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OF FORM AND SUBSTANCE: TAX-FREE INCORPORATIONS AND OTHER TRANSACTIONS UNDER SECTION 351

*Ronald H. Jensen**

> "The principle of looking through form to substance is no schoolboy's rule; it is the cornerstone of sound taxation."[1]

> "Taxpayer strongly argues that [the Commissioner's position] . . . elevate[s] form over substance. . . . However, the difference between form and substance in tax law is largely problematical."[2]

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[1] Estate of Weinert v. Commissioner, 294 F.2d 750, 755 (5th Cir. 1961).

[2] United States v. Davis, 397 U.S. 301, 312 (1970).

I. INTRODUCTION

No principle is more deeply embedded in our system of federal taxation than the rule that transactions are to be taxed in accordance with their substance and not their form. Unfortunately, this "rule" is not sufficiently precise either to predict results (and therefore serve as a guide in structuring transactions) or to explain the divergent results reached by the courts while purporting to apply the rule. The purpose of this article is to go beyond general formulations like the supposed dichotomy between form and substance — what Learned Hand described as "anodynes for the pains of reasoning"[3] — and to probe the circumstances under which a court should respect the form in which a transaction is cast and when it may properly disregard that form. To give the discussion substantive content, this article will focus on a discrete area of cor-

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[3] Commissioner v. Sansome, 60 F.2d 931, 933 (2d Cir.), cert. denied, 287 U.S. 667 (1932).

porate taxation: tax-free incorporations and other transactions under section 351 of the Internal Revenue Code.[4]

The tax treatment of incorporations (and transfers of property to existing corporations) is governed primarily by sections 1001 and 351. The following example illustrates the operation of these sections:

> *Example 1.1*
> A owns Blackacre which he bought several years ago for $10,000 but which now has a fair market value of $50,000. For good and valid business reasons — possibly to insulate himself from personal liability for accidents occurring on Blackacre — A incorporates Blackacre by transferring the property to a newly-formed corporation (Newco) and taking back all of Newco's stock.

In the absence of section 351, A would be required to recognize and pay a tax on a $40,000 gain under the general rule of section 1001. Section 1001 directs a taxpayer who makes a sale or other disposition to recognize gain (or loss) to the extent the amount realized by the taxpayer exceeds (or is less than) his adjusted basis in the property sold or exchanged. In the above example, there has been a disposition, i.e., A has transferred Blackacre to Newco in exchange for the Newco stock. The amount realized by A is $50,000, the fair market value of the Newco stock received by A,[5] and A's adjusted basis in Blackacre was $10,000, the amount he had paid for Blackacre.[6] In the absence of section 351, A would therefore recognize a taxable gain of $40,000, the difference between the amount realized, $50,000, and A's adjusted basis in Blackacre, $10,000.

Section 351(a) creates an exception to the general rule of section 1001 by providing that a taxpayer will recognize no gain or loss if:

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[4] All section references hereafter are to the Internal Revenue Code of 1986 unless otherwise stated.

[5] See I.R.C. § 1001(b). Since A received all the stock of Newco whose only asset, Blackacre, has a fair market value of $50,000, it is reasonable to assume that the fair market value of the Newco stock received by A (and hence the amount realized by A) is $50,000. In any event, under modern tax theory, if the amount received in a transaction cannot otherwise be valued, it is presumed to have a fair market value equal to the fair market value of the property given up. Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184 (Ct. Cl. 1954) (holding that where the value of property received in an arm's length transaction could not be determined, the value was presumed to be the value of the property given up).

[6] See I.R.C. § 1012.

(1) The taxpayer transfers property to the corporation;

(2) The taxpayer receives at least some stock in exchange for the property he transfers;[7] and

(3) The taxpayer, together with all others transferring property as part of the same transaction, controls the corporation immediately after the exchange.[8] For this purpose, "control" means ownership of stock possessing at least 80% of the total combined voting power of all voting stock and at least 80% of the total number of shares of all other classes of stock.[9]

In the above example, A would recognize no gain or loss on his transfer of Blackacre to Newco. A transferred property, Blackacre, to Newco; he received stock in exchange for that property; and immediately after the transfer, A controlled Newco, that is, he owned at least 80% of the Newco's stock (in fact, he owned all of its stock). Section 358 provides as a corollary that in a section 351 transaction, the transferor takes the same basis in the stock as he had in the transferred property;[10] thus, A would have a basis of $10,000 in the Newco stock. Effectively, this rule provides that gain inherent in Blackacre at the time of transfer, $40,000, is not forgiven, but merely deferred until A sells his stock. A similar rule provides that the transferee corporation takes the same basis in the transferred assets as the transferor had in them prior to the transfer.[11]

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[7] In the case of transfers made to corporations on or before October 2, 1989, the Code permitted securities as well as stock to be received tax-free from the corporation. "Securities," in contradistinction to "stock," are generally long-term debt of the corporation. See generally Boris I. Bittker & James S. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 3.03(2) at 3-10 (5th ed. 1987). In the case of transfers made to corporations after October 2, 1989, securities of the corporation received by the transferor in exchange for property are treated as boot (see infra note 8) and therefore taxed to the transferor to the extent of any gain realized on the transfer pursuant to § 351(b). Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7203, 103 Stat. 2106, 2333 (1989).

[8] If the transferor receives any property from the corporation other than stock (such other property is commonly called "boot"), the transferor will recognize the gain on the transaction, if any, to the extent of the fair market value of the boot. No loss may be recognized in a transaction under § 351. I.R.C. § 351(b).

[9] I.R.C. § 351(a) (cross reference to definition of "control" in § 368(c)).

[10] I.R.C § 358(a)(1). If the transferor receives boot, the transferor's basis in the stock received is his or her basis in the property transferred to the corporation, decreased by the fair market value of such boot and increased by the amount of any gain recognized on the transaction. Id. Note that, pursuant to § 358(a)(2), the transferor's basis in the boot received is the fair market value of such boot.

[11] I.R.C. § 362(a). If the transferor recognized gain on the transfer, the corporation's basis

Section 351 also applies to transfers to existing corporations, "midstream" transfers, so long as the transferors own 80% or more of the stock immediately after the transfer.[12]

Example 1.1 was straightforward. The following example illustrates the difficulties that arise when the concepts of "form" and "substance" are introduced.

> *Example 1.2*
> As in Example 1.1, A owns Blackacre which has a fair market value of $50,000 and an adjusted basis of $10,000. B would like to buy a 30% interest in Blackacre from A for $15,000, but is unwilling to do so unless Blackacre is first placed in a corporation so the shareholders will be shielded from personal liability. Therefore, A and B enter into a binding agreement that A will first transfer Blackacre to a newly formed corporation (Newco) in exchange for all of its stock, and A will then sell a 30% stock interest in Newco to B. (For convenience, this type of transaction will hereafter be referred to as a "binding obligation case" since A was under a binding obligation to sell 30% of Newco's stock at the time A transferred Blackacre to Newco.)

If A's transfer of Blackacre to the corporation qualifies for nonrecognition under section 351, A will recognize no gain on the transfer. Instead, gain will be recognized when A sells his 30% stock interest to B. Pursuant to section 358, A would take a basis of $10,000 in the Newco stock he received for Blackacre. When A sells a 30% stock interest in Newco to B for $15,000, he would recognize a $12,000 gain: the amount realized, $15,000, less A's basis in the 30% stock interest he sold to B, $3,000.[13] However, if A's initial transfer of Blackacre to Newco fails to qualify under section 351, A will recognize a taxable gain on the entire $40,000 appreciation in Blackacre at the time of its transfer to Newco.

In Example 1.2, A satisfied all the literal requirements of section 351. He transferred property (i.e., Blackacre) to Newco; he received stock in return; and immediately after the transfer, he controlled Newco since he then owned 100% of the stock. Nevertheless, it is well established that where the property-transferor is

in the transferred assets is increased by the amount of gain so recognized. Id.

[12] See Bittker & Eustice, supra note 7, ¶ 3.07 at 3-27.

[13] A's basis in the 30% stock interest sold to B amounts to $3000 and is computed as follows: 30% of $10,000 [A's basis in all his Newco stock].

under a binding obligation at the time of the transfer to dispose of his stock to another person so that the transferor's stock interest will be reduced below the requisite 80% level, the transaction is not protected by section 351.[14] In the view of the courts, the taxpayer has complied only with the form of section 351 but not its substance. They have reasoned that the statute envisions that the property-transferor will control the corporation after the transfer, and where it is contemplated at the outset that the property-transferor will lose control of the corporation as part of the same transaction, the taxpayer has not complied with the spirit of section 351. In reaching this conclusion, the courts have invoked the "step transaction" doctrine — a tool frequently used by courts in resolving form versus substance problems. The step transaction doctrine is a judicially developed concept, which in its broadest form, permits a series of separate steps to be recharacterized and treated as a single transaction if the steps are closely related and focused toward a particular end result.[15] In other words, if the step transaction doctrine applies, the tax consequences will be tested by focusing on the end result rather than the situation existing at the end of any intermediate step. Thus, in Example 1.2, A fails to qualify for nonrecognition because, upon completion of the entire transaction, A wound up with less than the required 80% stock interest.

This article presents three principal theses:

First, the courts and the Internal Revenue Service have misapplied the substance over form doctrine to the binding obligation cases under section 351 and in the process have created a hodgepodge of hopelessly irreconcilable and frequently wrong decisions. Part II of this article illustrates the inconsistencies and contradictions found in current law. Part III diagnoses the reason for this malaise: the unthinking, mechanical and therefore erroneous application of the step transaction doctrine. Part IV then develops the true function of the doctrine: to assure that clearly defined statutory purposes are not frustrated by plans which technically comply with the statute but defeat its purposes. The corollary —

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[14] See, e.g., Intermountain Lumber Co. v. Commissioner, 65 T.C. 1025, 1031 (1976); Hazeltine Corp. v. Commissioner, 89 F.2d 513, 518 (3d Cir. 1937); Bassick v. Commissioner, 85 F.2d 8, 10 (2d Cir.), cert. denied, 299 U.S. 592 (1936).

[15] This formulation of the step transaction doctrine is taken from Marvin A. Chirelstein & Benjamin B. Lopata, Recent Developments in the Step-Transaction Doctrine, 60 Taxes 970, 970 (1982).

that to correctly apply the step transaction doctrine, one must first discover the purpose of the statute — leads to an examination of the reasons for the 80% control requirement and the other requirements in section 351.

Second, the reason traditionally ascribed for the 80% control requirement is faulty. The control requirement is usually explained as a means of differentiating between mere changes of form and changes of substance and restricting nonrecognition to the former. Part IV of the article shows that this rationale neither explains the way the statute operates in practice (which accords nonrecognition to major changes of substance) nor is it supported by the legislative history of section 351.

Finally, the most reasonable explanation of the 80% control requirement of section 351 is that it serves as a device to prevent a corporation, particularly a publicly-held corporation, from using its stock as a medium of exchange for purchasing goods and property on a tax-free basis to its vendors. Without the control requirement, U.S. Steel could "sell" its steel to General Motors (GM) without recognizing any income simply by accepting GM stock in payment.[16] The 80% control requirement prevents this result by limiting nonrecognition to transactions between a corporation and persons who are either insiders, shareholders owning 80% or more of the corporation's stock, or persons who become insiders by virtue of the transaction. Part V develops the historical and policy justifications for this interpretation of the control requirement, and Part VI illustrates how application of this new rationale brings increased order, consistency and predictability to questions arising under section 351.

II. The Current Status of the Law Under Section 351: Paradoxes, Incongruities and Anomalies

In their quest to distinguish form from substance in section 351 cases, the courts and the Internal Revenue Service ("Service") have created a patchwork of irreconcilable decisions, inexplicable on the basis of logic or policy and virtually devoid of any explanatory or predictive value. The result has been a series of *ad hoc*

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[16] Without the 80% control requirement, U.S. Steel's sale of steel to GM for GM stock would qualify for nonrecognition under § 351, since U.S. Steel would be transferring property, steel, in exchange for stock.

decisions distinguishable only on the basis of their factual variations, with little or no explanation as to why such factual variation justifies a particular result. This lack of a consistent rationale has made both prediction and rational development of the law virtually impossible.

A. *The Gift and Underwriting Cases*

As we saw in Example 1.2, a person who transfers assets to a newly formed corporation in exchange for all of its stock will nonetheless be denied nonrecognition under section 351 if he is under a binding obligation at the time of the transfer to dispose of control. The binding obligation case should be compared with two other common situations.

> *Example 2.1*
> A father, F, desires to incorporate his business which he has operated for many years as a proprietorship. At the same time he desires to turn over control of the business to his son, S, and therefore decides that as part of the same transaction he will give S a 75% stock interest in the corporation. Consequently, F transfers the assets of his business to Newco, a newly formed corporation. F can achieve his objective by taking back all of Newco's stock and then giving S 75% of the Newco stock. However, as a matter of convenience, F takes back only 25% of the stock and has Newco issue the remaining 75% stock interest directly to S. F therefore is never record owner of more than 25% of Newco's stock. (This situation will hereafter be referred to as the "gift" case.)

The similarities between the binding obligation case and the gift case would seemingly dictate the same result: the control requirement was unsatisfied. F's ownership of a controlling stock interest was just as fleeting as was the transferor's controlling stock interest in the binding obligation case; arguably more so, since F was never record owner of a controlling stock interest. Certainly it was no more permanent. Further, in both cases, the loss of control was predetermined and may be fairly characterized as part and parcel of the overall transaction. Nevertheless, the courts and the Service have with only rare exception treated the gift cases as satisfying the control requirement.[17]

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[17] See, e.g., D'Angelo Assocs., Inc. v. Commissioner, 70 T.C. 121, 132 (1978), acq. in result 1979-1 C.B. 1; Wilgard Realty Co. v. Commissioner, 127 F.2d 514, 516 (2d Cir.), cert. denied,

Example 2.2

O has successfully operated a proprietorship for many years but has now decided to incorporate and take the business public. Pursuant to this plan, O transfers his business assets to a newly formed corporation, Newco, taking back 20% of its stock. Simultaneously, U, a professional underwriter, pays cash to Newco for the remaining 80% of its stock under a firm commitment underwriting agreement. U only entered into the agreement because it anticipated and intended to sell all the stock it bought to the public at a mark-up over its purchase price. However, if unsuccessful, U would be required to retain the unsold shares. Prior to U's purchase, much time, effort and money had been expended by O and U in preparing a registration statement to assure that the stock could legally be sold to the public in compliance with the Securities Act of 1933.[18] Moreover, prior to U's purchase of the stock, U had been actively soliciting potential purchasers by distributing preliminary prospectuses ("red herrings") to them. U sells all of the stock it bought to the public within two weeks of its purchase. (This situation will hereafter be referred to as the "underwriting" case.)[19]

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317 U.S. 655 (1942). See also Stanton v. United States, 512 F.2d 13, 17 (3d Cir. 1975) (control requirement for a § 368(a)(1)(D) reorganization satisfied where transferor directed that 49% of transferee-corporation's stock be issued to his wife). In Fahs v. Florida Machine & Foundry Co., 168 F.2d 957, 959 (5th Cir. 1948), and Mojonnier & Sons, Inc. v. Commissioner, 12 T.C. 837, 849 (1949), nonacq. 1949-2 C.B. 4, appeal dismissed (9th Cir. 1950), the courts held the control requirement was not satisfied where more than 20% of the corporation's stock was issued directly to a family member of the transferor. These holdings were distinguished by the *D'Angelo* court on the ground that in each case, the transferor was obligated to transfer the shares to the family member by reason of a pre-transfer agreement. *D'Angelo* 70 T.C. at 133.

[18] 15 U.S.C. §§ 77a (1988).

[19] Under the Securities Act of 1933, securities may not be sold until the registration statement filed with the Securities and Exchange Commission ("SEC") becomes effective. § 5(a). However, between the time the registration statement is filed with the SEC and the time it is declared effective, the waiting period, the underwriters may solicit "indications of interest" from prospective purchasers both orally and through the distribution of preliminary prospectuses, commonly called "red herrings." The agreement between the underwriter and the company issuing the securities whereunder the underwriter becomes obligated to buy the securities and therefore assumes the market risk is generally not signed until the morning on which the registration statement becomes effective. See generally Securities Underwriting: A Practitioner's Guide 25-60, 235, 330 (Kenneth J. Bialkin & William J. Grant eds. 1985) [hereinafter Bialkin & Grant]; Louis Loss & Joel Seligman, Securities Regulation ch. 2 (3d ed. 1989). To minimize its risk, the underwriter will pre-sell the issue (secure informal but nonbinding understandings from potential customers) before committing itself:

> The market risk is generally not as great as it may appear in most offerings, because the underwriter usually does not commit until it has presold the entire issue plus 15 percent for good measure. If the mechanics of an offering work well, that risk can be

Again common sense would appear to require the same result in the underwriting case as in the binding obligation case: U's intentionally transitory ownership of stock should preclude nonrecognition. It is the height of artificiality to treat the transaction as complete for tax purposes upon U's purchase of the stock when the only reason for U's purchase of the stock was to immediately resell it to the public at a profit. U's controlling stock ownership was transitory; disposition of the stock was preplanned; and practical commercial necessity compelled U to dispose of the stock as quickly as possible, that is, its need to make its profit and to terminate its exposure to the possibility of adverse market price fluctuations.

Nevertheless, the Service in Revenue Ruling 78-294[20] declined to apply the step transaction doctrine to the firm-commitment underwriter stating that "the transaction is completed for section 351 purposes with the underwriter's exchange of property for the stock."[21]

Both the gift and the underwriting cases are factually distinguishable from the binding obligation case: in the former cases, the transferors (F and U) were legally free to retain control (although they had no intention of doing so) while in the latter case the transferor was legally bound to dispose of control. In fact, some courts have attempted to reconcile the cases under section 351 on this basis.[22] But this purported distinction hardly justifies the differing tax treatments:

First, it is anomalous to make tax treatment turn on a person's technical legal rights which he or she has no intention of exercising when the point of the exercise is to tax the transaction on its sub-

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reduced to an hour or so.

Bialkin & Grant, at 25 n.1.

[20] 1978-2 C.B. 141 (Situation 2). The Ruling does not recite that the underwriter was involved in the preparation of the prospectus or that it had solicited indications of interest prior to its purchase of the stock. However, these are standard practices in any underwriting today and must have been contemplated by the drafters of the Ruling. See supra note 19.

[21] Id. at 142. The Ruling concluded that "since *A* [the owner who transferred his business to *Z*, the new corporation, for 50% of its stock] and the firm-commitment underwriter hold 100 percent of the *Z* stock at the culmination of the incorporation transaction, the transferor group is in control of *Z* immediately after the exchange."

[22] See, e.g., Intermountain Lumber Co. v. Commissioner, 65 T.C. 1025, 1031-1032 (1978) ("[I]t is immaterial how soon [after the transfer] the transferee elects to dispose of his stock or whether such disposition is in accord with a preconceived plan *not amounting to a binding obligation*.") (emphasis added).

stance and not its form.

Second, no policy reason exists, nor has any been articulated, for making tax consequences turn upon the presence or absence of a binding obligation.

Moreover, making the tax consequences of the transaction dependent on the existence or nonexistence of a legally binding commitment opens the door to manipulation by taxpayers: if the parties wish to avoid section 351 treatment, they cast the transferor's plan to dispose of his stock as a legally binding commitment; if they desire section 351 treatment, they simply make sure that the transferor's plan is not legally enforceable.[23]

Finally, as shown below, application of the step transaction doctrine is generally not dependent on the existence of a binding obligation.

B. Ambiguity and Inconsistency in the Step Transaction Doctrine

Commentators and courts have discerned three variations of the step transaction doctrine, only one of which is dependent on the existence of a binding obligation. The three variations are the end result,[24] interdependence,[25] and binding commitment tests.[26] Under the end result test, "purportedly separate transactions will be amalgamated into a single transaction when it appears that they were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result."[27] The interdependence test asks whether the "the steps are

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[23] See Culligan Water Conditioning of Tri-Cities v. United States, 567 F. 2d 867, 869 n.2 (9th Cir. 1978) (arguing the step transaction doctrine "would itself be subject to manipulation by the parties if it required a binding obligation to dispose of control"); Security Indus. Ins. Co. v. United States, 702 F.2d 1234, 1245 (5th Cir. 1983) (requiring a binding obligation "would effectively permit taxpayers to evade the step transaction doctrine merely by abstaining from formal commitments"). Note that the risk taken by the transferor where the plan to sell a portion of his stock to a third party is not legally binding is normally quite minimal. If the third party reneges on his legally unenforceable understanding to buy a portion of the transferor's stock, the transferor is generally no worse off than he was before the transaction; his property is simply now held in his wholly-owned corporation.

