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The thesis of this Article is that the federal tax law governing the transfer of property to corporations in exchange for securities, section 351 of the I.R.S. Code, should be changed to foster the more effective development of small businesses. After examining the operation and legislative history of section 351, the author explicates the problems encountered with the section's control requirement and concludes that section 351, in current dress, impedes the underlying congressional policy of fostering small businesses. To address this problem, the author advocates that the control requirement be supplanted by a criterion based on net worth.

INTRODUCTION

THE CURRENT federal tax treatment of property transferred to small corporations in exchange for stock or securities significantly affects the ability of these corporations to acquire assets and the legal relationships between the contributors of such assets and the corporation.[1] In inflationary periods, many property owners

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1. A corporation generally does not recognize gain or loss upon the issuance of securities for cash or other property. I.R.C. § 1032. Purchase of securities with cash involves no immediate tax consequences for the purchaser. If, however, the purchase is with property other than cash, the transferor may have to recognize gain or loss equal to the difference between the adjusted basis of the transferred property and the fair market value of the securities received. I.R.C. § 1001(a), (b).

One important exception to treating an exchange transaction as a taxable event is contained in § 351 of the Internal Revenue Code (the Code). Section 351 provides for the nonrecognition of gain or loss, in certain circumstances, on transfers of property to a corporation in exchange for its stock or securities. For a description of the requirements of § 351, see text accompanying notes 14–18 *infra*. The requirements of § 351 may influence may realize substantial capital gains or ordinary income upon the disposition of property, particularly depreciated property.[2] Through nonrecognition of gain and income, and its attendant tax savings, section 351(a) facilitates the acquisition of property by small corporations in exchange for securities.[3] Such exchanges may be more advantageous than purchasing assets with either borrowed money, which entails incurring interest and principal payments, or money raised through the public sale of equity securities. The equity route is often particularly difficult for small

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the transferor's decision whether to transfer property to a corporation and may govern the nature of the securities received by the transferors. *See* notes 31–45 *infra* and accompanying text.

To obtain nonrecognition treatment, a transferor must receive a proprietary, equity interest in the corporation. *See* notes 39–40 *infra* and accompanying text. This Article primarily will discuss exchanges in which the transferor receives stock, although the transferor could receive securities and stock and still qualify for treatment under § 351. I.R.C. § 351(a).

In addition, this Article focuses on contributions of property to Subchapter C corporations, that is, corporations which are subject to all of the provisions of Subchapter C of Chapter 1 of the Code. Thus, the relevant provisions for tax treatment of contributions to Subchapter S corporations—corporations electing to be taxed pursuant to the provisions of Subchapter S of Chapter 1 of the Code—are omitted.

2. The cost of stock received in the exchange is equal to the amount paid for such property which, in an arm's length exchange, is presumed to be equal to the fair market value of the relinquished property. Treas. Reg. § 1.1012-1(a) (1957); *see* Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184 (Ct. Cl. 1954) (where value of property received in an arm's length transaction was unascertainable, fair market value of relinquished property was used to determine fair market value and cost basis of property received).

During inflationary periods, the fair market value of the transferred property, which would be used to compute the fair market value of the stock received, may have increased over the cost basis of the property, thereby resulting in potential gain recognition equal to the difference between the cost basis and the increased fair market value of the property. If an allowance for depreciation has been taken, the basis must be reduced by the amount of such allowance, and this adjusted basis would further increase the difference between the fair market value of the stock received and the adjusted basis of the transferred property. I.R.C. § 1016(a)(2).

3. It has been recognized that § 351 "is of particular importance when individual proprietorships and partnerships are incorporated." B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 3-3 (4th ed. 1979).

