See also Kamborian v. Comm'r*, 56 T.C. 847 (1971), *aff'd sub nom., Kamborian Est. v. Comm'r*, 469 F.2d 219 (1st Cir. 1972).
- 43 Treas. Reg. § 1.351-1(a)(1)(ii).

- 44 Rev. Proc. 77-37, § 307, 1977-2 C.B. 568.
- 45 Rev. Rul. 79-194, 1979-1 C.B. 145.
- 46 GCM 43422 (Feb. 9, 1978).
- 47 I.R.C. §§ 301 (tax to shareholders if distribution is a dividend), 311 (tax to distributing corporation).
- 48 Treas. Reg. § 1.1502-34. *See also* Rev. Rul. 89-46, 1989-1 C.B. 272; Rev. Rul. 70-141, 1970-1 C.B. 76.
- 49 Rev. Rul. 2003-51, 2003-21 I.R.B. 1.
- 50 Rev. Rul. 70-140, 1970-1 C.B. 73.
- 51 *See, e.g., Wilgard Realty Co., Inc. v. Comm'r*, 127 F.2d 514 (2d Cir. 1942) (control test satisfied notwithstanding gift of transferee corporation stock where transferor had the legal right to determine whether or not to keep the stock and was under no binding obligation to make the gifts of stock).
- 52 *Compare Mojonnier & Sons, Inc. v. Comm'r*, 12 T.C. 837 (1949), *nonacq.*, 1949-2 C.B. 4 (control test not satisfied where transferee corporation directly transferred its stock to the transferors' family members); *Fahs v. Florida Machine & Foundry Co.*, 168 F.2d 957 (5th Cir. 1948) (same) *with Wilgard Realty Co., Inc. v. Comm'r*, 127 F.2d 514 (2d Cir. 1942) (control test satisfied where transferee corporation transferred all its stock to transferor and on the same day, transferor transferred some of the stock received to family members).
- 53 I.R.C. § 351(d)(1); Treas. Reg. § 1.351-1(a)(1)(i).
- 54 I.R.C. § 351(d)(2).
- 55 I.R.C. § 351(d)(3).
- 56 Katherine M. Bristor and Anthony L. Leibler, *Intellectual Property as Transferable Property for Purposes of Section 351*, 9 PLI 579 (2000) (quoting J. Clifton Fleming, Jr., *Domestic Section 351 Transfers of Intellectual Property: The Law as it is Vs. the Law as the Commissioner Would Prefer it To Be*, 16 J. Corp. Tax'n 99 (1989)).
- 57 Boris I. Bittker and James S. Eustice, *Federal Income Taxation of Corporations and Shareholders*, ¶¶ 3.02-3.03 (7th ed. 2002).
- 58 Treas. Reg. § 1.351-1(a)(2), Ex. 3.
- 59 Rev. Rul. 76-123, 1976-1 C.B. 94 (transaction was a Section 351 exchange because the purpose was to reincorporate in another jurisdiction and not solely for tax avoidance); Rev. Rul. 68-349, 1968-2 C.B. 143 (disregarding a purported Section 351 reorganization because an entity was created solely to obtain the tax benefits of Section 351); Rev. Rul. 60-331, 1960-2 C.B. 189 (purported Section 351 transfer was taxable because the only motive for the transfer was to minimize federal tax liability); Rev. Rul. 55-36, 1955-1 C.B. 340 (transaction was not entitled to the tax benefits provided by Section 351 because no business purpose existed for the transfer); F.S.A. 9905008 (Oct. 29, 1998) (advising the IRS agent to apply a business purpose requirement to a transaction to prohibit tax-free treatment under Section 351).
- 60 *Estate of Kluener v. Comm'r*, 154 F.3d 630 (6th Cir. 1998) (taxpayer denied tax-free treatment because he did not have a valid, non-tax business purpose for the property transfer); *Caruth v. United States*, 688 F. Supp. 1129, 1141 (N.D. Tex. 1987), *aff'd on other grounds*, 865 F.2d 644 (5th Cir. 1989) (a business purpose is required under Section 351); *Stewart v. Comm'r*, 714 F.2d 977, 989 (9th Cir. 1983) (stating that non-recognition treatment is inappropriate under Section 351 where a recipient is merely a conduit for the transferor to sell its assets); *Hempt Bros., Inc. v. United States*, 490 F.2d 1172, 1178 (3rd Cir. 1974) (implying that a business purpose is required under Section 351). *But see W. & K. Holding Corp. v. Comm'r*, 38 B.T.A. 830 (1938) (Turner, J., Arnold, J., Disney, J., and Oppen, J. dissenting) (exchange of securities that were declining in value for a company's stock was nontaxable, notwithstanding the fact that the sole reason for the transfer was to offset a capital gain with expected loss from the sale of contributed securities).
- 61 *See, e.g., Hallowell v. Comm'r*, 56 T.C. 600 (1971) (contribution of stock by transferor shareholder to transferee corporation followed by sale by transferee corporation resulted in taxable gain to the transferor shareholder); *Stewart v. Comm'r*, 714 F.2d 977 (9th Cir. 1983) (same).
- 62 *Hallowell*, 56 T.C. 600 (interval between transfer and sale was as short as 1 day and as long as 6½ months; the average interval was less than 1½ months).
- 63 *Lessinger v. Comm'r*, 872 F.2d 519 (2d Cir. 1989).
- 64 I.R.C. § 267(f)(2); Treas. Reg. § 1.1502-13(c).
- 65 I.R.C. § 267(f)(2)(B).
- 66 Treas. Reg. § 1.482-1(f)(1)(iii).
- 67 Treas. Reg. § 1.482-1(f)(1)(iii)(B).
- 68 137 F.2d 600 (3d Cir. 1943).
- 69 *National Securities Corp.*, 137 F.2d at 602-03. *See also Foster v. Comm'r*, 756 F.2d 1430 (9th Cir. 1985) (gain from sale of property contributed by partnership to corporations reallocated to partnership); *Ruddick Corp. v. Comm'r*, 3 Cl. Ct. 61 (1983) (gain to parent from sale of property received from subsidiary reallocated to subsidiary); *Northwestern Nat'l Bank of Minneapolis v. United States*, 556 F.2d 889 (8th Cir.