[24] See, e.g., *Security Indus. Ins. Co.*, 702 F.2d at 1244; Chirelstein & Lopata, supra note 15, at 970-71.

[25] *Security Indus. Ins. Co.*, 702 F.2d at 1244.

[26] Id. at 1245.

[27] King Enters., Inc. v. United States, 418 F.2d 511, 516 (Ct. Cl. 1969) (quoting David R. Herwitz, Business Planning 804 (1966)).

so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series."[28] The binding commitment test forbids the application of the step transaction doctrine to a multistep transaction unless "there [is] a binding commitment to take the later steps."[29]

Amazingly, the courts have not developed clear tests for determining which variation is to apply in a given case.[30] Indeed, this confusion over the proper test for applying the step transaction doctrine is itself a source of the inconsistency in cases arising under section 351. This failure to arrive at a consistent test for applying the doctrine reflects a more basic failure: namely, a failure to understand the purpose and rationale of the doctrine itself.[31]

Despite the confused application of the step transaction doctrine, some generalizations are possible. Normally, the doctrine applies regardless of whether there is a binding obligation. With the exception of cases arising under section 351 and section 368(a)(1)(D) (whose statutory language is similar to that of section 351),[32] the binding commitment test applies only in a highly selected class of cases. The courts have generally confined this test to cases where the transaction spans more than one taxable year; in those cases, there is a practical need to determine the resulting tax consequences prior to the final step, so the transaction can properly be reported on the taxpayer's annual return.[33] One court as-

[28] Redding v. Commissioner, 630 F.2d 1169, 1177 (7th Cir. 1980), cert. denied, 450 U.S. 913 (1981) (quoting Randolph E. Paul & Philip Zimet, Step Transactions, in Randolph E. Paul, Selected Studies In Federal Taxation 200, 254 (2d series, 1938)).

[29] Commissioner v. Gordon, 391 U.S. 83, 96 (1968).

[30] See Penrod v. Commissioner, 88 T.C. 1415, 1429 (1987) ("There is no universally accepted test as to when and how the step transaction doctrine should be applied to a given set of facts"); Howard J. Rothman, Transfers To Controlled Corporations: In General, Tax Mgmt. (BNA) 347-2d at A-21 ("The courts are seldom rigid in applying these various tests. . . . [I]t appears that the test that assists the court in reaching its conclusion is the one applied."); *Security Indus. Ins. Co.*, 702 F.2d at 1244 (noting that "the courts' applications of the step transaction doctrine have been enigmatic").

[31] Part III of this article offers a rationale for the step transaction doctrine.

[32] Section 368(a)(1)(D) defines "reorganization" as a transfer by a corporation of all or a part of its assets to another corporation if "immediately after the transfer" the transferor, or one or more of its shareholders, is "in control" of the transferee corporation, provided that stock or securities of the transferee corporation are distributed in a transaction which qualifies under §§ 354, 355 or 356.

[33] See McDonald's Restaurants of Illinois v. Commissioner, 688 F.2d 520, 525 (7th Cir. 1982); Redding v. Commissioner, 630 F.2d 1169, 1177 (7th Cir. 1980), cert. denied, 450 U.S.

serted the test should be limited to cases involving divestiture of control under section 355,[34] while some commentators have suggested it applies only where the taxpayer, rather than the government, invokes the doctrine.[35] The highly circumscribed situations in which the binding commitment test is applied show that a binding obligation is normally not a precondition to the application of the step transaction doctrine.[36] Thus the binding commitment test as generally applied does not justify the differing tax consequences accorded to the binding obligation cases on the one hand, and the gift and underwriting cases on the other.

What about the interdependence test? Can it explain or justify the differing tax results in the binding obligation case and the gift and underwriting cases? Under this test, the differing tax results in the gift and underwriting cases may arguably result because the formation of the corporation had independent significance from the subsequent disposition of stock and hence the two events should not be integrated. This argument is unconvincing. Even in a binding obligation case, formation of the corporation has independent legal and commercial significance separate and apart from the subsequent disposition of the stock. Suppose the transferor (or the prospective purchaser) in a binding obligation case reneges on his or her agreement to sell (or buy) the stock because of a change of

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913 (1981); *Security Indus. Ins. Co.*, 702 F.2d at 1245; Chirelstein and Lopata, supra note 15, at 971 ("the 'binding commitment' test has been applied only in the case of a transaction spanning several taxable years.") In King Enters. v. United States, 418 F.2d 511, 518 (Ct. Cl. 1969), the court rejected the binding commitment test, stating "[c]learly, the step transaction doctrine would be a dead letter if restricted to situations where the parties were *bound* to take certain steps."

[34] See *King Enters.*, 418 F.2d at 517-18; see also Jack S. Levin & Stephen S. Bowen, Taxable and Tax-Free Two-Step Acquisitions and Minority Squeeze-Outs, 33 Tax L. Rev. 425, 428 n.6 (1978) (*Gordon* limited to divestiture of control requirement in § 355 D reorganizations). It may be asserted that the control requirement in § 355 is a close analogue of the control requirement in § 351 and therefore the *Gordon* case supports the application of the binding commitment test to § 351 problems. However, this would not resolve the problem of the apparent inconsistency in the application of the step transaction doctrine but merely change the focus of the inquiry. The question would then be: Why is the binding commitment test used in § 351 and § 355 cases but not in other areas of the tax law?

[35] Bittker & Eustice, supra note 7, at ¶ 14.51(3).

[36] 11 Mertens, Law of Federal Income Taxation § 43.256 (1990) ("The cases have been eager to confine [Commissioner v. Gordon, 391 U.S. 83 (1968), which appeared to apply the binding commitment test] to its facts, of series of transactions occurring over more than one taxable year, and, preferably, involving distributions under Section 355. . . . The binding-commitment test has fared equally poorly with the commentators.")

heart, a lack of funds or for any other reason. The formation of the corporation would still have independent legal and economic substance, even though the anticipated plan of disposing of the control stock was not carried out. The interdependence test therefore does not satisfactorily explain or justify the different tax results in the binding obligation cases and the gift and underwriting cases. In fact, the courts have not attempted to justify the difference in these cases on the basis of the interdependence test.

Moreover, the interdependence test has generally been confined to section 351 and section 368(a)(1)(D) cases.[37] Courts purporting to apply the test outside the section 351 context have been much more ready to find that events are interdependent than when applying the test within the section 351 context.[38] Thus the general tax law does not support the narrow application of the interdependence test that would justify the results in the gift and underwriting cases.

Under the end result test — said by one court to be the test "most often invoked in . . . the application of the step transaction

[37] William D. Andrews, Federal Income Taxation of Corporate Transactions 138 (2d ed. 1979) ("The interdependence test . . . has been often cited but rejected in relation to reorganizations."); Seymour S. Mintz & William T. Plumb, Jr., Step Transactions in Corporate Reorganizations, 12 N.Y.U. Inst. on Fed. Tax'n 247, 253, 285 (1954) ("It is almost exclusively in this area [i.e., cases under the statutory predecessors of sections 351 and 368(a)(1)(D) and related basis provisions] that the 'interdependence' test has flourished"; interdependence test cannot be given "universal application"; does not apply to reorganizations except "possibly in applying the 'control' requirement of" the predecessor of § 368(a)(1)(D)); Brown v. United States, 782 F.2d 559 (6th Cir. 1986) (applied end result test and rejected interdependence and binding commitment tests in determining whether taxpayer is subject to § 631(c) with respect to royalties paid before taxpayer became sublessor). However, the Tax Court in McDonald's of Zion, 432, Ill., Inc. v. Commissioner, 76 T.C. 972 (1981), rev'd sub nom. McDonald's Restaurants of Illinois v. Commissioner, 688 F.2d 520 (7th Cir. 1982), applied the interdependence test, over the Government's objection, to determine whether the continuity of proprietary interest requirement was satisfied in a § 368(a)(1)(A) merger. The Seventh Circuit, in reversing the Tax Court, did not choose to apply one of the three variations of the step transaction doctrine, but held that the doctrine applied under each of the three variations.

[38] McDonald's Restaurants of Illinois v. Commissioner, 688 F. 2d 520 (7th Cir. 1982) discussed in text infra. The court formulated the relevant question as "whether the merger would have taken place without the guarantees of salability, and the answer is certainly no." Id. at 524. Arguably, a more traditional way to apply the interdependence test would be to ask whether the merger would have any independent significance apart from the subsequent disposition of the McDonald's stock, in which case the answer would certainly have been yes.

doctrine"[39] — the transferors in both the gift and underwriting cases would have failed to satisfy the control requirement; hence their transfers would have been taxable, because in each instance the intended end result from the outset was the loss of control by the transferors.[40]

McDonald's Restaurants of Illinois v. Commissioner[41] neatly illustrates the contrast between the niggardly application of the step transaction doctrine in section 351 cases and its expansive application in other areas of the tax law. In that case, Garb, Stern and Imerman (the Garb-Stern Group), who operated McDonald's franchises through 27 wholly owned corporations, had a falling out with McDonald's and wanted McDonald's to buy out their stock for cash.[42] McDonald's was anxious to rid itself of the Garb-Stern Group but was unwilling to buy them out for cash; McDonald's wanted to acquire their stock for McDonald's stock so that the transaction could be accounted for financially as a "pooling of interests" rather than a "purchase."[43] The parties compromised by structuring the transaction as a merger of the franchisee-corporations into McDonald's, with the Garb-Stern Group receiving McDonald's stock in exchange for their stock in the franchisee-corporations.[44] In return, the Garb-Stern Group would be given guarantees that it could sell the McDonald's stock in the open market.[45] Elaborate provisions were adopted whereunder the Garb-Stern Group could compel registration of the stock under the Securities Act of 1933, which was required before the stock could be sold to the public.[46] The Garb-Stern Group, however, was under no legal obligation to sell the stock.[47] The transaction closed on April 1, 1973, and the Garb-Stern Group sold their McDonald's stock in

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[39] Security Indus. Ins. Co. v. United States, 702 F. 2d 1234, 1244 (5th Cir. 1983).

[40] Likewise, the gift and underwriter cases would fail to qualify for § 351 treatment under the "transitory ownership" doctrine, which holds that transitory ownership is to be disregarded in determining tax consequences. See, e.g., United States v. General Geophysical Co., 296 F.2d 86 (5th Cir. 1961), cert. denied, 369 U.S. 849 (1962); Idol v. Commissioner, 38 T.C. 444 (1962), aff'd, 319 F.2d 647 (8th Cir. 1963), and discussion of doctrine in Esmark, Inc. v. Commissioner, 90 T.C. 171, 189-192 (1988), aff'd without op., 886 F.2d 1318 (7th Cir. 1989).

[41] 688 F.2d 520 (7th Cir. 1982).

[42] Id. at 521.

[43] Id.

[44] Thus the transaction would be accounted for as a "pooling of interests."

[45] *McDonald's*, 688 F.2d at 521-22.

[46] Id. at 522.

[47] Id.

October, 1973 as part of a public stock offering by McDonald's.[48]

In a reversal of traditional roles, the Service treated the transaction as a tax-free reorganization, which required McDonald's to use the franchisee-corporations' low bases in their assets for depreciation and amortization purposes.[49] McDonald's, on the other hand, contended the exchange was taxable; this would permit McDonald's to depreciate the assets of the acquired corporations on their higher date-of-acquisition values.[50] While the exchange met all of the statutorily imposed requirements for a tax-free reorganization, McDonald's argued that the exchange flunked the judicially-created "continuity of proprietary interest" requirement.[51] From the start, the parties intended that the shareholders of the acquired franchisee-corporations would sell all their McDonald's stock at the first available opportunity, thereby not maintaining their proprietary interest as required by the judicial test.[52] The court of appeals, reversing the Tax Court, held in favor of McDonald's under the step transaction doctrine.[53]

The court had no difficulty in finding that the step transaction doctrine was applicable under both the end result and the interdependence tests.[54] Disposition of the McDonald's stock had clearly been contemplated from the outset; the entire transaction had been structured to assure that the Garb-Stern Group would be able to dispose of their McDonald's stock: thus, the end result test was satisfied.[55] The court also found that the transaction satisfied the interdependence test because the merger would not have taken place unless steps were taken to assure the salability of the stock.[56]

The court found that the transaction satisfied the "binding commitment" test as well.[57] The court first suggested this test did not apply, because it had been formulated to deal with the characteri-

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[48] Id.

[49] Id. at 523. The Service ruled that the transaction was a tax-free statutory merger under § 368(a)(1)(A) with the result that McDonald's was required by § 362(b) to assume the Garb-Stern Group's basis in the acquired assets. Id.

[50] Id. at 522.

[51] Id. at 523-24.

[52] Id.

[53] Id. at 525.

[54] Id. at 524-25.

[55] Id. at 524.

[56] Id. at 524-25.

[57] Id. at 525.

zation of a transaction that spanned several tax years, whereas in *McDonald's* the merger and subsequent disposition of stock occurred in a single tax year.[58] Beyond that, the court argued there were significant practical pressures for the parties to sell the stock in 1973: if the Garb-Stern Group did not participate in the 1973 public offering, it would lose their right to compel McDonald's to register their stock.[59] Hence, the "spirit, if not the letter"[60] of the binding commitment test was satisfied.

The failure to apply the step transaction doctrine in Revenue Ruling 78-294,[61] the underwriting ruling, cannot be reconciled with the doctrine's application in *McDonald's*. In both cases, practical business and commercial pressures made a prompt sale of the stock likely: in *McDonald's*, the loss of registration rights if the Garb-Stern Group did not sell their stock in the 1973 offering and in Revenue Ruling 78-294 the underwriter's need to quickly sell the stock to the public so it could reap its profit and end its exposure to adverse market fluctuations. In *McDonald's*, elaborate registration rights were negotiated to assure salability of the stock; in a typical underwriting, the underwriter is intimately involved in the preparation of the registration statement to assure salability of the stock to the public in compliance with the Securities Act.[62] In *McDonald's*, the Garb-Stern Group bore the risk of price fluctuations in McDonald's stock until the stock was sold; likewise, in Revenue Ruling 78-294, the underwriter bore the market risk of changes in the price of the stock until it was sold.[63] In short, no valid distinction exists between the two situations. Neither the In-

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[58] Id.

[59] Id.

[60] Id.

[61] See supra notes 20-21 and accompanying text.

[62] Bialkin & Grant, supra note 19, at 103 ("Counsel for the underwriters will become very actively involved in the actual preparation of the registration statement and prospectus because of the potential liability of underwriters under the securities laws").

[63] In fact, the market risk assumed by the Garb-Stern Group was much greater than that normally assumed by an underwriter in the typical firm commitment underwriting. As indicated above, the underwriter's exposure in a well managed firm commitment underwriting may last only "an hour or so." See note 19 supra. In contrast, the Garb-Stern Group members' profits were totally dependent upon whether, and if so, when, McDonald's would register their stock during the first year after the mergers. In fact, the Garb-Stern Group's stock was not registered and sold until more than six months after the mergers, during which period the Garb-Stern Group bore the entire risk of loss on their stock. *McDonald's of Zion*, 76 T.C. 972, 981-987.

ternal Revenue Service nor the courts have explained or articulated a rationale for applying the step transaction doctrine narrowly in section 351 cases and broadly in the rest of the tax law.[64]

Even after selecting the appropriate test for application of the doctrine, the result is not clear. The tests are imprecise, amorphous and susceptible of widely varying application. In *McDonald's*, the court of appeals tested for interdependence by asking whether the transaction would have been entered into without assurances that the stock received could be sold to the general public, to which of course the answer was no. In contrast, the Tax Court tested for interdependence by asking whether the merger would have independent legal and commercial significance even if the Garb-Stern Group did not thereafter dispose of the McDonald's stock — to which the answer was assuredly yes.[65]

The step transaction doctrine is thus a mixture of inconsistency and ambiguity. Three different tests exist for determining its applicability, but the courts have articulated no standard for determining which test should be applied. Even after the appropriate

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[64] Mintz & Plumb, supra note 37, suggest that the restricted application of the step transaction doctrine in § 351 and § 368(a)(1)(D) cases may be attributable to the language found in those sections: "Decisions under those provisions are heavily colored by those words 'immediately after the transfer.' " Id. at 253. This may be a correct analysis of the psychological pressures causing the courts to give the step transaction doctrine a relatively narrow scope in such cases, but it is not a satisfactory doctrinal justification for the starkly different applications of the doctrine in the § 351 and § 368(a)(1)(D) cases, on the one hand, and in cases arising under other sections of the tax law, on the other. It ignores the fact that the courts have been quite willing in § 351 cases to ignore the statutory language where there is a preexisting binding obligation. If reverence for the statutory language explains these different approaches, why are the courts willing to ignore the statutory language in § 351 cases involving a binding agreement? Nor does the statutory language explain or justify why the courts rule one way in the binding obligation cases arising under § 351 and another way in the gift and underwriting cases arising under the same section.

[65] See Chirelstein & Lopata, supra note 15, at 974 ("It is at least arguable in McDonald's that the Tax Court's application of the step-transaction doctrine, rather than that of the Seventh Circuit, was technically correct"). Also contrast the Seventh Circuit's application of the "binding commitment" test in *McDonald's* with the Eighth Circuit's application of the doctrine in Stephens, Inc. v. United States, 464 F.2d 53 (8th Cir. 1972), cert. denied, 409 U.S. 1118 (1973). In *McDonald's* (a reorganization case), the Seventh Circuit found the binding commitment test satisfied because of the practical commercial pressures for a prompt sale, while in *Stephens* (a § 368(a)(1)(D) case) the Eighth Circuit (without specifically alluding to the binding commitment test) refused to apply the step transaction doctrine despite significant pressure to proceed with the subsequent stock sale since otherwise the taxpayer-brokerage firm might be classified as a Public Utility Holding Company and thus required to obtain prior SEC approval to any further financing operations.

test is chosen, the test can be applied restrictively or expansively, but the courts have not coherently or persuasively explained whether a narrow or a broad application is appropriate. Finally, the doctrine is normally applied narrowly in section 351 and section 368(a)(1)(D) cases and broadly in the rest of the tax law; but again, the courts have not justified or rationalized this differing tax treatment.

C. Inconsistent Standards for Applying the Step Transaction Doctrine to Section 351 Cases.

The failure to apply the step transaction doctrine in the gift and underwriting cases is not only inconsistent with the way the doctrine is normally applied but also with the ruling positions of the Service in applying section 351 to other situations. For instance, the Service ruled in Revenue Ruling 55-36[66] that an individual who transferred appreciated property to a newly formed corporation in exchange for all of its stock and debentures and then immediately gave away all the stock to a charity failed to qualify for nonrecognition under section 351. The ruling held that he failed the control requirement, "since his ownership of the stock was only transitory and the object of the plan was to place control in the hands of the [charity]."[67]

In Revenue Ruling 54-96,[68] a corporation transferred some of its assets to a newly formed corporation in exchange for all of its stock and then, pursuant to a prearranged plan, exchanged the new corporation's stock for stock of a third corporation. The ruling contains no indication that the transferor-corporation was legally bound at the time of the transfer to engage in the subsequent stock-for-stock swap although that was its plan. The Service integrated both the initial transfer of assets and the subsequent exchange of stock holding that the transferor-corporation did not satisfy the control requirement: "The two steps of the transaction described above were part of a prearranged integrated plan, and may not be considered independently for Federal income tax purposes."[69]

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[66] Rev. Rul. 55-36, 1955-1 C.B. 340.
[67] Id. at 341.
[68] Rev. Rul. 54-96, 1954-1 C.B. 111.
[69] Id. at 112.

The standards in these rulings cannot be squared with either Revenue Ruling 78-294[70] or the gift case. Clearly, an underwriter's sale of stock to the public following its purchase of stock under a firm commitment agreement is preplanned; its ownership of the stock is "only transitory" and the "object of the [underwriter's] plan was to place control in the hands of the" public. Likewise, the father's planned gift of stock to his son upon the formation of his corporation in Example 2.1 was "prearranged," at best, the father's ownership of the gifted stock was "only transitory," and the "object of [his] plan was to place control in the hands of" his son.