In this Article, the nonelective provisions of § 351 which guarantee the nonrecognition of gain are viewed favorably. In certain instances, however, the recognition of gain may be advisable. *See* Oberst, *Incorporating a Business: Alternatives to a Complete Tax-Free Exchange*, 3 TAX. FOR LAW. 186 (1974). The potential of double tax and assignment of a tax detriment when § 351 is used to provide for the nonrecognition of gain has been discussed and criticized in Thompson, *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 (1975). Moreover, § 351 prohibits the recognition of losses incurred in certain exchange transactions. If, however, the transferors want to recognize the loss, they often can purposely structure the transaction to avoid § 351.

corporations because of market conditions and the cost of compliance with governing securities regulations.[4]

The current test for entitlement to section 351 is that immediately after the exchange, the transferors own at least 80% of the voting stock and 80% of the total number of all other classes of stock.[5] The traditional rationale for section 351 is that transfers satisfying the control requirement involve only a change in form rather than substance of ownership, thereby rendering immediate taxation inappropriate.[6] By generating increasingly complicated conditions for satisfying the control requirement and by strict interpretation,[7] judges and administrators employing this "same substance, different form" rationale have stymied Congress' original purpose of facilitating transfers of property to small corporations in exchange for stock.[8]

The control requirement and the same substance, different form rationale, however, are not necessary to achieve the policies underlying this favorable tax treatment. The continued use, therefore, of this requirement and its rationale is counter-productive. The specific 80% post-transfer stock ownership control requirement most likely was adopted arbitrarily as a relatively easy mechanism for limiting such favorable tax treatment to small corporations.[9] Moreover, the same substance, different form rationale is simply invalid in most cases because, under general corporate law provisions, significant changes in substance of ownership occur even after compliance with the control requirement.[10]

The public policy goal of encouraging the development of small corporations is prevalent in federal law and was a major factor in the enactment of favorable tax treatment for transfers of property to certain corporations.[11] It is now evident, however, that the specific 80% post-transfer control requirement is so restrictive that it hinders the achievement of the underlying policy of facilitating the development of small corporations.[12] Accord-

4. The Securities and Exchange Commission has reduced the burdens of securities regulation on small corporations by exempting offerings by small companies from the full registration requirements. *See, e.g.*, S.E.C. Regulation A, Securities Act of 1933, 17 C.F.R. §§ 230.251-.264 (1981).

5. I.R.C. §§ 351, 368(c).

6. *See* text accompanying notes 46-55 *infra*.

7. *See* notes 22-30 *infra* and accompanying text.

8. *See* notes 67-98 *infra* and accompanying text.

9. *Id.*

10. *See* notes 50-59 *infra* and accompanying text.

11. *See* notes 99-110 *infra* and accompanying text.

12. *See* notes 19-45 *infra* and accompanying text.

ingly, this Article urges the abandonment of the percentage control requirement and its traditional same substance, different form rationale and, instead, proposes an alternative criterion using corporate net worth to determine which transfers of property merit favorable tax treatment.[13] This proposed criterion would be less restrictive than the present control requirement and thus would be more likely to facilitate the development of small businesses.

I. THE OPERATION OF SECTION 351

Section 351(a) provides that no gain or loss shall be recognized upon the transfer of property to a corporation solely in exchange for its stock or securities if the transferors of such property control the corporation immediately thereafter.[14] Section 368(c) defines control as the ownership of at least 80% of the total combined voting power of all classes of stock of the corporation entitled to vote and at least 80% of all other classes of stock.[15] In most cases, gain not recognized at the time of the exchange will be recognized later upon the sale or disposition of the stock or securities by the transferor and upon the sale or disposition of transferred property by the corporation due to the substituted and carry-over basis provisions applicable to section 351 transactions.[16] If section 351 operates to suspend immediate recognition of gain or loss, then the transferor's basis for the stock or securities received in the exchange is equal to the basis of the property transferred, subject to certain possible adjustments.[17] The transferee corporation takes

13. *See* notes 111–47 *infra* and accompanying text.

14. I.R.C. § 351(a). If in the exchange the transferor or transferors received from the controlled corporation cash or other property, referred to as "boot," in addition to stock or securities, then § 351(b) requires the recognition of any gain realized under § 1001 to the extent of the boot received. I.R.C. § 351(b).

15. I.R.C. § 368(c). Section 368 applies generally to corporate reorganizations. This section defines the term "reorganization" in subsections 368(a)(1)(A)–(F). The control requirement of § 368(c) is applicable to the "Type B" reorganization defined in subsection (a)(1)(B) in which the acquisition of the stock of one corporation is given in exchange solely for part or all of the voting stock of the acquiring corporation or its parent. In a Type B reorganization, the acquiring corporation must have "control" of the acquired corporation, as that term is defined in § 368(c), immediately after the acquisition. I.R.C. § 368(a)(1)(B). *See* B. BITTKER & J. EUSTICE, *supra* note 3, at 14–37 to –48. The control requirement of § 368(c) also is utilized in a "Type D" reorganization defined in § 368(a)(1)(D) which involves the merger of one corporation into a controlled subsidiary with the stock of its parent used as consideration for the acquisition. I.R.C. § 368(a)(1)(D); *see* B. BITTKER & J. EUSTICE, *supra* note 3, at 14–66 to –71.