1977) (parent's charitable deduction from stock received from subsidiary reallocated to subsidiary).

70 See, e.g., *John P. Warner et al.*, 887 T.M., *Transfer Pricing: The Code and the Regulations*

71 See *G.D. Searle & Co. v. Comm'r*, 88 T.C. 252 (1987) and cases cited therein.

72 *Id.*

73 305 F.2d 681 (9th Cir. 1962)

74 John A. Townsend, *Reconciling Section 482 and the Non-recognition Provisions*, 50 Tax Law. 701 (1997).

75 See, e.g., Rev. Rul. 70-140, 1970-1 C.B. 73; *West Coast Marketing Corp. v. Comm'r*, 46 T.C. 32 (1966). But see *Vest v. Comm'r*, 57 T.C. 128 (1971) (incorporation transfer and subsequent stock-for-stock exchange upheld as separate tax-free transactions).

76 *Esmark, Inc. v. Comm'r*, 90 T.C. 171, *aff'd without opinion*, 886 F.2d 1318 (7th Cir. 1989) (quoting *Penrod v. Comm'r*, 88 T.C. 1415 (1987)).

77 *Gregory v. Helvering*, 293 U.S. 465 (1935) (stating that a taxpayer has the legal right "to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits").

78 *Esmark, Inc. v. Comm'r*, 90 T.C. 171 (1988), *aff'd without opinion*, 886 F.2d 1318 (7th Cir. 1989).

79 I.R.C. § 351(e).

80 I.R.C. § 351(e)(1); Treas. Reg. § 1.351-1(c)(1).

81 Treas. Reg. §§ 1.351-1(c)(4) and (5).

82 Rev. Rul. 87-9, 1987-1 C.B. 133.

83 Treas. Reg. § 1.351-1(c)(5).

84 See, e.g., PLR 200006008 (Sept. 30, 1999).

85 Rev. Rul. 87-9, 1987-1 C.B. 133.

86 Treas. Reg. § 1.351-1(c)(6).

87 I.R.C. § 368(a)(2)(F)(ii).

88 11 T.C. 397, *aff'd*, 177 F.2d 513 (3d Cir. 1949).

89 Specifically, the court determined the basis of assets acquired by the newly formed corporation, which

determination required an analysis of whether the transaction was tax-free under the then-existing version of Section 351.

90 11 T.C. at 404.

91 89 F.2d 513 (3d Cir. 1937).

92 85 F.2d 8 (2d Cir. 1936).

93 11 T.C. at 406.

94 *Id.*

95 *Id.*

96 *Id.*

97 *Id.* at 408.

98 Although the *American Bantam* court observed that courts have considered such factors as the intent of the parties, the time element, and the ultimate result, 11 T.C. at 405, the court's analysis was based primarily on the "mutual interdependence" test.

99 Under this test, separate transactions are combined if 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. *Security Indus. Ins. Co. v. United States*, 702 F.2d 1234, 1244 (5th Cir. 1983).

100 *Security Indus. Ins. Co.* at 1245.