D. *The Lack of Any Unifying Rationale*

The conundrum exposed by these cases and rulings can be summed up as follows: in certain instances, a transferor's divestiture of control shortly after the transfer pursuant to a preconceived plan disqualifies the transaction under section 351 while in others it does not. Neither the courts nor the Service have articulated a persuasive rationale explaining these apparently inconsistent applications of the step transaction doctrine. Indeed, there was no reasoned justification for application of the step transaction doctrine to section 351 in the first place.

Some early cases suggested that even momentary control would suffice. As stated by the Board of Tax Appeals in *Evans Products Co. v. Commissioner*: "[I]t is not essential that [the transferor] should retain control for any length of time. It is sufficient that he was momentarily in control."[71]

Judge Magruder endorsed this view in *Portland Oil Company v. Commissioner*[72] pointing out that the statute "does not say that such control shall 'remain' in the transferors"[73] and adding that:

> The character of this transaction is not altered by what the transferor may subsequently do with the property received in exchange; such a subsequent transfer should stand on its own footing and may or may not involve the recognition of a gain or loss, depending

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[70] See supra notes 20-21 and accompanying text.

[71] 29 B.T.A. 992, 997 (1934), acq. XIII-1 C.B. 6 (1934), aff'd, 84 F.2d 998 (6th Cir. 1936), cert. denied, 298 U.S. 675 (1936).

[72] 109 F.2d 479 (1st Cir. 1940), cert. denied, 310 U.S. 650 (1940).

[73] Id. at 489.

upon what kind of a transfer it is.[74]

Judge Magruder opined in *dictum* that the statute would be satisfied even if the transferor had been contractually bound at the time of the transfer to subsequently divest himself of control.[75] However, when that issue arose, the courts uniformly ruled the other way. In so deciding, the courts reformulated the operative test. According to the Board of Tax Appeals, where the divestiture of control is an integral and inseparable part of an overall plan: "[T]he question of control is to be determined by the situation existing at the completion of the plan rather than at the time of the fulfillment of one of the intermediate steps."[76]

It is remarkable that the courts felt no need to justify a result clearly at odds with the language of the statute. By its terms, the statute requires only that the transferor control the corporation immediately after the transfer of property; and the courts had previously stated that momentary control was sufficient. Nevertheless, in these cases, the courts held that the statute was not satisfied even though the transferor was concededly in control immediately after the transfer. The courts did not attempt to justify this departure from the statute on the basis of its language or its legislative history or upon any perceived policy of the statute. Apparently, the courts found it self-evident that the spirit and purpose of the statute was not being complied with where the transferor immediately divested himself of control following the transfer pursuant to a prearranged plan.[77]

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[74] Id. at 490.

[75] Id.

[76] Burns v. Commissioner, 30 B.T.A. 163, 172 (1934), aff'd sub nom. Bassick v. Commissioner, 85 F.2d 8 (2d Cir. 1936), cert. denied, 299 U.S. 592 (1936).

[77] West Tex. Ref. & Dev. Co. v. Commissioner, 25 B.T.A. 1254 (1932), rev'd in part on other grounds and aff'd, 68 F.2d 77 (1933), one of the earliest cases to apply the step transaction doctrine to the requirement that control exist immediately after the transfer, is typical. The court held where one corporation, pursuant to a preexisting, binding agreement, transferred assets to a newly formed corporation for all of its stock and sixteen days later another corporation pursuant to the same agreement transferred cash to the newly formed corporation for an equal amount of stock, the transfer by the first corporation was taxable because at the completion of the plan the first corporation no longer had "control," that is, it no longer owned 80% of the stock of the newly formed corporation:

> We think the provisions of [the predecessor of section 368(a)(1)(D)] are applicable as of the date the plan was completed. . . . One step must precede another and we do not think the language of [such section], "immediately after the transfer," intended that questions of tax liability should be determined by the fact that a transfer of property

The question then arose as to the tax treatment of one who forms a corporation and transfers property to it with the predetermined intent to give away control immediately after the transfer. The courts, with few exceptions, found the control requirement satisfied; the Second Circuit explained its decision as follows:

> In the absence of any restriction upon his freedom of action after he acquired the stock, he had "immediately after the exchange" as much control of the [newly formed corporation] as if had not before made up his mind to give away most of his stock and with it consequently his control. And that is equally true whether the transaction is viewed as a whole or as a series of separate steps. The transferor's freedom, at the time he acquired it, to keep the stock for himself is the basic distinction between this case and [the binding obligation cases].[78]

The Second Circuit successfully distinguished the two types of cases on their facts; however, the court failed to explain why the factual distinction it observed should produce different results. If the crucial element in the binding obligation cases were the transitory nature of the transferor's control, that element was present here as well. If the crucial element were the fact that the initial transfer of property and the subsequent disposition of stock were parts of a preconceived plan, that was true here too. The court did not explain why the fact of legal compulsion should be determinative. In other contexts (e.g., reorganizations), the presence or absence of legal compulsion to complete the plan is not decisive.[79] In retrospect, one can see the lack of legal analysis in the gift cases was foreordained: since the courts had not explained the rationale

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> occurred a few days before cash was paid in, when both are essential steps in the plan of organization.

Id. at 1258. Note the vagueness, or more accurately, the absence of any reasoned explanation for departing from the literal language of the statute. No explicit reason is given why adherence to the statutory language would undermine the purposes of the statute. Rather the court apparently found it self-evident that where the loss of control occurs pursuant to a preexisting, binding agreement, the "spirit" of the statute is violated. *West Texas* involved the predecessor of § 368(a)(1)(D) whose statutory language is similar to § 351. See supra note 32. The *West Texas* analysis was approved and applied to a case arising under the predecessor of § 351 in Omaha Coca-Cola Bottling Co. v. Commissioner, 26 B.T.A. 1123 (1932), nonacq. XI-2 C.B. 16 (1932).

[78] Wilgard Realty Co. v. Commissioner, 127 F.2d 514, 516 (2d Cir.), cert. denied, 317 U.S. 655 (1942).

[79] See supra notes 32-36 and accompanying text.

for decisions in the binding obligation cases, the courts in the gift cases lacked the analytical tools to craft a persuasive and coherent resolution of the problem. Instead, the courts were left to grope their way as best they could, noting the factual distinctions between the cases that had come before them and then deciding on the basis of some unarticulated instinct how the case at hand should be resolved.

The lack of any clearly articulated rationale makes it difficult to resolve novel questions and to develop a coherent and consistent body of law. Consider, for example, an individual who transfers the assets of his proprietorship to a newly formed corporation for all of its stock but who prior to the transfer had given an enforceable option to another to buy the stock. If the relevant factor is freedom of action, presumably the transferor would fail the control requirement, since he did not have complete freedom of action over the shares at the time of the transfer.[80] Alternatively, if the crucial question is whether the prospective purchaser is bound to buy the transferor's stock, a mere option would not destroy the transferor's control since an optionee has no obligation to exercise the option.[81] If the relevant inquiry is the transitory nature of the transferor's control, the answer might turn on when the option could be exercised, or possibly when in fact it was exercised.[82] If interdependence is the key, then presumably one would need to know whether exercise of the option was essential to the successful completion of the plan.[83] Each of these factors has been articulated at one time or another in section 351 cases. Because the courts lack a

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[80] Barker v. U.S., 200 F.2d 223, 229 (9th Cir. 1952) (transferors had not retained control because they had granted options: "Such a restriction upon their freedom of action deprived the Lawrence Barker Interests of unrestricted control of the stock.").

[81] Harder v. Commissioner, 17 T.C.M. (CCH) 494, 499 (1958) (§ 351 applied notwithstanding option granted by transferor at time of transfer to sell up to all of his stock since optionees "were under no obligation whatever to buy any of the corporation's stock").

[82] Compare National Bellas Hess, Inc. v. Commissioner, 20 T.C. 636, 647 (1953), acq. in part, 1953-2 C.B. 5, aff'd, 220 F.2d 415 (8th Cir. 1955), reh'g denied, 225 F.2d 340 (8th Cir. 1955) (good D-reorganization notwithstanding option granted by transferor to sell entire original issue to key employees where option not exercised "for approximately a year" and then in modified form by assignees of original optionees) with Banner Mach. Co. v. Routzahn, 107 F.2d 147 (6th Cir. 1939), cert. denied, 309 U.S. 676 (1940) (not a good D-reorganization where stock received by transferor was sold to an underwriter pursuant to an option within 60 days of transfer).

[83] Ericson Screw Mach. Prods. Co. v. Commissioner, 14 T.C. 757 (1950) (not a good D-type reorganization because of intent to exercise option to provide funds to transferor).

coherent unifying rationale, however, they are unable to determine the significance and the relative importance of these factors.

III. The Function of the Step Transaction Doctrine

The confusion and inconsistencies in section 351 cases described above stem from a basic misunderstanding of the function of the step transaction doctrine. Courts have viewed the doctrine as an instrument for perceiving reality, that is, for determining what really took place.[84] The courts typically employ the doctrine to ascertain "what really happened," and then apply the relevant legal principles to the facts thus determined.[85]

This approach misses the true nature of the step transaction doctrine. Legal doctrines are not, and by their nature cannot be, devices for determining reality. They do not add to our ability to discern the facts. Rather, legal doctrines, including the step transaction doctrine, are means of determining legal consequences. A necessary corollary of this observation is that the proper scope and limits of the doctrine must ultimately be grounded in the policy the law seeks to implement.[86]

As we have seen, the courts hold — with the assistance of the step transaction doctrine — that section 351 is not satisfied where the transferor is contractually bound at the time of the transfer to thereafter divest himself of control. The courts have reasoned, based on the step transaction doctrine, that the transferor did not really control the corporation after the transfer. In these cases, the courts have acted as "hard-headed realists" who are not going to be duped by a fleeting, ephemeral control; they are going to apply the tax law on the basis of reality (or substance) and not appearance (or form). But this simplistic approach does not provide a

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[84] See, e.g., Richard Wood, Is the Step-Transaction Doctrine Still a Threat for Taxpayers?, 72 J. Tax'n 296 (1990) ("the step-transaction doctrine seeks to determine what 'really' happened").

[85] See Timothy Keller, The Tax Effects of a Shareholder's Post-Incorporation Sale of Stock: A Reappraisal, 2 Tax L.J. 89, 95 n.28 (1985) (step transaction doctrine "supplies the facts to which the statute is applied").

[86] Chirelstein and Lopata, supra note 15, at 974 (The step transaction doctrine is "dependent for its application on underlying considerations of substantive tax policy or Code structure. . . . [I]t is necessary to go beyond the formal factors that on their face invite the doctrine's application and analyze the substantive considerations at issue in each transaction.").

convincing justification for the results in these cases. The facts are readily determinable without reference to the doctrine; and the fact is that in these cases the transferor did control the corporation, that is, he owned at least 80% of the corporation's stock for a finite period of time immediately after the transfer. Indeed, that control may last a significant period of time; in one case, the court applied the step transaction doctrine where the transferor would continue to control the corporation (i.e., own more than 80% of its stock) for more than seven years after the transfer of property under the terms of the incorporation agreement.[87] Nor in any of these cases is there an absolute certainty that a divestiture of control will occur. Even where the transferor is legally bound to divest himself of control, such divestiture may never take place. The buyer of the stock may lack the funds to consummate the purchase, or either the buyer or seller may back out of their agreement (in which case, the courts will award damages but probably not order specific performance), or the parties may by mutual consent change the terms of their agreement.[88] In these cases, the transferor did, in fact, control the corporation immediately after the transfer as that term is defined by the statute, i.e., he owned more than 80% of the corporation's stock.

Therefore, if courts find that section 351 is not satisfied, they cannot do so on the ground that in reality the control requirement

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[87] Intermountain Lumber Co. v. Commissioner, 65 T.C. 1025 (1976). The transfer of assets to the corporation occurred on July 15, 1964; under the terms of the parties' agreement, the transferor would continue to hold control until November 1, 1971 — more than seven years after the transfer. Id. at 1027-28. The agreement also provided that the purchaser would immediately receive the right to vote approximately 50% of the corporation's stock for a period of one year. This fact should not have any bearing on the result. First, the cases uniformly hold that "control" as used in § 351 simply means ownership of stock and that voting power over that stock is not necessary. See infra notes 97-99 and accompanying text. Second, after the lapse of fourteen months, voting power was to be based on actual stock ownership. 65 T.C. at 1028.

[88] See Kaczmarek v. Commissioner, 21 T.C.M. (CCH) 691 (1962) (transfer by taxpayer qualified under § 351 even though pre-incorporation agreement stated taxpayer's lawyers would have 25% interest in corporation, where lawyers never performed promised services and never became entitled to 25% interest). The same result was reached under the statutory predecessor of § 368(a)(1)(D) where the shareholders of the transferor-corporation had agreed prior to the transfer to sell at least 50% of the stock of the transferee-corporation to a brokerage firm. This sale never took place. The court ruled that the agreed-upon sale of stock should be disregarded in determining whether shareholders had control of the transferee-corporation immediately after the transfer. Scientific Instrument Co., 17 T.C. 1253, 1260 (1952), aff'd per curiam, 202 F.2d 155 (6th Cir. 1953).

was not met. Rather, the only possible justification for denying nonrecognition in these cases is that to do otherwise would offend an underlying policy of the statute. If a sound policy exists for restricting nonrecognition to cases where the transferor intended in good faith at the time of transfer to retain control for a meaningful period thereafter, application of the doctrine, in any of its variations, will assist the court in implementing that policy.

On the other hand, if no discernible policy exists for limiting nonrecognition to such cases, application of the doctrine serves no purpose. In short, before a court applies the step transaction doctrine, it first needs to determine the reason for the various requirements of the statute. Only then can it determine whether application of the doctrine would further the underlying purposes of the statute.[89]

This is a striking departure from the way in which the doctrine is usually applied. The tendency of courts to view the doctrine as an instrument for making a factual determination has led them to focus on factual distinctions relating to the probability that the transferor will or will not divest himself of control. For example, courts focus on questions of whether the transferor is legally bound to divest himself of control, whether the transfer of property and the subsequent sale of stock are mutually interdependent, etc. This approach has made it difficult to draw any meaningful or intelligible lines. Since the courts' analyses have been divorced from consideration of the policy underlying the control requirement, the courts have lacked a rational basis for assessing the significance of the factual distinctions they observed. This accounts for the inconsistencies found in the section 351 cases and the difficulty the courts and Service have encountered in applying established doctrine to novel situations, e.g., whether the transferor's pre-transfer grant of options disqualify the transaction under section 351.[90]

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[89] This approach (i.e., viewing the step transaction doctrine as an instrument for implementing policy and thus applying the doctrine only where it furthers some discernible policy) was arguably adopted by the Tax Court in Esmark, Inc. v. Commissioner, 90 T.C. 171 (1988), aff'd without op. 886 F.2d 1318 (7th Cir. 1989). The Tax Court refused to apply the doctrine to a stock purchase followed by a redemption of the acquired stock even though the stock purchaser was legally bound to tender the acquired stock for redemption. Although the court advanced various reasons for its holding, it seemed strongly influenced by its failure to find any tax policy thwarted by the parties' transactions. Id. at 198-199.

[90] See supra text accompanying notes 80-83.

The approach advocated here asks about the purpose or reason for the control and other requirements of section 351. Once these reasons are discovered, we can draw lines based on how strongly the policy is implicated in any given case. Below we will analyze the policy reason conventionally ascribed to the control and other requirements of section 351.

IV. The Mere Change of Form Rationale

Although there is a dearth of judicial explanation for the various requirements of section 351, legal commentators have valiantly struggled to make sense out of them. Possibly the most common explanation is that each of the three requirements for qualification under section 351 is designed to limit nonrecognition to mere changes in the form of one's investment, while excluding changes of substance.[91] Thus, it is said, one must transfer property — as opposed to services — to come within the protection of section 351, since a conversion of human labor into corporate stock is too drastic a change to warrant nonrecognition, that is, it is a change of substance rather than a change of form.[92] The way in which the two other requirements perform this function can best be shown by referring to Example 1.1 at the beginning of this article. In that example, A transferred Blackacre, which had appreciated in value during A's ownership, to Newco in exchange for all of the stock of Newco — a transaction qualifying for nonrecognition under section 351. Note that before the transfer, (1) A had a direct financial interest in Blackacre, in that he prospered or suffered financially as the value of Blackacre appreciated or depreciated, and (2) A had complete control and management over Blackacre. The requirement that A must receive at least 80% of the stock for his property assures that A will have a continuing substantial financial interest in Blackacre just as before the transfer, and the requirement that A must control the corporation after the transfer means that A will continue to exert control over Blackacre just as before the transfer.

[91] See, e.g., Richard L. Doernberg, Howard E. Abrams, Boris I. Bittker & Lawrence M. Stone, Federal Income Taxation of Corporations and Partnerships 92 (1987) ("Through these requirements, § 351 seeks to differentiate those exchanges more closely resembling mere changes in the form of investment from those exchanges resembling sales.").

[92] Id. ("Because such an exchange radically alters the form of a taxpayer's investment from human to corporate capital, immediate taxation seems appropriate.").

Thus, the three requirements coalesce to assure that nonrecognition treatment is restricted to mere changes in the form of one's investment.

This understanding of the role played by the three requirements of section 351 provides a possible explanation for the results in the binding obligation cases. If the transferor is contractually bound to divest himself of control following the transfer, it follows that the transaction involves more than a mere change of form and therefore nonrecognition is unwarranted. This was the rationale adopted by the court in *Intermountain Lumber Co. v. Commissioner*:

> We note also that the basic premise of section 351 is to avoid recognition of gain or loss resulting from transfer of property to a corporation which works a change of form only. . . . Accordingly, if the transferor sells his stock as part of the same transaction, the transaction is taxable because there has been more than a mere change of form.[93]

A. *Critique of the Mere Change of Form Rationale*

The mere change of form rationale is premised on the idea that any change, save the most minor, in the nature of a transferor's pre-transfer proprietary interest brought about by the transfer is sufficient to preclude nonrecognition; in such cases, there has been more than a mere change of form. Thus a sole transferor who takes back all of the stock of his newly formed corporation and sells a 21% stock interest in it to a third party pursuant to a preexisting binding agreement fails to qualify under section 351 and will have to recognize all gain (or loss) inhering in the transferred property rather than just on the 21% stock interest he sold. This is so, even though the transferor's retained 79% stock interest gives him virtually complete control over the corporation (and thus over his transferred property) under state corporate law, and even though the transferor would have had to fully recognize all gain or loss on the stock interest he actually sold even if section 351 applied. The trouble with this theory is that the cases and rulings simply do not

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[93] 65 T.C. 1025, 1033-34 (1976). Note that even if the mere change of form rationale were the correct explanation of the binding obligation cases, it would not explain the contrary results in the gift and underwriting cases. In both the gift and underwriting cases, there has been more than a mere change of form, yet nonrecognition is permitted.

require the rigid identity between the transferor's pre-transfer and post-transfer proprietary interests that the mere change of form theory presupposes. This is illustrated by the following examples.

> *Example 4.1*
> Ten unrelated persons wish to form a manufacturing company. Each owns a different type of property: one has undeveloped land which will be used as the site of the factory; another owns a truck; a third owns machinery; a fourth has cash; etc. Each makes his or her respective contribution and takes back a 10% stock interest in the corporation.

Under the language of the statute and the case law, this transaction qualifies for nonrecognition.[94] Yet by no stretch of the imagination can it be described as a mere change in the form of each investor's respective investment. Prior to the transfer, each investor started out with complete control over a distinct type of asset; each ends up with a 10% minority interest in an integrated manufacturing operation. Clearly, there has been a change of substance in the nature of each investor's investment; however, section 351 accords each of them nonrecognition.

> *Example 4.2*
> A and B, who are unrelated, own Blackacre and Whiteacre respectively. Each property has a fair market value of $100,000. A and B form X Corp. and transfer their respective properties to the corporation, A taking back all of X Corp.'s nonvoting preferred stock and B taking back all of X Corp.'s voting common stock.