16. I.R.C. § 362.

17. I.R.C. § 358. If boot also was received, the transferor's basis in the stock or securities of the controlled corporation is computed by deducting the boot from the basis of the property exchanged and adding the amount of gain recognized on the exchange. If the

the transferor's basis for the property received, again subject to certain adjustments.[18]

The "controlled corporation" requirement of section 351 demands that the transferors control the corporation immediately after the exchange.[19] Because of high stock ownership requirements in the definition of control, public corporations with many shares outstanding and share ownership widely dispersed are unable, in most cases, to meet the controlled corporation definition.[20] In addition, even small corporations and transferors to such corporations attempting to use section 351 face substantial uncertainty as to whether the proposed exchange will result in the required controlled corporation.[21]

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transferee corporation assumed a liability of the transferor or took the property subject to a liability, the amount of liability constitutes "money received" and reduces the transferor's basis. I.R.C. § 358(d).

18. I.R.C. § 362. The transferee corporation's basis figure is increased by the amount of gain recognized by the transferor on the exchange. A corporation might argue that § 351 was not applicable to the exchange to obtain a stepped-up basis for the property received in the exchange. *See* Portland Oil Co. v. Commissioner, 109 F.2d 479 (1st Cir.), *cert. denied*, 310 U.S. 650 (1940).

19. I.R.C. § 351(a).

20. A large corporation might attempt to qualify a contribution of property under § 351 in the following way: "[W]hat of a transfer of his assets by one corner groceryman for 0.01 percent of the stock of a newly organized corporation, simultaneously with a transfer by A. & P. of its assets in exchange for 99.99 percent of the stock?" The language of § 351 might cover this transaction, "but the cautious tax adviser would surely have some qualms . . . ." B. BITTKER & J. EUSTICE, *supra* note 3, at 3-5. If a corporation were willing to exchange 80% of its stock for certain property, the transaction likely would be structured as a "Type A" reorganization under § 368(a) of the Code. In the event both § 351 and the reorganization provisions apply to a transaction, it is unclear which provision would prevail. *Id.* at 3-73.

Public corporations sometimes have utilized the nonrecognition provisions of § 351 for the incorporation of a holding company in acquisition transactions where certain minority shareholders desire tax-free treatment in an otherwise taxable cash purchase of a business. *See* Letter Rul. 7839060 (June 28, 1978). Recently, the Service has indicated that it might reverse its prior approval of this use of § 351 and that, in the future, the applicability of § 351 to an incorporation interposed into an acquisitive transaction will depend on whether the formation of a holding company had sufficient economic substance, independent of the acquisitive transaction. Rev. Rul. 80-285, 1980-2 C.B. 119. This criteria has been criticized because it ignores the possible existence of a valid business purpose underlying the formation of the holding company. Rosenberg, *Use of Sec. 351 by Minority Shareholder in Acquisitions Challenged by New Rulings*, 54 J. TAX. 76 (1981). The use of either criteria would involve further uncertainty in the applicability of the nonrecognition provisions of § 351.

21. In 1957, it was observed that the "[r]ules governing taxability of incorporation of a business grow more rigid and specific with each change in the statute and case law." Kahn, *Incorporating the Going Business: How to Find the Method With the Least Tax Cost*, 6 J. TAX. 72 (1957). In a more recent article, the authors noted that "although Section 351 is a relatively uncomplicated section on the surface, problems can arise." Jefferies & Schellen-

The effectiveness of section 351 is hampered by three major factors. First, it is difficult to determine which transferors to include in the control group to meet the 80% requirements of section 368(c). Furthermore, it is difficult to determine whether the transfers should be simultaneous or close in time, how economically interrelated the transfers should be, and whether each transfer should involve receipt of stock by the transferor.[22]