101 Treas. Reg. § 1.351-1(a)(3)(i).

102 Rev. Rul. 2003-48, 2003-19 I.R.B. 863.

103 Rev. Rul. 77-449, 1977-2 C.B. 110.

104 Rev. Rul. 83-84, 1983-1 C.B. 66.

105 *Royal Marcher v. Comm'r*, 32 B.T.A. 76 (1935).

106 *Handbird Holding Corp. v. Comm'r*, 32 B.T.A. 238 (1935).

107 Rev. Rul. 83-156, 1983-2 C.B. 66, *amplifying* Rev. Rul. 77-449, 1977-2 C.B. 110.

108 See also PLR 9710018 (Dec. 5, 1996), PLR 9422057 (Mar. 11, 1994).

109 Rev. Rul. 64-73, 1964-1 C.B. 142.

110 Rev. Rul. 2003-51, 2003-21 I.R.B. 1.

- 111 1984-1 C.B. 106.
- 112 *National Starch & Chem. Corp. v. Comm'r*, 93 T.C. 67, *aff'd*, 918 F.2d 426 (3d Cir. 1990).
- 113 Rev. Rul. 73-427, 1973-2 C.B. 301.
- 114 Even in a valid Section 351 transaction, the Newco shareholders would be taxable upon receipt of Newco securities (subject to the installment reporting rules).
- 115 Rev. Rul. 84-44, 1984-1 C.B. 105.
- 116 1970-1 C.B. 73.
- 117 46 T.C. 32 (1966).
- 118 *Weikel v. Comm'r*, 51 T.C.M. 432 (1986). *See also Vest v. Comm'r*, 57 T.C. 128 (1971), *aff'd in part and rev'd in part*, 481 F.2d 238 (5th Cir. 1973).
- 119 I.R.C. § 357(d)(1)(A).
- 120 I.R.C. § 357(d)(1)(B).
- 121 I.R.C. § 357(d)(2).
- 122 I.R.C. § 357(b).
- 123 Treas. Reg. § 1.357-1(c).
- 124 *See, e.g., Drybrough v. Comm'r*, 376 F.2d 350 (6th Cir. 1967), *aff'g in part and rev'g in part* 42 T.C. 1029 (1964); *Wheeler v. Campbell*, 342 F.2d 837 (5th Cir. 1965).
- 125 *See, e.g., Wheeler v. Comm'r*, 342 F.2d 837 (5th Cir. 1965).
- 126 I.R.C. § 357(c).
- 127 I.R.C. § 357(c)(2)(A).
- 128 Rev. Rul. 95-74, 1995-2 C.B. 36.
- 129 *Holdcroft Trans. Co. v. Comm'r*, 153 F.2d 323 (8th Cir. 1946).
- 130 *See Kevin M. Keyes, Dealing with Contingent Stock and Contingent Liabilities in Tax-Free Transactions*, 8 PLI 767 (2002) for a discussion of the treatment of contingent liabilities in Section 351 transactions.
- 131 *Lessinger v. Comm'r*, 872 F.2d 519 (2d Cir. 1989).
- 132 *Id.*, *rev'g* 85 T.C. 824 (1985).
- 133 *Peracchi v. Comm'r*, 143 F.3d 487 (1998), *rev'g* 71 T.C.M. (CCH) 2830 (1996).
- 134 I.R.C. § 357(d)(1)(A).
- 135 Notice 2001-17, 2001-19 I.R.B. 730.
- 136 I.R.C. § 358(d)(2).
- 137 I.R.C. § 358(h)(1).
- 138 S Rep. No. 106-2, 106th Cong., 1st Sess. (1999).
- 139 Note that under Section 357(c), P would recognize gain of \$40 per asset (\$60 liability assumed less \$20 basis), or \$120 total. If P is foreign or otherwise tax-exempt, P pays no U.S. tax on the gain, yet each transferee takes a stepped-up basis in the asset received.
- 140 I.R.C. § 357(d)(1)(A).
- 141 I.R.C. § 357(d)(1)(B).
- 142 I.R.C. § 357(d)(2).
- 143 REG-100818-01, 68 Fed. Reg. 23931-35 (May 6, 2003).
- 144 Rev. Rul. 74-503, 1974-2 C.B. 117.
- 145 Treas. Reg. § 1.1032-3(b)(1).
- 146 Treas. Reg. § 1.1032-3(b)(2).
- 147 Treas. Reg. § 1.1032-3(c).
- 148 Treas. Reg. § 1.1032-1(d).
- 149 Treas. Reg. § 1.1032-3(c)(2).
- 150 T.D. 8883.
- 151 Rev. Rul. 80-76, 1980-1 C.B. 15.
- 152 T.D. 8883.