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[94] American Compress & Warehouse Co. v. Bender, 70 F.2d 655 (5th Cir. 1934), cert. denied, 293 U.S. 607 (1934); Bittker & Eustice, supra note 7, at ¶ 3.01. Professors Bittker and Eustice suggest, however, that in extreme cases (e.g., where a transferor receives only a 0.01 percent interest in the corporation), the courts might engraft restrictions upon the statutory language to prevent a perceived abuse of § 351 as they have done in the case of other provisions of Subchapter C of the Internal Revenue Code. Id. In one situation, swap-funds, Congress has restricted the use of § 351 as a vehicle for diversifying the investments of a transferor. These funds involved the transfer of appreciated securities by a large number of unrelated individuals, solicited and selected by the fund's promoter, to a newly-formed investment company in exchange for its stock. Originally, the Service issued favorable rulings on their qualification under § 351, but in 1961 suspended the issuance of rulings if the transaction occurred "as a result of solicitations by promoters, brokers, or investment houses." In 1966, Congress enacted the predecessor of § 351(e)(1) which makes § 351 inapplicable in the case of transfers to an investment company. Boris I. Bittker & James S. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 3.02 (1) (4th ed. 1979).

This transaction also qualifies for nonrecognition under section 351, since the property transferors as a group own all of X Corp.'s stock. But again one cannot seriously contend that it constitutes a mere change in the form of the participants' preexisting investments. Before the transaction, A: (1) had complete control over Blackacre; and (2) stood to enjoy, or suffer, all gain or loss in the value of Blackacre. After the transaction, A: (1) has no control over Blackacre (or the corporation); (2) will not participate in any future appreciation in the value of Blackacre, or the corporation (since his investment is now a frozen preferred stock interest), and (3) has secured downside protection against possible depreciation in the value of Blackacre and the corporation, since his interest is now "cushioned" by B's junior equity interest. Nonetheless, the transaction is tax-free to both A and B.[95] The editors of a leading casebook on corporate taxation assert this example exposes a "flaw" in section 351[96] — but maybe the flaw is in the mere change of form rationale that purports to explain section 351.

> *Example 4.3*
> A, B and C are the sole partners of ABC partnership which has experienced financial difficulties. In order to extricate themselves from these problems, the partners induce M to take over management of the business. Pursuant to a binding agreement, A, B and C transfer the assets of the business to Newco in exchange for all of Newco's stock and immediately place the Newco stock in a voting trust of which M is the voting trustee; M is also granted an option to acquire up to 10% of Newco's stock.

Clearly, this transaction has effected a substantial change in the operation of the business. Prior to the incorporation, the partners had full operating control of the business; now, as part of the incorporating transaction, the partners have ceded full control of the corporation for the duration of the voting trust. Nevertheless, in

[95] See, e.g., Burr Oaks Corp. v. Commissioner, 43 T.C. 635 (1965), aff'd, 365 F.2d 24 (7th Cir. 1966), cert. denied, 385 U.S. 1007 (1967) (one transferor received corporation's voting stock while another received its nonvoting stock); Gus Russell, Inc. v. Commissioner, 36 T.C. 965 (1961) (one transferor received corporation's voting common stock while the other received its nonvoting preferred stock).

[96] Teacher's Manual (at 13) to accompany Stephen A. Lind, Stephen Schwarz, Daniel J. Lathrope & Joshua D. Rosenberg, Fundamentals of Corporate Taxation (2d ed. 1987) ("From a policy standpoint, this illustrates one of the flaws in §351").

Federal Grain Corp. v. Commissioner,[97] the Board of Tax Appeals held that a similar transaction qualified for nonrecognition under the predecessor of section 351. The Board stated: "[T]he term 'control' relates to 'ownership' and has no bearing upon the actual control over the corporate affairs which a stockholder exercises through his vote; therefore, the fact that the agreement . . . vested the voting rights in the trustee is of little or no importance."[98] This holding has been consistently followed.[99]

One might object that the incorporation was collateral to the transfer of management power to M, and should therefore be judged and taxed separate and apart from the transfer of management power. However, the same analysis can be made in the binding obligation case. Assume A, who has operated a proprietorship for 20 years, is approached by B who would like to buy a 50% interest in A's business. They agree on a price, and also agree that as part of the same transaction they will incorporate the business. Therefore, pursuant to a pre-existing, binding agreement, A transfers the assets of the proprietorship to Newco, takes back all of its stock and then sells 50% of the stock to B. Here, too, it can be argued that the incorporation is collateral to the sale of a 50% interest in the business, and therefore the incorporation should be judged and taxed separate and apart from the subsequent sale of the 50% stock interest, but under established precedent the two transactions are telescoped and treated as taxable.

> *Example 4.4*
> A transfers assets to X Corp. in exchange for 80% of its stock; then, as part of the same plan, X Corp. transfers the same assets to Y Corp. in exchange for 80% of the stock of Y Corp.

As explained above, the 80% control requirement is conventionally

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[97] 18 B.T.A. 242 (1929).

[98] Id. at 248.

[99] See, e.g., Griswold Co. v. Commissioner, 33 B.T.A. 537, 543-44 (1935), acq. XV-1 C.B. 10 (residuary beneficiaries "controlled" transferee corporation even though stock was held by executors, citing *Federal Grain Corp.*); Gen. Couns. Mem. 2177, VI-2 C.B. 112 (1927) (a good D-type reorganization; transferor corporation and its shareholders "controlled" transferee corporation even though voting power vested in trustees); Peabody Hotel Co. v. Commissioner, 7 T.C. 600, 617 (1946), acq. 1946-2 C.B. 4 (creditors of bankrupt corporation held to control transferee corporation even though voting power vested in trustees, citing *Federal Grain Corp.*); National Bellas Hess, Inc. v. Commissioner, 20 T.C. 636, 646 (1953), aff'd, 220 F.2d 415 (8th Cir. 1955), reh'g denied, 225 F.2d 340 (8th Cir. 1955) (good type-D reorganization notwithstanding voting power being placed in a voting trustee).

explained as the statutory mechanism for sorting out changes of substance from mere changes of form. The 80% requirement assures that nonrecognition will be restricted to cases where the transferor group continues to exercise effective control over, and has a continuing substantial financial interest in, the transferred assets. Here, however, the transferor only retained an indirect 64% beneficial interest (80% of 80%) in the transferred assets, and thus fell below the 80% threshold established (per the conventional theory) as the benchmark for distinguishing between changes of form and changes of substance. Nonetheless, the Service ruled in Revenue Ruling 83-34[100] that each transfer qualified under section 351, basing its holding on an earlier ruling which had stated in a similar case that "the transfers are viewed separately for purposes of section 351" even though both transfers were "part of the same plan."[101]

> *Example 4.5*
> A transfers property worth $80,000 and B transfers property worth $20,000 to Newco, a newly-formed corporation, in exchange for 80% and 20%, respectively, of the stock of Newco. Pursuant to a binding, pre-transfer agreement, A sells a 31% stock interest in Newco to B, reducing A's interest to 49%. Newco would not have been formed if B had not agreed to transfer property to it, and B's agreement to do so was conditioned on the sale by A to her of part of A's Newco stock.

Again there has been a significant change of substance: A goes from having complete control over assets constituting 80% of the transferred property to a minority and non-controlling interest in the resulting enterprise. Nonetheless, the Service ruled in Revenue Ruling 79-194[102] that section 351 applied; it reasoned the transac-

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[100] 1983-1 C.B. 79. See also Rev. Rul. 83-156, 1983-2 C.B. 66 (§ 351 satisfied where assets transferred from a corporation to its wholly owned subsidiary and from that subsidiary to a newly formed partnership in conjunction with a transfer by the other partner to the partnership, even though all transfers were part of same plan).

[101] Rev. Rul. 77-449, 1977-2 C.B. 110.

[102] 1979-1 C.B. 145, Situation (1). In Situation (2) of the same ruling, the Service held that a party who transferred property that was "of relatively small value" in comparison to the value of all the stock received by him in the transaction would not be treated as a bona fide property transferor and his stock would not be counted in determining whether the property transferors had control after the transfers. Thus, where A and B transfer their separate properties to Newco in exchange for 99% and 1%, respectively, of the stock of Newco, and A then sells a 50% stock interest in Newco to B (thereby reducing A's interest

tion satisfied the control requirement since collectively the transferors (A and B) retained control after the prearranged sales notwithstanding the shift of control occurring between themselves. Nonetheless, the transaction as a whole constitutes a significant change from the pre-incorporation status of the parties; the end result cannot be described as a mere change of form.

Contrast Revenue Ruling 79-194 with the binding obligation case described in Example 1.2. In Example 1.2, the sole property transferor ended up with 70% of the stock of the corporation. Revenue Ruling 79-194 thus represents a greater change of substance than Example 1.2. In Example 1.2, the property transferor retained effective control over the resulting enterprise while in Revenue Ruling 79-194 the 80% property-transferor yielded control over the business because of his resulting minority interest. Yet Revenue Ruling 79-194 allows nonrecognition while the property transferor in Example 1.2 must recognize taxable gain.

Finally, reconsider Example 2.1 (the gift case) and Example 2.2 (the underwriting case). In each case, the property interests of the parties underwent a significant change of substance but nonetheless the transaction qualified for nonrecognition.

The above examples demonstrate that radical changes can occur in the relationship of the transferor to the transferred assets in a transaction, and yet the transaction may still qualify for nonrecognition under section 351. This casts serious doubt upon validity of the mere change of form rationale of the control requirement. However, these examples may merely illustrate flaws in the design of the statute, or alternatively are incorrect applications of the statute. Below the legislative history of section 351 and its predecessors is reviewed to shed whatever light possible on these questions.

B. *The Legislative History of Section 351 and Its Predecessors*

The first proposal to accord tax free treatment to incorporations was contained in a bill reported by the Senate Finance Committee

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to 49%) pursuant to a binding pre-transfer agreement, B would not be treated as a bona fide property transferor. Consequently, the transaction would fail to qualify under § 351 since A as the only property transferor would not control Newco upon completion of the transaction.

in 1918.[103] Under the bill, gain or loss in a property-for-property exchange would be computed as though the property received were cash in the amount of the fair market value of the property received; thus the gain or loss would be recognized.[104] However, the bill contained two exceptions to this general rule of recognition. First, no gain or loss would be recognized on the receipt of stock or securities in a reorganization, merger or consolidation of a corporation, where the aggregate par or face value of the stock or securities received did not exceed the aggregate par or face value of the stock or securities surrendered.[105] Secondly, no gain or loss would be recognized on stock or securities received from a corporation in exchange for property where the corporation had been "formed to take over such property."[106] The Senate Report justified these nonrecognition provisions on the ground they would "negative the assertion of tax in the case of purely paper transactions."[107] The bill, when finally enacted as the Revenue Act of 1918, retained the exception for reorganizations but dropped, without explanation, the exception for stock or securities received for property from a corporation formed to take over such property.[108]

Although the proposal for according tax free treatment to incorporations was not initially enacted, the underlying idea was resuscitated in a more limited form in a regulation adopted in 1919. Article 1566 of Regulations No. 45 (interpreting the 1918 Act) stated that an owner of property who transferred the property to a corporation would recognize no gain or loss if the "owner of the property receives 50 per cent or more of the stock of the corporation, so that an interest of 50 per cent or more in such property remains in him . . . ."[109] The Article explicitly stated that it applied "to the incorporation of a business previously conducted by an in-

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[103] See H.R. 12863, 65th Cong., 3d Sess. § 202(b) (1918) as reported by Senate Finance Committee, S. Rep. No. 617, 65th Cong., 3d Sess., pt. 1, at 5-6 (1918). For general legislative history of § 351 and its predecessors, see generally Kathryn L. Powers, "Decontrol" of Section 351 of the Internal Revenue Code: Facilitating Capital Formation by Small Corporations, 31 Case W. Res. L. Rev. 814, 827-32 (1981).

[104] See H.R. 12863, 65th Cong. 3d Sess. § 102(b) as reported by Senate Finance Committee, S. Rep. No. 617, 65th Cong., 3d Sess., pt 1 at 5-6 (1918).

[105] Id.

[106] Id.

[107] See id. at 5.

[108] Revenue Act of 1918, ch. 18, § 202(b), 40 Stat. 1057.

[109] T.D. 2831, 21 Treas. Dec. Int. Rev. 394 (1919).

dividual or by a partnership."[110] Less than six months later, the above provision was revoked as "not being warranted in law."[111] The revised Article simply stated that where property was transferred to a corporation in exchange for stock, gain or loss would be recognized "if the stock has a market value."[112]

In September, 1919, the Chairman of the House Ways and Means Committee announced that his committee would undertake a general study of the internal revenue laws.[113] In response to the Chairman's request, the Secretary of the Treasury, Carter Glass, submitted to the Committee a list of suggestions for amendment of the tax law that had occurred to members of the Treasury Department supplemented by suggestions received from outside sources.[114] The Department took no position on these proposals — "indeed, the department entertain[ed] serious doubt as to the advisability of" some of them — but merely submitted them for the Committee's consideration.[115] The 1918 Act Notes observed that "it is difficult to determine . . . gain or loss in the absence of an actual sale" and it had been suggested that a transaction in which no actual sale had occurred "should be treated in the same manner [as a] reorganization, merger, or consolidation of a corporation."[116] The 1918 Act Notes suggested that this change could be accomplished by amending the existing law to extend nonrecognition to "[a] person or persons [who] exchange property for not less than 95 per cent of the stock of a corporation."[117]

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[110] Id. at 394-395.

[111] T.D. 2924, 21 Treas. Dec. Int. Rev. 844 (1919).

[112] Id.

[113] Notes on the Revenue Act of 1918 (Letter of Transmittal) (1919) [hereinafter 1918 Act Notes] printed for the use of the House Ways and Means Committee reprinted in 94 U.S. Revenue Acts, 1909-1950, The Laws, Legislative Histories & Administrative Documents (Bernard D. Reams, Jr. ed. 1979) [hereinafter Reams].

[114] See id. (Letter of Transmittal).

[115] Id.

[116] Id. at 7-8.

[117] Id. at 8. The relationship between the 1918 Act Notes, supra note 113, and the 1921 Act is unclear. Carlton Fox, Special Assistant to the Attorney General in 1936, disputed the assumption "in some quarters" that the 1918 Act Notes formed the basis of the 1921 Act. Mr. Fox pointed out that (1) Dr. T.S. Adams, whom he credits as the "father of the 1921 Act," never referred to them in his testimony before the Senate Finance Committee on the bill that was to become the 1921 Act; (2) D.F. Houston who succeeded Carter Glass as Secretary of the Treasury and who made extensive suggestions for revision in the revenue laws in a letter to the House Ways and Means Committee in 1920 never referred to them; and (3) the 1918 Act Notes are "not referred to anywhere in the legislative history" of the 1921 Act.

In 1921, the new administration undertook a general revision of the tax laws which resulted in the Revenue Act of 1921.[118] The new Act made sweeping changes in the existing law. First, Congress enacted an entirely new rule where property (other than cash) was received in exchange for other property. While the Revenue Act of 1918 had provided that gain or loss would be recognized based on the fair market value of the property received, the Revenue Act of 1921 stated that gain or loss would be recognized if, and only if, the property received had a "readily realizable market value."[119] In the absence of a readily realizable market value, no gain or loss would be recognized and the property received would have a basis equal to the basis of the property surrendered.[120] The Act went on to provide that even if the property received had a readily realizable market value, gain or loss would still not be recognized in three cases:

(1) where property held for investment or for productive use in a trade or business was exchanged for property of a like kind or use;[121]

(2) where the taxpayer received stock or securities in a corporate reorganization (as defined);[122] and

(3) where one of more persons transfer property to a corporation in exchange for stock or securities provided such persons had control[123] of the corporation immediately after the transfer and pro-

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See 95 Reams, supra note 113, addendum to Explanatory Note following Revenue Act of 1921.

[118] Revenue Act of 1921, ch. 18, 40 Stat. 1057.

[119] Id. at § 202(c).

[120] Id. at § 202(d)(1). Where boot, money and property having a readily realizable market value, was received in addition to the property not having a readily realizable market, the basis of the stock received was to be reduced by the fair market value of such boot, and if the fair market value of the boot exceeded the basis of the stock received, the excess was to be taxed as gain. Id. at § 202(e).

[121] Id. at § 202(c)(1). This provision is the original predecessor of § 1031 of the current Code which provides that no gain or loss shall be recognized if "property held for productive use in a trade or business or for investment . . . is exchanged . . . for property of a like kind."

[122] Id. at § 202(c)(2). "Reorganization" was defined to include a merger, a consolidation, the acquisition by one corporation of a majority of the voting stock and a majority of the total number of nonvoting shares of another corporation, the acquisition by one corporation of substantially all the properties of another corporation, and a mere change in the identity, form or place of organization of a corporation.

[123] See id. at § 202(c)(3) (second sentence). "Control" was defined as ownership of at least 80% of the voting stock and at least 80% of the total number of shares of all other classes of stock of the corporation.

vided also that the amount of stock and securities received by each person was substantially proportionate to his interest in the property prior to the exchange.[124]

The overall thrust of these provisions was explained in the Reports of the Senate Finance Committee and the House Ways and Means Committee in similar language:

> [The Bill] provides new rules for those exchanges or "trades" in which, although a technical "gain" may be realized under the present law, the taxpayer actually realizes no cash profit.
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> Under existing law "when property is exchanged for other property, the property received in exchange shall, for the purpose of determining gain or loss, be treated as the equivalent of cash to the amount of its fair market value, if any." Probably no part of the present income tax law has been productive of so much uncertainty or has more seriously interfered with necessary business readjustments. The existing law makes a presumption in favor of taxation. The proposed act modifies that presumption by providing that in the case of an exchange of property for property no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value, and specifies in addition certain classes of exchanges on which no gain or loss is recognized even if the property received in exchange has a readily realizable market value. These classes comprise the cases where productive property (other than stock in trade or property held primarily for sale) used in a trade or business is exchanged for property of a like kind or use; where in any corporate reorganization or readjustment stock or securities are exchanged for stock or securities of a corporation which is a party to or results from such reorganization; and where an individual or individuals transfer property to a corporation and after such transfer are in control of such corporation.
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> The preceding amendments, if adopted, will, by removing uncertainty and by eliminating many technical constructions which are economically unsound, not only permit business to go forward with

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[124] See id. at § 202(c)(3). This provision of course is the original predecessor of § 351 of the present Code.

If "boot" was received in any of the three nonrecognition transactions enumerated in § 202(c) of the 1921 Act, the basis of the nonrecognition property received was to be reduced by the fair market value of such boot, and if the fair market value of the boot exceed such basis, the excess was to be taxed as gain. See id. at § 202(e). This rule was changed by the Act of March 4, 1923, Pub. L. No. 545, 42 Stat. 1560 (1923), which amended § 202(e) to provide, like the present rule, that any gain realized on the transaction will be recognized to the extent of the fair market value of the boot received.

> the readjustments required by existing conditions but also will considerably increase the revenue by preventing taxpayers from taking colorable losses in wash sales and other fictitious exchanges.[125]

Three main themes emerge from this passage. First, the bill was concerned with facilitating necessary and desirable business readjustments, particularly in light of the then existing economic conditions.[126] The prior law was faulted for "seriously interfer[ing] with necessary business readjustments" while the proposed bill promised, if enacted, to "permit business to go forward with the readjustments required by existing conditions."[127] Secondly, the bill evinced an aversion to taxing purely paper transactions, that is, in cases where there might be a "technical" realization of gain but no actual realization of a "cash profit."[128] This was reflected most dramatically in the provision limiting the recognition of gain or loss in exchanges of property to cases where the property received had a "readily realizable market value." Congress seemed to feel it was unfair and excessively burdensome to tax a person on a transaction where the property received could not readily be converted to cash. In addition, Congress was concerned that even where the property received had a readily realizable value there would be cases, specifically, like-kind exchanges, reorganizations and transfers to controlled corporations, in which it was unfair or inappropriate to recognize a gain or loss since no gain or loss had been "economically" realized. Finally, the sponsors of the bill contended that enactment of their handiwork would replace the existing confusion in the law with greater certainty.

Neither the committee reports nor the floor discussions reveal the reason for the 80% control requirement in the case of transfers to corporations. Most of the floor discussion involved the mechani-

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[125] S. Rep. No. 275, 67th Cong., 1st Sess. 11-12 (1921), reprinted in 95A Reams, supra note 113. The corresponding discussion in the Report of the House Ways and Means Committee is found in H.R. Rep. No. 350, 67th Cong., 1st Sess. 10 (1921) reprinted in 95 Reams, supra note 113.