Second, the 80% stock ownership requirement is ambiguous. The Code requires ownership of at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of all other classes of stock.[23] The terms "total combined voting power" and "stock entitled to vote," however, are not defined. It must be asked, therefore, whether "stock entitled to vote" includes stock which has only contingent voting rights, conditioned upon the occurrence of certain corporate events, such as the nonpayment of dividends.[24] Ownership of 80% of the total number of shares entitled to vote is not necessarily equivalent to the ownership of 80% of the total combined voting power because of the existence of shareholder's voting agreements, trusts, or credit agreements that might divest the shareowner of actual voting power.[25] The Internal Revenue Service (the Service) has further complicated the uncertainty surrounding the 80% tests by

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berg, *Tax considerations when contributing property to a business in exchange for an interest*, 1977 TAX. FOR ACCOUNTANTS 298. *See* text accompanying notes 22–45 *infra*.

22. In Portland Oil Co. v. Commissioner, 109 F.2d 479 (1st Cir. 1940), the court stated: "It is also clear that the several transfers need not be effected simultaneously, where executed in pursuance of an antecedent arrangement." *Id.* at 488. In another case, transfers separated by four years were combined to satisfy the control requirement of § 351. Stanley, Inc. v. Schuster, 295 F. Supp. 812 (S.D. Ohio 1969). *See also* Treas. Reg. § 1.351-1(a)(1) (1955).

23. I.R.C. § 368(c).

24. For the purpose of defining "voting power" or "voting stock" under § 302(b)(2), the Service takes the position that stock which grants the power to vote only on the occurrence of a specified event, such as default on the payment of a required dividend, should not be deemed voting stock until the event occurs. Treas. Reg. § 1.302-3(a) (1955). It is unclear, however, whether this interpretation would apply to the "entitled to vote" phrase contained in § 368(c).

25. In interpreting a control test similar to the one contained in § 368(c), the Service has stated:

> A share of stock will generally be considered as possessing the voting power accorded to such share by the corporate charter, bylaws, or share certificate. On the other hand, if there is any agreement, whether express or implied, that a shareholder will not vote his stock in a corporation, the formal voting rights possessed by his stock may be disregarded in determining the percentage of the total combined voting power possessed by the stock owned by other shareholders in the corporation . . . .

Treas. Reg. § 1.1563-1(a)(6) (1965).

ruling that "80 percent of the total number of shares of all other classes of stock" means 80% of the total number of each class of stock.[26] Thus, according to the Service, ownership of 75% of outstanding Class A preferred nonvoting shares and ownership of 85% of outstanding Class B preferred nonvoting shares would not satisfy the requirement of ownership of "80 percent of the total number of shares of all other classes of stock."

The third area of uncertainty is the requirement that control exist "immediately after the exchange." This requirement has fostered many unanswered questions regarding the definition of "immediately after the exchange." It is difficult to determine, for instance, how long the requisite control must persist after transfer to satisfy the "immediate" requirement,[27] whether the transferors can receive the 80% stock and dispose of some of it shortly thereafter so as to fall below the 80% level,[28] and whether it makes a difference to whom and for what reasons the dispositions were made.[29] Furthermore, there is a question whether the 80% test is satisfied when, after receipt by the transferors of the requisite amount of stock, the corporation issues additional stock, thereby reducing the transferors' proportionate share below the 80% level.[30]

In addition to the questions surrounding the control require-

26. Rev. Rul. 59-259, 1959-2 C.B. 115.

27. Subsequent transfers of the stock received in the exchange or the issuance of additional stock after an exchange may cause loss of control by the transferors, particularly if transferred or issued pursuant to a "prearranged and integrated plan." *See* Treas. Reg. § 1.351(a)(1) (1955); Rev. Rul. 70-140, 1970-1 C.B. 73; Rev. Rul. 54-96, 1954-1 C.B. 111.

The courts regard the existence of a binding agreement for the subsequent transfer of the stock received in the exchange or for the issuance of additional shares as determinative. *Compare* Intermountain Lumber Co. v. Commissioner, 65 T.C. 1025 (1976) (binding agreement by incorporator to sell 50% of his stock violated control requirement) *with* American Bantam Car v. Commissioner, 11 T.C. 397 (1948), *aff'd per curiam*, 177 F.2d 513 (3d Cir. 1949), *cert. denied*, 339 U.S. 920 (1950) (nonbinding, "informal oral understanding" of transferors to retransfer stock did not violate control requirement). *See also* Fahs v. Florida Mach. & Foundry Co., 168 F.2d 957 (5th Cir. 1948); Wilgard Realty Co. v. Commissioner, 127 F.2d 514 (2d Cir.), *cert. denied*, 317 U.S. 655 (1942).