[126] The country was experiencing a severe business recession in 1921. "Wages dropped; about 20,000 business failures occurred in 1921; and some 4,750,000 persons were unemployed." Encyclopedia of American History 392 (Richard B. Morris & Jeffrey B. Morris 6th ed. 1982).

[127] S. Rep. No. 275, supra note 125, at 11.

[128] S. Rep. No. 275, supra note 125, at 11; there are no references to "technical" gains or to "cash profit" in the Report of the House Ways and Means Committee.

cal operation of the reorganization provisions.[129]

In 1924, the provision for nonrecognition where the property received had no readily realizable market value was eliminated because of the difficulty encountered in applying it.[130] However, the balance of the 1921 provisions relating to transfers to controlled corporations were retained. Those provisions have continued in the law, with relatively few modifications, to the present day.[131]

C. *What Light Does the Legislative History Shed on the Mere Change of Form Rationale?*

Despite the paucity of legislative history, strong circumstantial evidence exists for rejecting the contention that the 80% control requirement was intended to limit nonrecognition to mere changes

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[129] Powers, supra note 103, at 830; Samuel C. Thompson, Jr., Tax Policy Implications of Contributions of Appreciated and Depreciated Property to Partnerships, Subchapter C Corporations and Subchapter S Corporations in Exchange for Ownership Interests, 31 Tax L. Rev. 29, 42-46 (1975).

[130] Revenue Act of 1924, ch. 234, § 202(c), 43 Stat. 253 (1924); S. Rep. No. 398, 68th Cong., 1st Sess. 13-14 (1924) reprinted in 96 Reams, supra note 113. The Senate Report explained the reasons for eliminating this exception as follows:

> Great difficulty has been experienced in administering this provision. The question whether, in a given case, the property received in exchange has a readily realizable market value is a most difficult one, and the rulings on this question in given cases have been far from satisfactory. Furthermore, the construction placed upon the term by the department has restricted it to such an extent that the limitation contained therein has been applied in comparatively few cases. The provision can not be applied with accuracy or with consistency.

Id.

[131] The most significant changes in § 351 and its predecessors were:

(1) The elimination in the 1954 Code of the requirement that each transferor receive an amount of stock or securities proportionate to his interest in the property prior to the transfer. See H.R. Rep. No. 1337, 83d Cong., 2d Sess. 39 (1954) and S. Rep. No. 1622, 83d Cong., 2d Sess. 264 (1954).

(2) The explicit provision in the 1954 Code that services do not constitute "property" within the meaning of § 351. § 351(d)(2). While there was no provision explicitly to this effect in the prior statutes, the 1954 provision seems to have simply codified holdings under prior law. See Columbia Oil & Gas Co. v. Commissioner, 41 B.T.A. 38 (1940), acq. 1940-1 C.B. 2, acq. 1943 C.B. 5 withdrawing partial nonacq. 1940-1 C.B. 6, aff'd, 118 F.2d 459 (5th Cir. 1941).

(3) Enactment in 1966 of a provision excluding transfers to investment companies from nonrecognition. This provision, which is now found in § 351(e)(1), was enacted by Pub. L. No. 89-809, § 203, 80 Stat. 1539 (1966).

(4) The elimination in 1989 of "securities" as property that could be received by the transferor without recognition. Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7203, 103 Stat. 2106 (1989).

in the form of the transferor's investment.[132]

The statute clearly contemplated one situation where nonrecognition would be granted notwithstanding a significant transformation in the nature of the transferors' respective investments, namely, where multiple investors came together for the first time and pooled their distinct investments in a newly formed corporation. Such transactions can effect radical changes in the nature of each contributor's investment: prior to the transfer each investor has complete control over his or her particular asset; after the transfer each investor may end up with only a small noncontrolling interest in an entirely different type of enterprise.[133] It appears this result was recognized and intended under the statute enacted in 1921.

First, the language of the statute was specifically made applicable to transfers by "two or more persons" provided such persons are in control of such corporation immediately after the transfer. Indeed, Congress had changed the original language in the bill from a "group of persons" to "two or more persons" because of concern that the word "group" had a "restricted meaning" and "sometimes mean[t] an association for particular purposes."[134] Arguably, by using the word "property" rather than "propert*ies*," when referring to multiple transferors, the statute implied that all transferors were required to have a preexisting interest in the same property. On the other hand, the word "property" is sometimes a collective noun and thus may properly be referring to the totality of items being transferred rather than to any particular item.[135] In any event, the issue was conclusively resolved by the court in

[132] In the following discussion, it is important to sharply differentiate between the mere change of form rationale and the continuity of proprietary interest requirement. The mere change of form rationale requires recognition of gain or loss whenever a significant change in the nature of the transferor's proprietary interest occurs. In contrast, the general continuity of proprietary interest requirement tolerates substantial changes in the nature of the transferor's interest so long as the transferor retains a proprietary interest in the transferred assets.

[133] See supra note 94 and accompanying text.

[134] Confidential Print for use of Members of the Senate, Hearings before the Senate Comm. on Finance on H.R. 8245, 77th Cong., 1st Sess. 202 (1921) [hereinafter Senate Hearings on 1921 Act], reprinted in 95A Reams, supra note 113.

[135] Contrast the first meaning of the word "property" ("the sum total of one's possessions") with the second ("an item considered as part of one's property") in Random House College Dictionary 1061 (rev. ed. 1988).

American Compress & Warehouse Co. v. Bender[136]:

> The language of the . . . provision indicates that the framers of it had in mind what frequently occurs in bringing a corporation into existence. It is by no means an unusual occurrence for a corporation to be a result of several separate owners of different properties associating themselves for the purpose of bringing about the creation of a corporation by severally subscribing for stock in the proposed corporation, each subscriber for stock agreeing to pay therefor by transferring to the corporation property solely owned by him at a valuation equal to the amount of stock subscribed for by him. To say the least, the language of the provision is consistent with the existence of an intention to make it applicable whether the property transferred by two or more persons to a corporation solely in exchange for stock of such corporation was owned jointly or in common by the transferors or consisted of separate parcels or groups of properties separately and solely owned by the several transferors, respectively. . . .[137]

The construction adopted by the court in *American Compress & Warehouse Co.*, which had been advocated by the Government, has been consistently followed.

Secondly, discussion of the reorganization provisions, which were adopted as part of the same legislative package, show the drafters and sponsors of the statute in that instance intended tax free treatment where separate properties owned by different interests were pooled. Senator McCumber who acted as floor manager of the bill illustrated the effect of the reorganization provisions with an example involving three corporations, each of which owned a separate piece of land:

> Now the corporations unite and put all of their stock into a new corporation, issuing $30,000 worth of stock to the owners of the land in . . . proportion [to the respective values of the different parcels of land.] The Senator from New Mexico would not say that they had either gained or lost by that transaction; they would have exactly the same interest which they previously had; and the Senator would not allow the Treasury Department to say to those stockholders, "You have made a gain even though you have not sold a single acre of land."[138]

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[136] 70 F.2d 655 (5th Cir. 1934), cert. denied, 293 U.S. 607 (1934).

[137] Id. at 657.

[138] 61 Cong. Rec. 6566 (1921). Dr. T.S. Adams testified before the Senate Finance Com-

Congress therefore recognized in the reorganization provisions that the nature of a shareholder's interest could be substantially transformed and yet qualify for nonrecognition treatment. A shareholder of a corporation owning one parcel of land could exchange his stock in that corporation for stock of a new corporation owning a portfolio of different parcels of land. A more dramatic example would be the merger of the corner hardware store, operated as a corporation, into a multinational corporation involved in a multiplicity of different businesses whose stock is traded on the New York Stock Exchange. Here the shareholder's investment in a hardware corporation has been transformed from an illiquid but controlling stock interest in a one-business corporation into an infinitesimal but highly liquid stock interest in an international conglomerate. Despite this radical metamorphosis, the stockholder of the hardware store will receive his stock in the international conglomerate tax free.[139] The argument that such transformations partake of a sale and should therefore be taxed was made but rejected; Senator Reed had argued as follows:

> Suppose that corporation A, instead of selling itself outright to corporation B, sells its interest in corporation A to corporation B, which has taken in four or five other corporations, and . . . that instead of getting the cash, stock is issued. What is the stock? It is stock in an entirely new thing, stock in an entirely new corporation, which takes in a lot of new elements of value. It partakes of the nature of a sale, and not of the nature of an exchange of property.[140]

Thus whenever Congress confronted the issue, it voted to accord tax free treatment to a transferor even if his investment had undergone substantial changes so long as he retained a continuing, even if radically altered, proprietary interest. Congress seemed more concerned that there had been no cash realization or termination of ownership than with whether the nature of the transferor's post-transfer interest dovetailed with that of his pre-trans-

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mittee that under the proposed reorganization provisions "if there are *two or three* corporations and they reorganize, and the stockholders, having certain securities get new securities, they will not be taxed." Senate Hearings on 1921 Act, supra note 134, at 324 (emphasis added).

[139] See infra note 147 and accompanying text.

[140] 61 Cong. Rec. 6568 (1921).

fer interest. In addition, since the reorganization provisions and the provisions governing transfers to controlled corporations were drafted, discussed and voted on as a single package,[141] it is reasonable to assume that the degree of change in proprietary interest Congress found tolerable in one set of provisions (reorganizations), was also found tolerable in the other (transfers to controlled corporations).

Moreover, Congress was aware it was not uncommon for different persons to come together and pool their separately owned properties to start up a business. In 1921, when the partnership was a major form of business organization, this was frequently accomplished by forming a partnership.[142] In 1920, the year before the enactment of the 1921 Revenue Act, the Treasury had ruled that no taxable gain or loss was recognized when persons formed a partnership by contributing property in exchange for partnership interests.[143] For Congress to have enacted a statute creating (or perpetuating) a disparity in the tax treatment of corporate formations and partnership formations in light of its stated purpose of

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[141] The committee reports discussed both the "reorganization" and the "transfer to controlled corporation" provisions in the same paragraphs; the arguments made by the reports for adoption of both provisions were the same; and both provisions were contained in the same subsection (§ 202(c)) of the bills and the statute as enacted. See J.S. Seidman, Seidman's Legislative History of Federal Income Tax Laws, 1938-1861, 789-797 (1938) for different versions of bill and relevant passages of committee reports and floor debates.

[142] In 1921, there were approximately 259,000 partnerships compared with about 356,000 corporations. I Alan R. Bromberg & Larry E. Ribstein, Bromberg & Ribstein on Partnership § 1.01(c) (1988). Put differently, partnerships represented approximately 42% of all businesses other than sole proprietorships.

[143] S.O. 42, 3 C.B. 61 (1920). The opinion discussed a fact pattern where a partnership had been dissolved by the death of one partner and where the surviving partners contributed their respective interests in the old partnership's property (together with additional capital) to a new partnership. A new partner was also admitted who made a contribution to capital. The surviving partners reported as income the difference between their basis in the old partnership and value of their respective partnership interests as of the date of the new partnership's formation. The opinion ruled this improper, holding that the surviving partners realized no gain or loss upon the formation of the new partnership. Since these partners had a preexisting interest in common, it might be suggested that this opinion does not support the principle that individuals who were previously unassociated and who contributed separately owned properties to a newly formed partnership would not recognize income. However, the reasoning of the opinion makes it clear that the fact that the partners had a preexisting interest in common had no bearing on the result. Moreover, the opinion specifically held that a new partner who contributes his separately owned property to a partnership will realize no income even though he was previously unassociated with the partnership and the other partners. Id. at 64 (paragraph (3)).

facilitating business readjustments would have been anomalous. The more reasonable assumption is that Congress desired to eliminate such disparities. Since different persons contributing their separately owned properties to form partnership would not have incurred a tax, persons contributing their separately owned properties to a corporation should likewise not incur a tax.

Additionally, the drafters and sponsors of the 1921 legislation evidenced great concern over the liquidity problems of taxpayers; first, they had provided no gain or loss should be recognized unless the property received had a "readily realizable market value" and secondly, they provided that even if the property received had a readily realizable market value, gain or loss should still not be recognized in certain specified situations where the realization was thought to be of a "technical" rather than an "economical" nature. Given this sensitivity for liquidity problems, it is unlikely that Congress meant to tax run-of-the-mill incorporations where different individuals pooled their separately owned properties for non-cash stock interests in the corporation.

The language of the 1921 forerunner of section 351 permitted other changes of substance in the taxpayer's investment on a tax free basis, for example, where one property transferor takes back all the voting common stock and the other takes back all the non-voting preferred stock. This transaction effects a radical change in each participant's investment, yet it never seems to have been doubted or contested that it was tax free under section 351 and its predecessors.[144] The statute did not require voting power to be allocated among the transferors in proportion to the value of their respective transfers; only that the transferors in the aggregate control the corporation immediately after the transfer and (until the 1954 Code) that the values of the stock and securities received by each transferor be proportionate to the value of the property he or she transferred. From a broader perspective, this result should not seem strange or anomalous. Congress's stated purpose of facilitating business "readjustments" suggests that Congress wanted, in general, to accord tax free treatment to corporate formations to the same extent that partnerships could be formed on a tax free basis. Since the elements of control and financial interest can be allocated among partners in an infinite number of ways without tax

[144] See supra notes 95-96 and accompanying text.

consequences, Congress presumably would have desired to accord this same flexibility to persons forming a corporation. From that perspective, the result in this type of transaction should not be viewed as a flaw in the design of the statute but rather as a logical implementation of its underlying purpose.

In short, the legislative history shows that Congress was not obsessed with restricting nonrecognition to transactions involving mere changes in the form of the taxpayer's investment; rather its primary purpose in 1921 was to facilitate desirable business readjustments and to avoid recognition of gain where there was no realization of a cash profit.

D. A Reexamination of the Binding Obligation Cases

Reconsider the binding obligation cases in light of the legislative history by examining the following example:

> *Example 4.6*
> A has operated a proprietorship for many years. The proprietorship has a fair market value of $100,000 and A's basis in the assets of the proprietorship is $10,000. B would like to buy a 30% interest in A's business for $30,000 but is unwilling to do so unless the business is first incorporated to avoid the risk of personal liability. Therefore, A and B agree that A will transfer the proprietorship to a newly formed corporation (Newco) for all of its stock and then sell 30% of his stock to B for $30,000.

If section 351 applies, A will be required to recognize a taxable gain of $27,000 attributable to A's sale of his 30% equity interest in the business. Conversely, if section 351 does not apply, as under present law, A will be required to recognize a taxable gain of $90,000, all of the gain that inhered in the transferred property.

Thus, the choice is not between taxation or no taxation, but between limiting the gain (or loss) to the actual stock interest sold or alternatively requiring recognition on all of the gain (or loss) that inhered in the transferred property. The statute, through its carryover basis provisions, has its own mechanism for assuring full recognition of gain (or loss) on all stock sold after the transfer. The real question, therefore, is whether a preplanned sale of stock, reducing the transferor's interest below 80%, so violates the policy of the statute as to require the immediate recognition of all gain or loss inhering in the transferred property rather than relying on the statute's mechanism for assuring recognition of gain or loss when

the stock is actually sold. The classic answer to this question is "yes," on the ground the policy of the statute is to exempt transactions only where a mere change in the form of the investor's interest occurs. The legislative history shows this answer to be wrong.

Facilitation of Business Readjustments: Taxing A, in Example 4.6, on the *entire* appreciation in his business, $90,000, and not just on the gain allocable to the 30% interest A sold to B, $27,000, defeats Congress's explicitly stated purpose in enacting section 351 to facilitate desirable business readjustments. Had A simply sold his 30% interest in his proprietorship to B thereby converting the proprietorship to a partnership, he would have recognized gain only on the 30% he sold. Yet under the existing interpretation of section 351, if the parties form a corporation in conjunction with A's sale of a 30% interest in the business to B, A will have to recognize gain on 100% of the appreciation in his business. Instead of facilitating A's and B's formation of a corporation, the present construction of section 351 more than triples the tax A would otherwise pay.[145]

Easing liquidity problems: Taxing A on the entire appreciation in his business when in fact he has only "cashed out" to the extent of 30% contravenes Congress's explicitly stated concern with easing the liquidity problems of taxpayers and only taxing them only on the "cash profit" actually realized.

The statutory language: The results in the binding obligation cases contravene the express language adopted by Congress which demands only that the transferor have control of the corporation immediately after the exchange. Granted it is sometimes appropriate to deviate from the literal language of the statute when neces-

[145] In Hempt Bros., Inc. v. United States, 490 F.2d 1172 (3d Cir. 1974), cert. denied, 419 U.S. 826 (1974), the court recognized the overriding importance of Congress's intent to facilitate the incorporation of ongoing businesses in applying § 351. The court held that accounts receivable assigned by a predecessor cash-basis partnership to a corporation were taxable to the corporation and not the partnership; the court reasoned that under § 358 (which was applicable by reason of § 351) the receivables took the same basis they had in the hands of the partnership, i.e., zero, and hence were taxable to the corporation when collected. The taxpayer had argued that this statutory rule was overridden by the pervasive "assignment of income" doctrine that income is to be taxed to the one who earns it (i.e., the partnership) — a doctrine once described by the Supreme Court as the "first rule of income taxation" (Commissioner v. Culbertson, 337 U.S. 733, 739-740 (1949)). Nevertheless, the court held that Congressional policy of facilitating the incorporation of ongoing businesses was of such magnitude that it overrode the "assignment of income" doctrine. *Hempt Bros.* 490 F.2d at 1178.

sary to effectuate a statute's policy. Here, however, deviation from the literal language furthers no discernible policy but defeats the most reasonable interpretation of the policies underlying section 351.

The mere change of form policy: In light of the foregoing, only the strongest and clearest policy would justify taxing A on the entire appreciation in his business. The proffered justification that the statute was designed to limit tax free treatment to mere changes of form conflicts with the legislative history which demonstrates with relative clarity that Congress did not demand a rigid identity in the nature of a transferor's pre-transfer proprietary interest and his post-transfer proprietary interest. On the contrary, Congress was prepared to tolerate significant changes in the transferor's pre-transfer and post-transfer proprietary interests. Certainly, the legislative history is devoid of the clear and convincing evidence one would require to justify the Draconian result of taxing the transferor on *all* of the gain in the transferred property.

One further point. One suspects an unstated reason for the present construction of section 351: protection of the revenue. In fact, it is doubtful whether the present construction achieves this objective. Frequently it is the taxpayer rather than the Service who asserts that section 351 is inapplicable because of a pre-incorporation plan or obligation to dispose of a controlling stock interest in the corporation.[146] Taxpayers have many reasons to avoid section 351:

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[146] In the following cases, the taxpayer asserted the exchange failed to qualify for nonrecognition treatment under § 351 or its statutory predecessor: Intermountain Lumber Co. v. Commissioner, 65 T. C. 1025 (1976) (successful claim by taxpayer to stepped-up basis and greater depreciation deductions); Culligan Water Conditioning of Tri-Cities v. United States, 567 F.2d 867 (9th Cir.1978) (unsuccessful claim by transferee-corporation to stepped-up basis); O'Connor v. Commissioner, 16 T.C.M. (CCH) 213 (1957), aff'd, 260 F.2d 358 (6th Cir. 1958), cert. denied, 359 U.S. 910 (1959) (unsuccessful claim to stepped-up basis in transferred patent); May Broadcasting Co. v. United States, 200 F.2d 852 (8th Cir. 1953) (successful claim by transferee-corporation to stepped-up basis for purposes of computing excess profits tax liability); Independent Oil Co. v. Commissioner, 6 T.C. 194 (1946), acq., 1946-2 C.B. 3 (successful claim by transferee-corporation to stepped-up basis); Briggs-Darby Const. Co. v. Commissioner, 119 F.2d 89 (5th Cir. 1941) (successful claim by transferee-corporation to stepped-up basis); Heberlein Patent Corporation v. United States, 105 F.2d 965 (2d Cir. 1939) (successful claim to stepped-up basis in patents); Hazeltine Corp. v. Commissioner, 89 F.2d 513 (3d Cir. 1937) (successful claim for stepped-up basis in transferred patents); Schmieg, Hungate & Kotzian Inc. v. Commissioner, 27 B.T.A. 337 (1932) (unsuccessful claim to stepped-up basis); Omaha Coca-Cola Bottling Co. v. Commissioner, 26 B.T.A. 1123 (1932), nonacq. XI-2 C.B. 16 (1932) (successful claim to stepped-up basis).

recognition of a loss on the transfer of property to the corporation; a stepped-up basis in the transferred assets in the hands of the corporation producing larger depreciation deductions; etc. Section 351 is a double-edged sword, and a desire to protect the revenues provides no justification for the present construction.

V. A Reformulation of the Policy in Section 351

If the mere change of form rationale does not explain section 351 and its various requirements, what does? Consider each of the three requirements in turn:

A. Transferor must receive some stock: This requirement assures that the transferor will have an ownership interest in the transferred assets and therefore performs the same function as the continuity of proprietary interest requirement does in the reorganization area. Note how the continuity of proprietary interest requirement differs from the mere change of form rationale: the continuity of interest requirement does nothing to ensure that the nature of the transferor's investment remains substantially the same. In the reorganization area, it has long been recognized that the nature of a shareholder's proprietary interest may undergo radical change and still qualify for tax free treatment.[147] Likewise, section 351's "receipt of stock" requirement by itself does nothing to assure that the investor's post-transfer investment will remain substantially unchanged from the investor's pre-transfer investment. The receipt of stock should be viewed as a continuity of interest requirement.[148]

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[147] See Helvering v. Minn. Tea Co., 296 U.S. 378 (1935). That case involved the transfer by a corporation of substantially all of its assets for voting trust certificates representing 18,000 shares of common stock of the transferee corporation. These 18,000 shares constituted 7 ½ percent of the outstanding stock of the transferee corporation. The substantial reduction in the transferor's control over the transferred assets caused the Board of Tax Appeals to deny reorganization treatment to the transaction. The Supreme Court found that the transaction constituted a tax-free reorganization: "True it is that the relationship of the taxpayer to the assets conveyed was substantially changed, but this is not inhibited by the statute." Id. at 386.

[148] An interesting question arises: If the receipt of stock requirement is viewed as a "continuity of proprietary interest" requirement, does that have the effect of importing all of the learning in the reorganization area on continuity of interest into § 351? The Service on at least one occasion applied the continuity of interest doctrine to a § 351 problem. In Revenue Ruling 73-472, 1973-2 C.B. 114, the Service ruled that a transferor who received only securities in exchange for the transfer of property could not qualify for nonrecognition under § 351 even though the transferor and his co-transferors controlled the corporation immedi-

B. Transferor must transfer property: The principal effect of this requirement is to exclude services from the protection of section 351. This requirement simply reflects the deeply embedded principle of the tax law that compensation received for services should be taxed whether paid for in cash, property or otherwise.

C. Transferors must control corporation immediately after the transfer: Recall it was suggested above that given Congress's explicitly stated purpose of facilitating business readjustments, it was reasonable to assume that Congress generally would have wanted that the 1921 legislation to accord tax free treatment to corporate changes to the same extent that such changes could be accomplished tax free if done in a noncorporate or partnership context. The analogy between corporate and partnership formations breaks down in one obvious situation. If a person transfers property to an existing corporation and takes back less than 80% of the corporation's stock, the transfer fails to qualify under section 351 since the transferor would not control the corporation im-

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ately after the transfer and even though the statute at that time provided for nonrecognition if the transferor received either stock *or* securities. Citing Le Tulle v. Scofield, 308 U.S. 415 (1940) (a reorganization case), the Service held the transferor must receive at least some stock to qualify for nonrecognition treatment.

If the reorganization "continuity of interest" test applies to § 351, arguably the holding of McDonald's Restaurants of Illinois v. Commissioner, 688 F.2d 520 (7th Cir. 1982), would also apply (i.e., that stock acquired by a transferor with the preconceived intent of disposing of it cannot count for continuity purposes). Several points should be noted. First, it is far from clear that *McDonald's* holding requiring continuity in the *identity* of the shareholders is correct. See Bernard Wolfman, "Continuity of Interest" and the American Law Institute Study, 57 Taxes 840, 841 ("I suggest that the transmutation of the concern about proprietary interest into one about the identity of the proprietors is a distortion of enormous magnitude."); Jere D. McGaffey & Kenneth C. Hunt, Continuity of Shareholder Interest in Acquisitive Reorganizations, 59 Taxes 659, 680-82. Secondly, application of the McDonald's holding to § 351 would impose a substantially less severe burden upon the taxpayer than current doctrine. Under present doctrine, a binding preexisting commitment by a transferor to dispose of his stock which will reduce his holdings and that of his co-transferors to less than 80% will disqualify the transaction from qualifying under § 351. If the rationale for the control requirement presented in this article were adopted but the McDonald's continuity of interest were applied to § 351, the transferor would qualify for nonrecognition under § 351 even if he had a preconceived intent to dispose of some of the stock he received in the transaction so long as he retained stock representing "a material part of the value of the transferred assets." Helvering v. Minn. Tea Co, 296 U.S. 378, 386 (1935). In John A. Nelson & Co. v. Helvering, 296 U.S. 374 (1935), the Supreme Court held this latter requirement was satisfied where the transferor received nonvoting preferred stock representing only about 38% of the value of the property transferred. Finally, it is conceivable that the statutory language "*immediately* after the exchange" in § 351 would limit the scope of the continuity of interest requirement when applied to that section.

mediately after the transfer. In contrast, if a newly admitted partner receives in exchange for property only a minuscule partnership interest (say, less than 1%), that transfer will still be nontaxable.[149] This differentiation, which is compelled by the statute, may provide the clue for understanding the purpose of the 80% requirement. Why was Congress willing to permit tax-free transfers by a partner no matter how small an interest he received in the partnership while a shareholder could receive tax free treatment only if he, and any contemporaneous transferors, ended up with 80% of the stock?

The thesis of this article is that Congress enacted the 80% requirement to prevent existing corporations with readily marketable stock from using their stock to buy goods and supplies on a tax free basis to their vendors. Or stated differently, the 80% control requirement prevents a supplier, for example, from selling supplies to a corporation without recognizing income or gain simply by accepting the corporation's stock in lieu of cash. In the absence of an 80% control requirement, U.S. Steel could sell its steel to General Motors tax free simply by accepting payment in GM stock. Since GM stock is highly marketable, constitutes good collateral and has proved to be a good investment, U.S. Steel might be content to hold on to the stock indefinitely, especially since it would not be required, in the absence of the 80% requirement, to recognize gain until it disposed of the stock. The 80% requirement effectively blocks this stratagem, since a supplier selling goods to GM for GM stock will not end up with 80% of GM stock.

Under this rationale, the 80% cut-off serves to distinguish transactions in which the corporation is merely using its stock as a medium of exchange, i.e., a cash-substitute, from those in which it is not. Where 80% of the corporation's stock is issued to a new investor, a significant and meaningful shift occurs in the control of the corporation; the corporation is not simply using its stock as currency for buying goods. The 80% control requirement also permits the existing controlling shareholders to transfer property to the corporation without recognizing taxable gain or loss. Here too, the 80% requirement serves to distinguish a transaction between a corporation and its controlling shareholders from the case where the

[149] I.R.C. § 721 (no recognition on transfer of property to partnership in exchange for partnership interest; control irrelevant); Thompson, supra note 129, at 39.

corporation is buying property from third-party vendors on a tax free basis and using stock merely as a substitute for cash. Under this rationale, it is irrelevant what happens to the stock after the exchange is completed. So long as the 80% control requirement is satisfied immediately after the transfer, the transaction will be significantly different from the abusive situation the statute is designed to counter and should enjoy nonrecognition treatment. Note that under this analysis, the operation of the 80% requirement should be limited primarily (possibly exclusively) to existing, rather than newly formed, corporations. Indeed, it is questionable whether there is any significant role for the 80% control requirement to perform in an initial incorporation. The possible reasons for the 80% control requirement in the context of an initial incorporation seem limited to the following:

(1) To limit nonrecognition where there are multiple transferors to cases where the transferors had a preexisting joint interest in the transferred property. Under this analysis, existing partners of a partnership could qualify for a tax-free incorporation so long as new investors, people not previously associated with the partnership, receive no more than 20% of the stock.

(2) To preclude nonrecognition where new investors providing new cash to the venture receive more than 20% of the stock in the corporation.

(3) To ensure that the property-transferors in an incorporation retain an 80% continuing interest in the enterprise for a meaningful period after the incorporation.

(4) To preclude nonrecognition if the service-providers receive more than 20% of the stock.

Proposition (1) has some superficial plausibility. Possibly the thought of the drafters was that if a group of persons, conducting a business or jointly owning property, transfer that business or property to a newly formed corporation, they should qualify for nonrecognition, since there was only a change of form, but that if new investors, persons having no preexisting association with the property or the business, receive more than 20% of the stock, more than a change of form has occurred and the transaction should be taxed. This seems unlikely. As stated above, Congress changed the term originally used in the bill, "group of persons," to "two or more persons" specifically to negate any implication that there had

to be some sort of special association among the transferors.[150] Furthermore, Congress's desire to facilitate desirable business readjustments makes it unlikely that Congress intended to tax run-of-the-mill incorporations, where persons, previously unassociated, come together and pool their various resources to carry on business. Finally, it is of some significance that the courts have consistently held the transferors need not have had a preexisting joint interest in the transferred property to qualify for nonrecognition.[151]

Proposition (2) is simply a more limited version of proposition (1). Proposition (2) says that nonrecognition is appropriate where unrelated individuals come together for the first time and contribute different properties to a newly formed corporation but not if the cash provider[s] receive more than 20% of the corporation's stock. Essentially proposition (2) says that cash does not qualify as property. One can rationalize this construction on the ground that where the infusion of cash exceeds 20% of the total equity, the transaction partakes more of a sale and therefore nonrecognition should be denied. This argument has several difficulties. First, such a transaction lacks the essential characteristic of a cash sale: the transferor does not receive the cash. Rather, the cash is dedicated to the use of the corporation and most likely can be obtained by the transferors only as ordinary income. Secondly, the word "property" is an extremely comprehensive one; it seems inconceivable that if the drafters inserted the 80% control requirement to deny nonrecognition where more than 20% of the stock was issued for cash, they would not have made it explicitly clear that the term "property" did not include cash (e.g., by adding a phrase like "other than cash").[152] Thirdly, it is unclear why cash transfers should potentially destroy a tax-free incorporation whereas other property transfers would not. If one rejects proposition (1) as the explanation for the 80% control requirement, and therefore agrees that an incorporation in which different transferors transfer their different (and separately owned) properties should qualify for nonrecognition treatment, it is difficult to understand why the fact

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[150] See supra note 134 and accompanying text.

[151] See supra notes 136-137 and accompanying text.

[152] See Portland Oil Co. v. Commissioner, 109 F.2d 479, 488 (1940) ("Where it is necessary to differentiate between money and other property, the statute does so.").

that person[s] transferring cash receive more than 20% of the stock should disqualify the transaction. Finally, ever since 1935, the courts have uniformly rejected the notion that cash does not qualify as property.[153]

Proposition (3) is of course the mere change of form theory, the deficiencies of which are discussed elsewhere in the article. What should be noted here is that even those who embrace the mere change of form argument must in candor acknowledge that it is highly doubtful that Congress or the statute's drafters ever conceived of the 80% requirement as a device for requiring the transferors to hold their stock for a meaningful period after the exchange. If so, they surely would not have used the limiting phrase "immediately after" — a phrase which so obviously suggests that momentary control, even when accompanied by a binding obligation to sell, is sufficient to satisfy the statute.[154]

Proposition (4) of course accurately states the law, that is, if a service provider receives more than 20% of the stock of the corporation the transaction fails to qualify for nonrecognition treatment. Elsewhere in this article it is argued that this is a dubious application of the law.[155] In any event, it appears unlikely that the 80% requirement was inserted to achieve this result. Certainly, if that had been the motivating factor, the drafters in 1921 would have made it explicitly clear that services do not constitute "property" (as the present Code does in section 351(d)(1)) — especially since some embodiments of services, e.g., employment contracts, may quite easily be thought of as "property."[156] The infrequency with which this issue was reported in cases under the 1939 Code suggests that it was not a significant issue.[157] Note also that if this

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[153] Halliburton v. Commissioner, 78 F.2d 265 (9th Cir. 1935).

[154] See *Portland Oil Co.*, 109 F.2d at 489 (per Magruder J., the statute "does not say the such control shall 'remain' in the transferors").

[155] See infra notes 195-200 and accompanying text.

[156] The difficulty in distinguishing between property and services is illustrated by the problems encountered by the Service in distinguishing between "know-how," secret formulas, processes (which are considered property even though created by personal services) and services. The Service promulgated guidelines for distinguishing between industrial know-how and services in Revenue Ruling 64-56, 1964-1 C.B. (pt. 1) 133 and Revenue Ruling 71-564, 1971-2 C.B. 179, amplifying it. See also Rev. Proc. 69-19, 1969-2 C.B. 301 and Rev. Proc. 74-36, 1974-2 C.B. 491 (guidelines for advance rulings).

[157] There appears to be only one reported case prior to the 1954 Code where a transaction was disqualified under the predecessor of § 351 because a service-provider received more than 20% of the stock. Columbia Oil & Gas v. Commissioner, 41 B.T.A. 38 (1940), acq. 1944

were the explanation for the 80% control requirement, it would not justify the results in the binding obligation cases.

Thus, after considering the various possibilities, it appears the 80% control requirement was probably intended to apply to midstream transfers of property and not to initial incorporations.[158] It is suggestive, though obviously not conclusive, that the first proposal in this area, the amendment proposed by the Senate Finance Committee in 1918, which apparently would have applied only to incorporating transactions, had no control requirement, while the other proposals, which seemingly contemplated midstream transfers, all had control requirements.[159]

Two questions remain:

(1) Why did Congress not feel that a similar limitation was required in the case of partnerships, where there is no 80% requirement, to prevent tax-free sales to partnerships? and

(2) Is there any basis in the legislative history or the structure of the 1921 legislation that supports this explanation for the 80% requirement?

The most likely reason Congress found it unnecessary to impose an 80% control requirement, or similar limitation, in the case of partnerships was that a partnership interest, being illiquid and unmarketable, could not effectively be used to effect tax-free sales. U.S. Steel, in the above hypothetical, would have been unwilling to accept a partnership interest in payment for its steel because partnership interests were unmarketable.

C.B. 6, aff'd, 118 F.2d 459 (5th Cir. 1941).

[158] Thompson, supra note 129, recognizes that under current law, there is no inherent difference "on formation of a new enterprise" between the operation of § 721, which grants nonrecognition to persons who contribute property to a partnership in exchange for a partnership interest and § 351, "because all of the contributing shareholders will be included in the control group without regard to the amount of stock received." Id. at 40. However, "different treatment can occur . . . on the admission of new investors to an operating enterprise." Id.

[159] The Senate's 1918 proposal according tax free treatment to persons transferring property to "a corporation *formed to take over such property*" would apparently have been limited in operation to initial incorporations. (Emphasis added). See supra notes 105-108 and accompanying text. In contrast, the provision in Article 1566 of Regulations No. 45 (see supra note 109 and accompanying text) and the proposal contained in the 1918 Act Notes (see supra note 113 and accompanying text) would have granted tax free treatment to persons who transferred property to a corporation (presumably including an *existing* corporation) in exchange for a specified percentage of stock and therefore would apparently have been applicable to "midstream" transfers as well as to initial incorporations.

Under the Uniform Partnership Act (which had been adopted by 14 states at the time of the enactment of the 1921 Revenue Act)[160] and at common law, a person buying a partnership interest did not thereby become a partner but merely became entitled to receive whatever payments from the partnership that the selling partner would have been entitled to.[161] This meant the purchaser had no right to vote on partnership matters or otherwise participate in the management of the partnership, or even to inspect partnership records or receive financial statements.[162] The purchaser's right to receive payments from the partnership would also necessarily be uncertain. Since a partnership interest is not a negotiable instrument, even a good faith purchaser of such an interest would be subject to claims against that interest created by the seller or a prior owner.[163] In many cases, a partner's right to receive income is dependent upon his performance. For example, his right to partnership income might be based on how much work he does or how much business he brings in to the firm. Thus, the right of a purchaser of such an interest to income payments would be doubly contingent: first, upon the success of the business, and second, upon the performance of the selling partner.[164] For all these reasons, a partnership interest would be an especially unattractive investment to a potential purchaser.

Moreover, partnership interests do not come in standard, interchangeable units. Generally partnership interests (even within a single firm) differ from one another in terms of the holder's share of profits and losses and the allocation of managerial power. This lack of standardized units makes the development of a market in partnership interests virtually impossible.[165]

Furthermore, many characteristics of a partnership, such as unlimited personal liability,[166] lack of centralized management,[167] and

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[160] Based on table appearing at 6 Uniform Laws Annotated 1 (Master ed. 1969).

[161] Unif. Partnership Act § 27(1), 6 U.L.A. 353 (1969). For the common law rule, see Theophilus Parsons, Treatise on the Law of Partnership § 406 (assignees and transferees do not become partners) (Joseph H. Beale, Jr. ed. 1893).

[162] Unif. Partnership Act § 27(1), 6 U.L.A. 353 (1969).

[163] See discussion of this point in Robert C. Clark, Corporate Law § 1.2.2 (1986).

[164] See id.

[165] See id.

[166] Unif. Partnership Act § 15, 6 U.L.A. 174 (1969) (partners liable for partnership debts and obligations).

[167] Unif. Partnership Act § 18(e), 6 U.L.A. 213 (1969) (in absence of any agreement to the

the lack of certainty as to the continuity of the enterprise,[168] made the partnership form unsuitable for large scale enterprises. These characteristics also made partnership interests unattractive as passive investments.

The combination of these factors meant that partnerships were generally confined to small business operations, and that partnership interests for all practical purposes were unmarketable. Indeed, the understanding that partnership interests were unmarketable was well entrenched in 1921. As late as 1934, Learned Hand, writing on behalf of the Second Circuit, held that a general partnership interest in a brokerage firm had no "fair market value" because of the limited rights accorded to an assignee of a partnership interest under partnership law.[169] Congress simply had no reason to fear that partnership interests would be used to effect tax-free sales.[170]

Is there any evidence that Congress was actually concerned with the danger of corporations issuing their marketable stocks to acquire goods or property on a tax free basis to the vendors? Although the legislative history is void of any discussion on this point, the structure of the statute strongly suggests this danger

contrary, each partner entitled to equal participation in management of the partnership). See also Unif. Partnership Act § 6(1), 6 U.L.A. 22 (1969) (partners are co-owners of the partnership) and Comment of the Commissioners, Unif. Partnership Act § 6(1), 6 U.L.A. 23 (1969) ("Ownership involves the power of ultimate control") suggesting that the right of each partner to participate in management of the business is an essential characteristic of a partnership.

[168] Unif. Partnership Act § 29, 6 U.L.A. 364 (1969) (partnership dissolved by any partner ceasing to be associated in the carrying on of the business). Moreover, dissolution results even when partner withdraws from partnership in violation of his agreement to continue in partnership. Unif. Partnership Act § 31(2), 6 U.L.A. 376 (1969). Dissolution entitles each partner to withdraw his share of any surplus remaining after the payment of the partnership liabilities. Unif. Partnership Act § 38(1), 6 U.L.A. 456 (1969). Where partner caused dissolution by violating his agreement, the offending partner is entitled to his share of the surplus reduced by any damage caused to his partners by the breach of the agreement, and if the business of the partnership is continued, the offending partner also is not allowed to include any portion of the goodwill of the business in the valuation of his interest. Unif. Partnership Act § 38(2)(c), 6 U.L.A. 456 (1969).

[169] Helvering v. Walbridge, 70 F.2d 683, 685 (2d Cir.), cert. denied, 293 U.S. 594 (1934).