28. *See* American Bantam Car Co. v. Commissioner, 11 T.C. 397 (1948), *aff'd per curiam* 177 F.2d 513 (3d Cir. 1949), *cert. denied*, 339 U.S. 920 (1950); Rev. Rul. 79-70, 1979-1 C.B. 144.

29. The following distinction has been made with respect to post-transfer transactions affecting control: "Although the courts have not distinguished between commercial and noncommercial transactions when deciding whether a loss of control after the exchange is fatal, much can be said for treating these situations differently." B. BITTKER & J. EUSTICE, *supra* note 3, at 3-42.

30. In Rev. Rul. 78-492, 1978-2 C.B. 141, the Service expressed its position on two variations of an incorporation of a sole proprietorship followed by a public offering of more than 50% of the corporation's stock. The Service ruled that the public offering, pur-

ment, section 351 may present other obstacles to an existing small corporation in need of a particular asset. If an appreciated asset or any asset involving a substantial amount of potential gain is the subject of the transaction, the owner of the asset may want to dispose of it for stock or securities of the corporation if the nonrecognition provisions of section 351 are applicable.[31] In many cases, the fair market value of the subject asset would not warrant an exchange for 80% of the corporation's voting stock.[32] In such a situation, control need not be obtained through the exchange in question. In calculating whether the 80% test has been satisfied, the transferor may include any and all stock of the corporation, even stock owned by the transferor prior to the exchange.[33] Thus, an existing shareholder with relatively large holdings could make a simultaneous transfer with the owner of the particular asset needed by the corporation so that the group as a whole would satisfy the control test.[34]

The Service has announced, however, that if an existing shareholder transfers "property which is of relatively small value compared to the value of stock and securities owned"[35] by the transferor-shareholder prior to the transfer in question and if the primary purpose of the transfer is to obtain section 351 entitlement for exchange of property by other transferors, then stock or securities received by the existing shareholder will not be considered as having been issued in exchange for property.[36] The property transferred will not be considered of "relatively small value"

suant to a "firm commitment" or "best efforts" underwriting arrangement, would not violate the control requirement of § 368(c) of the Code.

31. Professor Thompson has observed that "A denial of nonrecognition treatment to some (or possibly all) members of the organization group could certainly deter the organization of new business enterprises." Thompson, *supra* note 3, at 53.

32. If the current shareholders of the corporation consented to the corporation's transfer of 80% or more of its stock to the transferor, those shareholders effectively would be relinquishing control of the corporation to the transferor. *See* text accompanying notes 54-57 *infra*. The subject property of the transfer would have to be of significant value and/or importance to the corporation for the shareholders to be willing to relinquish their control.

33. In Rev. Rul. 73-473, 1973-2 C.B. 115, the Service stated that no gain or loss was recognized to any of four transferors of property to their wholly owned corporation in exchange for securities. Because the four sole shareholders controlled the corporation immediately after the transfer of property, the transaction received nonrecognition treatment pursuant to § 351.

34. These simultaneous transfers by an existing shareholder often are defined as an "accommodation" exchange. B. BITTKER & J. EUSTICE, *supra* note 3, at 3-12 n.26.

35. Treas. Reg. § 1.351-1(a)(1)(ii) (1955). *See also* Estate of Kamborian v. Commissioner, 469 F.2d 219 (1st Cir. 1972).

36. Treas. Reg. § 1.351-1(a)(7)(ii) (1955).

if its fair market value is equal to or in excess of 10% of the stock and securities already owned by the shareholder-transferor.[37] An existing shareholder may not possess or be in a position to transfer an asset of such value which could qualify the exchange of property by other transferors under section 351. If the exchange is not qualified, the proposed transfer of the specified asset will not qualify for nonrecognition treatment and thus may not be effectuated.