[170] The analysis in the text is primarily applicable to general partnership interests rather than limited partnership interests; the latter are in many ways comparable to stock interests (e.g., limited liability, relatively free transferability of interests, etc.) and thus theoretically posed the same threat of abuse. However, in 1921 the phenomenon of publicly-traded limited partnership interests probably did not exist, because there were probably no publicly-held limited partnerships. See Thompson, supra note 129, at 50. Congress undoubtedly did not even consider this potential problem.

would necessarily have occurred to the drafters. Recall the 1921 statute provided that (1) where property was exchanged, no gain or loss would be recognized unless the property received had a readily realizable market value; and (2) even if the property received had a "readily realizable market value," gain or loss would still not be recognized in three specified cases, including a transfer to a controlled corporation.[171] Thus the original predecessor of section 351 would only come into effect where the stock received had a readily realizable market value. This meant the attention of the drafters would naturally be drawn to the situation where publicly traded stock of a corporation was issued to a person in exchange for property. When focusing on this situation, the drafters would certainly have seen the danger described earlier (e.g., GM buying steel from U.S. Steel with GM stock) and inserted language to prevent that abuse.

The likelihood that the drafters saw this danger is heightened when one considers the original language of the bill prepared by the Treasury and passed by the House. Under the original bill proposal, gain or loss would be recognized only where the property received had a "*definite and* readily realizable market value."[172] Only if this stringent condition were satisfied would it be necessary to look at the predecessor of section 351. Dr. T.S. Adams, a Treasury Department consultant credited as the "father" of the 1921 Act, opined that "perhaps in a majority of cases of such exchanges the value of the property received is not definite." [173] The "definite and" language was stricken from the bill by the Senate Finance Committee, apparently to impose a less stringent standard for the recognition of a gain or loss.[174] Nevertheless, when the provisions

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[171] See supra notes 119-125 and accompanying text.

[172] See H.R. 8245, 67 Cong., 1st Sess. § 203 (amending § 202(d) of the Revenue Act of 1918) (emphasis added) as reported by the House Ways and Means Committee, H.R. Rep. No. 350, 67th Cong., 1st Sess., reprinted in 95 Reams, supra note 113 at 10. Dr. T.S. Adams, professor of political economy at Yale and economic adviser to the Treasury Department, fought for retention of the "definite and" language in his testimony before the Senate Finance Committee, stating that the "suggested language given here [the "definite and" language contained in the bill passed by the House] registers the official recommendation of the Treasury Department, made after much care and thought." See Senate Hearings on 1921 Act, supra note 134, at 199-200. Ultimately, however, the language was dropped from the bill by the Committee. See id. at 200.

[173] See Senate Hearings on 1921 Act, supra note 134, at 28.

[174] See Senate Hearings on 1921 Act, supra note 134, at 199-200.

relating to transfers to controlled corporations were originally drafted, the drafters believed they would come into effect only if the property received had a "definite and readily realizable market value." This would have occurred in few situations, probably only where there was an active market for a corporation's stock and securities. Given the limited situations in which the predecessor of section 351 would operate, the drafters almost certainly would have focused on the possibility of publicly held corporations using their stock as a cash-substitute to acquire supplies and goods and would have inserted measures to deal with this abuse. The 80% requirement was the means used to accomplish this.[175]

The above explanation of the 80% requirement is necessarily speculative. It cannot be confirmed by the Committee Reports, which are silent on the matter, nor by the drafters and sponsors of the 1921 legislation, who are no longer with us. It does, however, have the following advantages over the conventional mere change of form rationale: (1) it comports better with the way the statute operates in practice; (2) it is more consistent with the language of

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[175] Although the provision restricting the recognition of gain or loss to cases where the property received had a "readily realizable market value" was repealed in 1924, the 80% control requirement was retained. In the author's view, these facts do not undermine the explanation for the 80% control requirement set forth in this article.

(1) The danger of a publicly-held corporation in effect buying goods with its stock or securities on a tax free (or at least a tax deferred basis) to the seller still existed: without the 80% control requirement, GM would still be able after the 1924 legislation to buy its steel from U.S. Steel with its common stock on a tax-free or tax-deferred basis to U.S. Steel. Thus, there was a continuing need for the 80% control requirement or some alternative mechanism to guard against this abuse.

(2) It can be argued that after 1924 the 80% control requirement was overly broad to meet this perceived abuse; that is, the 80% control requirement after 1924 would result in disqualification under the predecessor to § 351 even where a noncontrolling transferor received unmarketable and illiquid stock or securities. Therefore, the failure of Congress to adopt a narrower provision more closely tailored to the perceived abuse suggests that the explanation proffered above was not in fact the motivation for adoption of the 80% control requirement in the first place. But how would Congress have gone about drafting a more closely tailored provision? Presumably, by applying the 80% control requirement only where readily marketable stock or securities were received; but this was the very concept (i.e., "readily realizable market value") which Congress had found to be administratively unworkable and which it rejected in the 1924 legislation. Apparently, Congress concluded that the injustice of taxing a taxpayer on his receipt of unmarketable property was outweighed by the administrative difficulty of determining when property was in fact unmarketable. Thus, the continuation of the 80% requirement after the repeal of the "readily realizable market value" standard is entirely consistent with the theory offered in this article.

the statute; and (3) it is more consistent with the overall thrust of the 1921 legislation.

As we have seen, the conventional mere change of form rationale comports poorly with the actual operation of the statute, since section 351 accommodates radical substantive changes in the nature of the transferor's investment. The proposed rationale, divorced from the mere change of form rationale, avoids this embarrassment.

The mere change of form rationale led the courts to deviate from the language of the statute; the proposed rationale requires no deviation from the language of the statute.

Application of the mere change of form rationale to the binding obligation cases results in a substantial penalty to a proprietor who incorporates his business in conjunction with a sale of a more-than-20%-interest in that business to another. This is because the entire appreciation in his business will be taxed, rather than just the appreciation attributable to the interest he sold to the third party. As mentioned earlier, this undercuts the stated Congressional policy of facilitating business readjustments and frustrates the Congressional policy of alleviating liquidity problems by limiting taxation to the portion of the taxpayer's investment that he actually "cashed out." In contrast, the proposed rationale furthers these policies since it would not impose taxation in these cases.[176]

VI. Application of the Proposed Rationale

A. The Loss of Control Cases

1. The Binding Obligation Cases: The focus of the proposed rationale is exactly opposite that of the mere change of form rationale. The mere change of form theory focuses on the transferor's proprietary interest and compares its post-transfer nature with its pre-transfer nature. If the two are sufficiently similar, tax free treatment is granted since there has only been a "change of form";

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[176] After all is said and done, there is no way of conclusively establishing the correctness of the proposed rationale. Perhaps that is not the real question. Perhaps the real question is whether the courts should stay with the conventional rationale even though it departs from the language of the statute, undermines basic policies of the statute and does not fulfill its purported mission of limiting nonrecognition to mere changes of form. The alternative rationale, in contrast, adheres to the language of the statutes, fulfills the policies of the statute and provides a persuasive explanation of the 80% control requirement.

otherwise, the transaction is taxable.

In contrast, the proposed rationale, like the statute, focuses on the stock holdings of the shareholders *immediately after the exchange*. If the corporation issues 80% of its stock to a transferor or to a group of transferors (or to persons who already own 80% of the stock or will do so after the issuance of the additional shares), the corporation is either shifting *control* to a new shareholder[s] or is dealing with a current controlling shareholder[s]. It is not using its stock as a cash-substitute to buy goods and property from a third-party vendor. Thus the transaction differs from the abuse situation the statute is designed to address, and it becomes irrelevant what the transferors thereafter do with their stock.

Accordingly, section 351 will be satisfied under the proposed rationale so long as the transferor[s] own at least 80% of the stock immediately after the exchange, even if the transferor[s] thereafter divest themselves of control pursuant to a preexisting binding agreement.

2. *The Gift Cases*: An advantage of the proposed rationale is that it dissolves the inherent conflict between the results in the binding obligation cases and the gift cases. Although divestiture of control in the gift cases may be preplanned (and indeed may be the motivating purpose of the transaction), and may result in just as radical (or even more radical) a change in the transferor's interest as in the binding obligation cases, the courts allow nonrecognition in the gift cases while denying it in the binding obligation cases. The "mere change of form" rationale utterly fails to explain this difference in results, and the courts merely note the factual differences in the two types of cases without explaining why the two situations should produce different consequences. Under the proposed rationale, section 351 would apply in both the gift cases and the binding obligation cases so long as the transferor owned at least 80% of the corporation's stock "immediately after" the exchange, regardless of the transferor's subsequent disposition of the stock. Thus, the heretofore existing discrepancy in the handling of these two types of cases would disappear.

3. *Public Offerings*: In Revenue Ruling 78-294,[177] the Service

[177] See supra notes 19-21 and accompanying text.

ruled that where (1) an owner transferred his business to a newly-formed corporation for stock, and (2) as a part of the same plan, the corporation made a public offering of its stock through an underwriter, the transaction qualified under section 351 even if control of the business passed from the owner as a result of the public offering. The ruling seemed to hold that this result would occur regardless of whether the underwriting was a "best efforts" underwriting or a "firm commitment" underwriting. Though the Service came to the same conclusion in both cases, its rationale in the two instances differed radically.

In a "best efforts" underwriting, in which the underwriter only agrees to use its best effort to place the stock and acts as the corporation's agent in effecting the sale, the Service concluded that the public subscribers, and not the underwriter, were "transferors" and thus should be treated as part of the "control group" for purposes of determining whether the 80% control requirement was satisfied.[178] Thus, where the both the owner's transfer of his business and the subsequent "best efforts" underwriting are parts of an integrated plan, section 351 will apply since the "transferors" (the owner who transferred his business and the public subscribers) will together receive 100% of the stock.[179]

In contrast, the underwriter in a "firm commitment" underwriting does not act as agent but technically buys the stock for its own account. In this case, the Service treated the underwriter as the "transferor" but disregarded its subsequent resales of the stock on the ground that the "transaction is completed for section 351 purposes with the underwriter's exchange of property for the stock . . . ."[180] Since the owner who transferred his business and the underwriter are treated as members of the "control group" and since the underwriter's subsequent sales are disregarded, section 351 is satisfied since the control group received 100% of the stock.[181] Had the underwriter's subsequent resales been taken into account (and if these sales amounted to more than 20% of the corporation's outstanding stock), the transaction would have failed to qualify under section 351, since the transferors would have

[178] See Rev. Rul. 78-294, 1978-2 C.B. 141, 142 (Situation 1).
[179] See id.
[180] See Rev. Rul. 78-294, 1978-2 C.B. 141, 142 (Situation 2).
[181] See id.

divested themselves of control.

Like any edifice built upon an unsound foundation, Revenue Ruling 78-294 does not stand up well. Assume that a firm commitment underwriter prior to its purchase of stock from the issuing corporation has binding commitments to resell more than 20% of the corporation's stock to its customers. Under the binding obligation line of cases, this transaction (which is not covered by Revenue Ruling 78-294) would fail to qualify under section 351.[182]

This is not a theoretical quibble. In fact, in *most* firm commitment underwritings the underwriters not only have secured firm commitments from their customers prior to their closing with the issuer, they have in fact *sold* the shares on a "when issued" basis to their customers prior to the closing. Once the registration statement becomes effective, the underwriters are free to sell the shares to the public on a "when issued" basis. The closing with the issuer is usually scheduled 7 to 10 days after the effective date of the registration statement[183] for the very reason that by then the underwriters will have collected the funds from their customers and

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[182] This result seems to be consistent with the few decided cases involving this issue. In Hartman Tobacco Co. v Commissioner, 45 B.T.A. 311 (1941), acq. on another issue, 1943 C.B. 11, three tobacco companies and an underwriter entered into an agreement whereunder the tobacco companies would transfer their assets (or cause the assets of their controlled corporations to be transferred) to a newly formed corporation for stock plus certain other consideration. The underwriter contracted to buy stock for cash which it intended to then sell to the public. The agreement was carried out according to its terms. The transferee corporation claimed that the transaction failed to qualify under the statutory predecessor to § 351 on the ground that transferors did not have control after the transfer by reason of the underwriter's subsequent resales. The Board treated the underwriter as a transferor (since it paid cash for its stock) but rejected the transferee corporation's claim because the record failed to show that the underwriter at the time of the transfer had "commitments [from its customers to buy the stock] . . . in sufficient volume to destroy" the 80% control required by the statute. Id. at 314. The Board stated that whether a sufficient number of resale commitments would have had the effect of disqualifying the transaction under the predecessor to § 351 was "a point that need not be decided here." Id. However, the tone of its opinion suggests it would have found the statute unsatisfied had it been shown that the underwriter had a sufficient number of purchase commitments from its customers at the time of the transfer to reduce the aggregate interest of the original transferors to less than 80%.

See also Commissioner v. Schumacher Wall Board Corp., 93 F.2d 79 (9th Cir. 1937) (transaction failed to qualify under predecessor to § 368(a)(1)(D) where underwriter which had acquired stock of the transferor corporation and caused such corporation to transfer its assets to newly formed corporation in exchange for its stock had binding commitments *at the time of the exchange* to dispose of more than 20% of the stock of the new corporation).

[183] See Bialkin & Grant, supra note 19, at 137.

thus be able to pay over the proceeds (net of commissions) to the issuer. Firm commitment underwritings as carried on in real life do not fit comfortably into the neatly dichotomous world of Revenue Ruling 78-294.

Some commentators have suggested that a conceptual escape from this quandary is to view as the "transferors" both (1) those customers who had committed themselves to buy shares from the underwriter; and (2) the underwriter with respect to those shares still unsold, treating any shares sold thereafter by the underwriter as separate transactions under the reasoning of Revenue Ruling 78-294.[184] But as the proposers of this "solution" acknowledge, this "seems too formalistic an approach."[185] What must be done is to uproot the existing doctrine and replace it with a theory that accommodates the realities of the market place. In each of the above cases, the issuer is selling its stock to the public with the underwriter acting as intermediary. No sound reason exists why different tax consequences should turn on the niceties of the way the transaction is structured.

The proposed rationale meets this need, since it would grant nonrecognition whenever the initial transferors (be they underwriters or the public) receive at least 80% of the stock regardless of any anticipated or completed resales of their stock. Therefore, it would grant nonrecognition in each of the above cases. It would reach the same results as Revenue Ruling 78-294 while avoiding both the practical difficulties and conceptual infirmities of the Ruling.

4. *Miscellaneous Cases: Drop Down Transactions and Options*: In Revenue Ruling 83-34,[186] the Service ruled that where a transferor transferred property to a corporation for 80% of its stock and that corporation in turn transferred the property to a second corporation for 80% of the second corporation's stock, both transfers qualified for nonrecognition under section 351 even though both were part of the same plan. As pointed out earlier, this result undermines the mere change of form rationale which holds that the

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[184] David R. Tillinghast & Denise G. Paully, Comment, The Effect of the Collateral Issuance of Stock or Securities on the "Control" Requirement of Section 351, 37 Tax L. Rev. 251, 263 (1982).

[185] See id.

[186] See supra note 100 and accompanying text.

80% control requirement is designed to ensure that the transferor continues to maintain a substantial (i.e., 80%) financial interest in the transferred property and continues to control management of that property (through 80% stock ownership). The mere change of form rationale aims to ensure that it can be fairly said that the transfer merely represents a change in the form, but not the substance, of the transferor's investment. The difficulty with the holding in the Revenue Ruling is that under its facts the transferor had only a 64% continuing equitable interest (80% of 80%) in the transferred property. Nevertheless, the Ruling held the two transfers tax free.

Under the proposed rationale, each transfer would be tax free since the each transferor received 80% of the stock of his or its transferee. Subsequent disposition of the transferred property, like subsequent disposition of the stock received, is irrelevant under the proposed rationale. Thus the proposed rationale reaches the same conclusions as Revenue Ruling 83-34, but without its conceptual weaknesses.

Under current law, the effect of options on an otherwise qualifying section 351 transaction is unclear. At least one court has held that an exchange in which a transferor grants an option which, if exercised, would divest him of control, is taxable since the transferor lacks complete "freedom of action" over his controlling shares.[187] Other courts, focusing on the fact that the transferor possesses control until actual exercise of the option and on the degree of contingency involved in whether the option will be exercised, have held the exchange is not disqualified from section 351 treatment.[188] The proposed rationale clears this tangled underbrush of competing doctrine. Since the proposed rationale calls for nonrecognition even where the transferor is contractually bound to divest himself of control, *a fortiori* it mandates nonrecognition where the transferor grants an option to his controlling stock.

5. Collateral Problems: Character of Income Recognized, Etc.: A possible objection to the proposed rationale is that it permits manipulation by the taxpayer. Reconsider Example 4.6, reproduced

[187] See Barker v. United States, 200 F.2d 223, 229 (9th Cir. 1952).
[188] See supra notes 81-82 and accompanying text.

here for convenience:

> *Example 4.6*
> A has operated a proprietorship for many years. The proprietorship has a fair market value of $100,000 and A's basis in the assets of the proprietorship is $10,000. B would like to buy a 30% interest in A's business for $30,000 but is unwilling to do so unless the business is first incorporated so as to avoid the risk of personal liability. Therefore, A and B agree that A will transfer the proprietorship to a newly formed corporation (Newco) for all of its stock and then sell 30% of his stock to B for $30,000.

Under current law, the transaction fails to qualify under section 351, and A will recognize the entire unrealized gain of $90,000 rather than the $27,000 of gain attributable to the stock he sold to B. It was argued above that this result undercuts the purposes of the 1921 legislation by aggravating the liquidity problems of the parties and impeding desirable business readjustments. Suppose all of A's property is depreciation recapture property, so that if A had sold a 30% interest in the property outright to B (instead of incorporating), A's entire gain of $27,000 would be ordinary income (since it would represent recovery of depreciation deductions previously taken by A).[189] If section 351 applied to this transaction (as advocated by this article), A's gain would presumably be long-term capital gain. The Newco stock would undoubtedly be a capital asset in A's hands,[190] and A would be permitted to tack on to his holding period in the Newco stock the time he held his proprietorship property before exchanging it for Newco stock.[191] Therefore the resulting gain would be a long-term capital gain, assuming that A had held the proprietorship assets for more than one year prior to the exchange.[192] Permitting section 351 to apply to this case thereby enables the parties to transmute ordinary income into

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[189] I.R.C. §§ 1245(a)(1), 1250(a)(1).

[190] Stock is almost always a capital asset in the hands of a taxpayer unless the taxpayer is a dealer in such stock. Even if the taxpayer engages in considerable stock transactions, so that he would be classified as a trader, stock will still be treated as a capital asset in his hands since he does not hold such stock for sale "to customers," and hence it does not come within the exception to the definition of "capital assets" in § 1221(1). See Kemon v. Commissioner, 16 T.C. 1026, 1033, 1034, (1951) acq. 1951-2 C.B. 3.

[191] See I.R.C. § 1223(1) (provided the transferred asset is either a capital asset or a § 1231 asset).

[192] See I.R.C. § 1222(3).

long-term capital gain. Several observations should be made.

First, the restrictive application of the control requirement under present law provides at best an incomplete solution to this problem. For example, if B had bought only a 20% stock interest in Newco from A rather than a 30% interest in Example 4.6, section 351 would apply notwithstanding A's preplanned disposition of stock since A will still end up owning 80% of Newco's stock. Therefore A would still be able to convert ordinary income to capital gain albeit on a lesser scale. The present restrictive application of the control requirement provides only a limited — indeed an accidental — solution to this problem.

Secondly, it is unclear that A has really enhanced his position by following the incorporation route. It is true that if the proposed rationale is adopted A will have converted what would otherwise have been an immediate ordinary income item into capital gain, but that is only half the story. Since the transferred assets in the hands of Newco will have the same basis, holding period and character (i.e., depreciation recapture property)[193] as they had in the hands of A, any subsequent sale of those assets by Newco will give rise to ordinary income to the same extent as if sold by A. Thus, this maneuver by A does not simply convert an ordinary gain into a capital gain; it may be more precise to say that A has converted the immediate recognition of ordinary income into (1) the immediate recognition of capital gain *plus* (2) the deferred recognition of ordinary income by Newco. Even if the assets are not sold by Newco, Newco will be stuck with A's low basis resulting in lower depreciation deductions.

Finally, if the above result is still considered unacceptable since it permits the immediate conversion of ordinary income into capital gain at the cost of only a deferred recognition of ordinary income, there is a better and more precise way of rectifying the result than disqualifying the transaction under section 351. It has been persuasively argued that where a transferor in a section 351 transaction sells some or all of his stock to a third party as an integral part of the overall transaction, the transaction should be restructured as follows: the third party should be viewed as paying

[193] I.R.C. § 362 (transferred basis to corporation); § 1223(2) (tack-on holding period for corporation); Treas. Reg. § 1.1245-2(c)(2) (recapture taint follows the property into the corporation).

to the corporation the consideration he paid to the transferor for his stock; and the transferor should be viewed as receiving from the corporation in exchange for his property, the net amount of stock he ended up with and the consideration he received from the third party.[194] Thus Example 4.6 would be recharacterized as follows: B pays Newco $30,000 for a 30% stock interest in Newco; and A transfers the assets of his proprietorship to Newco in exchange for a 70% stock interest in Newco and $30,000. Under this recharacterization, the $30,000 received by A will be taxed as boot under section 351(b), and thus the character of the income it generates (i.e., ordinary or capital) will be determined by the nature of the assets A transferred to Newco.[195] A will therefore recognize ordinary income since the property A transferred to Newco was depreciation recapture property.

The argument for this recharacterization is that it is necessary to carry out Congressional intent. Congress has specified how nonqualifying property (i.e., boot) should be taxed when received by a transferor in a section 351 transaction. The parties should not be allowed to evade that treatment by manipulating the form in which the transaction is carried out.[196]

This approach is superior to present law which is both overinclusive and underinclusive. Present law prevents the parties from converting ordinary income to capital gain when the transferor is under a binding obligation to divest himself of control by selling more than 20% of the corporation's stock to a third party. But it accomplishes this result in a blunt and crude fashion: it taxes the transferor on all of the appreciation in the transferred assets and not just the appreciation attributable to the stock he sold to the third party. In contrast, if the transferor is under a binding obligation to sell no more than 20% of the corporation's stock to a third party, present law taxes the gain on the sale as capital gain thus permitting the conversion of ordinary income into capital gain. If, as argued in this article, section 351 should apply even where the transferor is under a binding obligation to divest himself of control, and the above-described recharacterization is used to determine tax consequences, then (1) the transferor will be taxed only

[194] Keller, supra note 85, at 122-125.
[195] Bittker & Eustice, supra note 7, at ¶ 3.05.
[196] Keller, supra note 85, at 123-125.

to the extent he "cashes out" and (2) the gain, if any, the transferor recognizes on the sale of stock to the third party will be determined by the character (i.e., ordinary or capital) of the property he transferred to the corporation.

The above analysis presupposes that the transfer of property by the transferor and his subsequent sale of stock will be integrated. How does one determine whether these acts should be integrated? This inquiry should be answered by the step transaction doctrine. The step transaction doctrine is a means of implementing policy. The policy at issue here is adherence to the Congressionally prescribed method of taxing nonqualifying property (i.e., boot) received in a section 351 transaction. Application of the step transaction doctrine to Example 4.6 will enable a court to integrate A's transfer of assets to Newco with his subsequent sale of Newco stock to B, and then it will be able to recharacterize the two events as described above. This will cause the $30,000 received by A from B to be characterized as boot under section 351(b) and thus taxed as ordinary income. Only by so recharacterizing the transaction will Congressional policy be fully implemented.

Note that under this approach advocated here, the three commonly recognized variations of the step transaction doctrine (the binding commitment, mutual interdependence, and end result tests) should be viewed as complementary and not as mutually exclusive. The purpose of the step transaction doctrine is to implement policy. Therefore, what difference does it make in terms of implementing the statute's policy whether A was contractually bound to sell the 30% stock interest in Newco to B or whether he was technically free to keep that interest (although he had every intention of selling the stock to B). In either event, the two steps (i.e., the transfer of A's business to Newco and A's subsequent sale of 30% of the Newco stock to B) are factually intertwined, and a failure in either case to integrate the two steps would frustrate Congressional policy. Of course, if there is a binding commitment by A to sell a 30% stock interest to B, proof of an interrelationship is clear, and a court will naturally rely on cases decided under the binding commitment rubric. But where the parties intend that A sell a 30% stock interest in Newco to B (and A in fact does) the two steps are also factually intertwined and Congressional policy would be as equally frustrated as in the binding commitment case if the two steps are not integrated. In these cases, courts cannot

use the language of the binding commitment test and therefore will rely upon, and use the language of, the end result test or possibly the interdependence test. The point is that courts in each case are doing the same thing: implementing the statute's policy. The language they use and the test they employ differ, but that merely reflects the specific facts of the different cases.

This use of the step transaction doctrine points up an interesting paradox. This article has argued it is an error to use the doctrine to determine whether the control test is satisfied — yet it argues above that the doctrine should be used to determine whether to integrate the initial transfer of property for stock with the transferor's subsequent sale of his stock when applying the boot provisions of section 351(b). Moreover, it argues that for the latter purpose, the most expansive variant of the doctrine — the end result test — rather than the more restrictive binding commitment test should be used. These positions are not hopelessly irreconcilable. The reasons they are reconcilable go to very essence of the step transaction doctrine.

The control test: The statute requires that the transferor control the corporation immediately after the transfer. In every case where the courts have applied the doctrine (e.g., the binding obligation cases), the transferor technically complied with the statute, that is, the transferor for some finite period of time owned 80% of the corporation's stock. Thus the only reason for not according nonrecognition under section 351 would be that to do so would frustrate a policy of the statute, and the only policy reason offered for deviating from the literal language of the statute was the mere change of form rationale. Upon analysis we found that rationale to be unsatisfactory and thus did not justify deviation from the statute's literal language. Accordingly, there is no occasion to use the step transaction doctrine here since there simply is no policy to vindicate.

For recharacterizing payments received in a section 351 transaction: The basic premise here is that Congress has prescribed the tax consequences flowing from an incorporation of business. The parties should not be able to evade those consequences by manipulating the formal structure of the transaction. Since the step transaction is a means of implementing policy, it should be used to prevent such evasion. Note that here the policy being vindicated is not some semi-mystical concept of the purpose of the statute such

as the mere change of form rationale, but rather the explicit tax consequences spelled out by Congress for incorporating transactions. The policy is clear, and the step transaction doctrine being an instrument for implementing policy should be used.

B. *The Case of the Service Provider*

Consider the following case:

> *Example 6.1*
> C and S decide to form Newco. C contributes an undeveloped parcel of land worth $100,000 which he bought for $20,000, and S agrees to provide services worth $100,000. In exchange, C and S each receive a 50% stock interest in Newco.

The statute is clear that S must recognize ordinary income on the receipt of his stock. Section 351(d)(1) provides that stock received for services is not treated as "issued in return for property." Consequently, the stock received by S for services will not qualify for nonrecognition under section 351(a) since that section applies only to stock received in exchange for property.

But what about C? He is receiving stock for property (i.e., the undeveloped land). Moreover, under the analysis of the control requirement presented above, C should qualify for nonrecognition. This is not the case of an *existing* corporation using non-controlling blocks of its stock to buy property; rather Newco is a newly-formed corporation in which the founding shareholders emerge with 100% of the stock. Reference to the partnership analogue also points to nonrecognition: If C and S had formed a partnership instead of a corporation, S would recognize ordinary compensation income[197] but C would qualify for nonrecognition.[198] Finally, the legislative history of section 351(d)(1) at least suggests that its drafters did not intend for S's receipt of stock to disqualify C from enjoying nonrecognition. The House Ways and Means Committee

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[197] Treas. Reg. § 1.721-1(b)(1) (partner who receives an interest in partnership capital as recognition for services recognizes income). There is less certainty whether a receipt of a partnership interest in future income triggers recognition of compensation income. See generally Alan Gunn, Partnership Income Taxation 28-34 (1991). However, since a receipt of corporate stock gives a shareholder a claim to capital upon liquidation of the corporation, the appropriate analogy seems to be a partner who receives an interest in partnership capital.

[198] I.R.C. § 721.

Report explained the reasons for section 351(d) as follows:

> No statutory counterpart exists in section 112(b)(5) of the 1939 Code for [section 351(d)(1)] which provides that for the purpose of section 351 stock or securities issued for services shall not be considered as issued in return for property. In accordance with this provision, such stock or securities received by a person who has rendered or will render services to the transferee corporation would be fully taxable as compensation upon receipt. *Your committee does not intend, however, to vitiate the remaining portion of the transaction, through application of this provision.*[199]

The problem with this approach is that it conflicts with the statutory scheme. Section 351 applies only if the persons transferring *property* end up with control (i.e., at least 80% of the stock). By reason of section 351(d)(1), S is not treated as a property-transferor, and since C (who is a property-transferor) ends up with only 50% of the stock, section 351 does not apply. C, as well as S, must therefore recognize gain on the transaction.

The Tax Court faced with a conflict between the apparent intent of Congress as revealed by the Committee Report and the apparently ironbound language of the statute concluded in *James v. Commissioner*,[200] on facts similar to those in the above example, that it had no alternative but to apply the statute as written:

> This result [taxing the property-transferor as well as the service provider] is inconsistent with the apparent meaning of the second sentence from the committee report, but the statutory scheme does not permit any other conclusion.[201]

One may argue with the court's decision but on balance it seems justified. First, it is in accord with the language of the statute. Secondly, it is supported by the principle that exemptions from taxation are to be narrowly construed. Finally, the one-sentence statement in the committee report does not constitute the clear and convincing statement of Congressional intent one would insist upon before rejecting the unambiguous language of the statute. The *James* court found its decision "inconsistent with the apparent meaning" of the Committee Report, but this is not absolutely

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[199] H.R. Rep. No. 1337 (to accompany H.R. 8300, Pub. L. No. 591, 83d Cong., 2d Sess., at A117 (1954) (emphasis added).

[200] 53 T.C. 63 (1969).

[201] Id. at 69-70.

clear. Possibly the Committee's statement was simply meant to foreclose the argument that any issuance of stock for services, no matter how small, would automatically disqualify the balance of the transaction from nonrecognition. Under this reading, the Committee's statement simply did not address the situation where the service provider received more than 20% of the stock thereby making it impossible for the property-transferors to satisfy the 80% control requirement. In light of the statement's ambiguity, it is understandable that the Tax Court choose to go with clear language of the statute.

On the other hand, no justification exists for extending the holding in *James*, a holding which conflicts the basic policies of section 351 and may well be contrary to the intent of the drafters of section 351(d)(1). Nevertheless, this is exactly what the Service has attempted to do.

To revise Example 6.1 slightly:

> *Example 6.2*
> As above, C contributes a parcel of land worth $100,000 he purchased for $20,000 for a 50% stock interest in Newco. Now, however, S contributes services worth $90,000 and cash of $10,000 for a 50% stock interest worth $100,000.

Under a literal reading of the statute C should now qualify for nonrecognition. S is now a transferor of property, $10,000 cash, as well as of services, and the persons transferring property, namely, C and S, control Newco immediately after the transfer. Nothing in the statute requires that the control stock be obtained solely or exclusively in return for property. The Regulations accept this construction of the statute, recognizing that generally all of the stock S receives in the transaction, including that received for services, should be taken into account in determining whether the control requirement has been satisfied.[202] (Note that the transaction qualifies under section 351 although only 55% of the stock was received for property, $110,000/$200,000.)

The above construction of the statute produces a result consistent with the policy and the purposes of section 351: C receives nonrecognition treatment; S receives nonrecognition treatment on the stock he received for property but must recognize compensa-

[202] Treas. Reg. § 1.351-1(a)(2), Example (3).

tion income on the stock he received for services. This result establishes a parity in the treatment of corporate formations and partnership formations; and by eliminating a penalty which would otherwise be imposed upon the formation of corporations but not partnerships it furthers Congress's stated purpose of facilitating business readjustments. Moreover, it is consistent with the result that is at least suggested by the committee report cited in the *James* case.

Nevertheless, the Regulations state, apparently in the cause of placing substance above form, that S will not be recognized as a property transferor if the property transferred by S is of relatively small value in comparison to the value of the stock received by S for services and if the primary purpose of the transfer is to qualify C's receipt of stock for nonrecognition.[203] For advance ruling purposes, the Service recognizes that the property transferred by the service-provider is *not* of relatively small value if the value of such property is at least equal to 10% of the value of the stock to be received for services.[204]

The Service's position represents a classic misuse of the substance over form doctrine. It rides roughshod over the language of the statute, but in so doing, fails to advance any articulable policy of section 351. On the contrary, it frustrates the basic policies of section 351 developed above and the apparent intent of Congress as revealed by the Committee Reports.

Any contribution of property by S, including the proverbial peppercorn, should suffice to make S a property transferor. It may be objected that this approach leads to intolerably arbitrary results: Under *James*, no stock received by S will counted for control purposes where S contributes only services, whereas under this article's proposal, all stock received by S will be counted if S contributes only nominal property to the corporation. But the Service's ruling guidelines create an equally arbitrary test: once the 10% threshold is met, even where the proscribed purpose exists, all stock received by S is counted; if the threshold is not met and the proscribed purpose exists, no stock is counted. If we are going to be stuck with an arbitrary standard in any event, why should we prefer the one devised by the Service over the one enacted by Con-

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[203] Treas. Reg. § 1.351-1(a)(1)(ii).
[204] Rev. Proc. 77-37, 1977-2 C.B. 568.

gress in the statute. In short, the choice is not between a realistic test and an arbitrary one, but between two tests each of which will necessarily have arbitrary elements. The relevant criteria for making the choice are: which test most closely adheres to the statutory language, implements Congressional intent and furthers the general policy of section 351. On all these counts, the Service's ruling policy must be rejected.

C. *The Case of the Accommodation Transferor*

Consider the following case:

> *Example 6.3*
> A has owned all the stock of Oldco, 100 shares, for 20 years. B now transfers appreciated property to Oldco for 100 shares of newly-issued stock representing 50% of Oldco's stock.

Clearly, B fails to qualify for nonrecognition under section 351. Since B's acquisition of stock is clearly separate and distinct from A's acquisition of stock 20 years earlier, the two acquisitions may not be aggregated for purposes of determining whether B satisfied the control requirement. B must satisfy the control requirement solely on the basis of his acquisition and his acquisition alone, and since he only acquired 50% of the stock instead of the requisite 80%, his transfer flunked the control test.

Suppose, however, the parties foresaw this problem and adopted the following stratagem:

> *Example 6.4*
> As above, B transfers appreciated property to Oldco for 100 shares of its stock. Now, however, A as part of the same transaction buys 1 additional share of Oldco stock for cash.

Literally, the requirements of section 351 have now been satisfied. Both A and B are property transferors in the same transaction, and immediately after the transfer they control Oldco, i.e., they own 100% of Oldco's stock. The statute does not require that control be obtained as part of the transfer in question. Otherwise, a 100% shareholder who made a post-incorporation transfer of appreciated property to his corporation in return for stock would have to recognize gain unless he received 80% of the corporation's stock in that subsequent transfer. All the statute requires is that the property-transferors control the corporation immediately after the transfer. Therefore, A's preexisting ownership of stock in the

above example should presumptively be counted in determining whether A and B, the property-transferors, control the corporation immediately after the transfer, and if this done, the control requirement will be satisfied.

Not surprisingly, the Service has placed some limitations on this strategy. Under the same Regulation cited in the preceding section,[205] the Service takes the position that a person will not be treated as a property-transferor if the property he transfers is of relatively small value in comparison to the value of the stock he already owns and the principal purpose of the transfer is to qualify another for nonrecognition.[206] For ruling purposes, property transferred for stock will not be treated as of relatively small value if the value of the property is at least 10% of the value of the stock already owned.[207] Thus, in the above example, the cash A pays for his one additional share of Oldco (being only 1% of the value of the Oldco stock he already owns) will be considered to be of relatively small value. Accordingly, A will not be treated as a property transferor unless he can establish that he did not buy the one additional share for the principal purpose of qualifying B's transfer for nonrecognition.

Previously, this article argued that this Regulation and ruling policy constituted, in effect, unwarranted administrative legislation when applied to the case of the service provider. Does that analysis apply here?

First, note that the analogy with partnership formations previously used in resolving section 351 problems is not useful here. It is true that if A had conducted a sole proprietorship for 20 years and if B then transferred appreciated property to A's business in exchange for a 50% interest in the resulting partnership B would not recognize any gain; this might suggest that the Service's position is incorrect if the analysis in the foregoing sections is accepted. But the difference is that here Congress has explicitly rejected the partnership model. Congress mandated in the case of a corporation that the persons transferring the property must control the corpo-

[205] Treas. Reg. § 1.351-1(a)(1)(ii).

[206] Treas. Reg. § 1.351-1(a)(1)(ii); the validity of this Regulation (when applied in the case of an accommodation transferor) was sustained in Kamborian v. Commissioner, 56 T.C. 847 (1971), aff'd sub nom., Estate of Kamborian v. Commissioner, 469 F.2d 219 (1st Cir. 1972).

[207] Rev. Proc. 77-37, 1977-2 C.B. 568.

ration following the transfer.

The reason for this rule, according to the rationale developed in this article, was Congress's concern that without it corporations would use their stock to buy property from third-party vendors on a tax-free basis. The mechanism that Congress chose to prevent this abuse was the 80% requirement. Congress said essentially that a corporation would not be deemed to be using its stock as currency for buying property from third-party vendors if the transaction was with either:

(1) An existing insider (an 80% or more shareholder) who remained an insider after the transaction; or

(2) An outsider (less than 80% shareholder) who became an insider by virtue of the transaction.

Congress drew the line where the transaction was with an outsider who remained an outsider after the transaction: in that case, Congress felt the transaction was more akin to the corporation simply buying property with its stock from a third party vendor.

Obviously, this mechanism would be undermined if an insider could confer insider status upon an outsider simply by making a nominal or trivial transfer of property contemporaneously with that of the outsider and thereby exempt the outsider's transfer of property from taxation. Such a maneuver would clearly violate the policy of the rule as postulated by the rationale developed in this article, and therefore the Service is completely justified, per this rationale, in adopting a rule to prevent evasion of the policy.

Thus the rationale for the control requirement of section 351 developed in this article does not invariably lead to nonrecognition, or result in slavish obeisance to the form of the transaction; rather by more clearly identifying and explaining the reasons underlying section 351, it provides a more intelligible and predictable basis for determining when form must yield to substance.

VII. Conclusion

The courts have gone seriously awry in applying the step transaction doctrine to cases arising under section 351. This has stemmed from a basic misunderstanding of the nature and function of the doctrine. Courts have viewed the doctrine as a mechanism for determining what actually happened, that is, for determining reality. The issue in many section 351 cases is whether the transferor has control of the corporation immediately after the

transfer. The courts have used the step transaction doctrine to determine whether the transferor really did control the corporation immediately after the transfer, or whether his purported control was illusory. Application of the doctrine in this fashion has caused the courts to focus on the factual variations in the cases. In so applying the doctrine, the courts have virtually ignored the policy reasons for the 80% control requirement. Set adrift from the underlying policies of the statute, the courts have floundered in deciding cases under section 351. They have based their decisions on the factual variations in the cases but generally without any explanation as to why such factual variations should produce different results.[208]

The courts have it exactly backwards. The step transaction doctrine adds nothing to our ability to determine "what happened." The facts are just as readily determinable without resort to the doctrine as they are with it. The step transaction doctrine — like any legal doctrine — is a mechanism for determining legal consequences. Once this is grasped, it becomes clear that the true function of the doctrine is to implement policy. And once this is understood, it becomes apparent that one *first* needs to determine the policies of the statute, and *then* to apply the doctrine to the case at hand if, but only if, such application furthers the policies of the statute. In the case of the "control-immediately-after-the-transfer" problem, one must first determine the purpose for the 80% control requirement.

The purpose traditionally ascribed for the 80% control requirement, namely, to distinguish between changes of substance in one's investment and mere changes in the form of one's investment and to restrict nonrecognition to the latter, is supported neither by the way the statute operates in practice nor by its legislative history. Rather, the most persuasive explanation for the 80% control requirement based on the legislative history is to prevent corporations, particularly corporations with readily marketable stock, from using their stock to buy property from third party vendors on a tax

[208] Thus the courts have explained the different results they reach in the binding obligation cases, on the one hand, and the gift and underwriting cases, on the other, on the ground that the transferor has complete "freedom of action" over his shares in the latter cases but not in the former; however, they do not explain why this difference should produce different results. See supra notes 78-79 and accompanying text.

free basis.

This understanding of the purpose of the 80% control requirement will enable the courts to fashion a more coherent and predictable body of law in cases arising under section 351. Knowing the purpose of that requirement, the courts will be able to determine when they need to use their vast array of substance over form weapons to implement the policy underlying that requirement, and equally important, when they need not.