The obstacles which the control requirements impose on incorporation often may be overcome through simultaneous transfers by the contributors.[38] Even in that situation, however, the control requirements constrain the financial relationships between the contributors. According to Service rulings, to be included in the control group, a transferor must have a proprietary, equity interest in the corporation after the exchange.[39] It is sufficient that a transferor of property to a newly formed corporation receive corporate securities in exchange to qualify the transaction for nonrecognition; capital stock must be obtained through the exchange.[40] Thus, although the financial contributions and positions of the parties might prescribe a nonequity position for certain contributors, tax considerations could compel a different result.[41]

Another problem in meeting the control requirements at the time of incorporation is that section 351 prohibits the inclusion in the control group of a transferor receiving stock or securities in exchange for services unless the transferor has also received stock or securities in exchange for property other than services.[42] A per-

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

38. *See* note 22 *supra*.

39. Rev. Rul. 73-472, 1973-2 C.B. 114; Rev. Rul. 73-473, 1973-2 C.B. 115.

40. If a transferor receives only debt securities in the exchange, the exchange still can qualify under § 351 if the transferor owns previously acquired stock. Rev. Rul. 73-473, 1973-1 C.B. 115.

41. The nature and amount of the capital contribution by certain transferors might mandate the issuance of debt by the corporation for those transferors, whereas the contribution of essential services by other transferors might compel an equity position in the corporation for them. *See* Herwitz, *Allocation of Stock Between Services and Capital in the Organization of a Close Corporation*, 75 HARV. L. REV. 1098, 1098-99 (1962). For a discussion of the problems under § 351 related to the exchange of stock for services, see text accompanying notes 42-45 *infra*.

42. Section 351(a) provides that "stock or securities issued for services shall not be considered as issued in return for property." I.R.C. § 351(a). *See* James v. Commissioner, 53 T.C. 63 (1969), where the tax court held that because the taxpayer's stock was issued in exchange for his services, the taxpayer received ordinary income equal to the stock's fair market value. The court also held that the taxpayer's receipt of the stock for services disqualified him from the control group and left those transferring qualified property without control as defined by § 368(c). *Id.* at 69-70. All of the stock received by a transferor, who transferred both property, as defined in § 351, and services is counted in determining

son with the "know how" essential to the successful operation of the corporation often has no property to contribute to the corporation other than past or future services.[43] It has been suggested that this problem may be avoided if "knowledge" can be classified as an intangible asset with a fair market value and then transferred to the corporation for stock. This procedure would allow all of the stock received by the transferors, whether for services or property, to be counted in determining whether the control requirements were satisfied.[44] Not all services can be classified, however, as "know how" which would constitute an intangible asset.[45]

The difficulties and uncertainties surrounding compliance with the control requirement of section 351 indicate a fundamental inconsistency between the control requirement and the public policy favoring small corporations which underlies this nonrecognition provision. An exploration of the same substance, different form rationale which supports this control requirement will further highlight this inconsistency.

II. The "Same Substance, Different Form" Rationale

The requirement of control is cited as the critical element of section 351 because the transfer of property which results in that control often changes the form of ownership but not the substance.[46] Through satisfaction of the control requirement, the transferor retains the incidents of property ownership.[47] In one of the earliest cases to interpret and apply the nonrecognition provisions of section 351,[48] the court articulated the same substance, different form rationale in the following manner:

whether the control requirement has been met. Treas. Reg. § 1.351-1(c)(1), Example (3) (1955).

43. *See* Herwitz, *supra* note 41.

44. *See* Ruppert & Pansius, *Transfers of Know-How Under Section 351*, 55 DEN. L.J. 223 (1978).

45. *Id.* at 253-79.

46. B. BITTKER & J. EUSTICE, *supra* note 3, at 3-4. The same substance, different form rationale was articulated by A.W. Gregg, a special assistant to the Secretary of the Treasury in a letter to the Chairman of the House Ways and Means Committee. The letter explained certain tax changes proposed by the Secretary of Treasury in the Revenue Act of 1921. In explaining the rationale of the nonrecognition provisions for transfers of property to certain corporations in exchange for stock, the letter stated that such transactions "constituted a mere change in the form of ownership." *Statement of A.W. Gregg Shows Revisions of 1921 Act Sought by Mellon*, N.Y. Times, Jan. 5, 1924, at 8, col. 3.

47. *Id.*

48. American Compress & Warehouse Co. v. Bender, 70 F.2d 655 (5th Cir. 1934). Pertinent portions of this opinion have been cited in other decisions. *See* Portland Oil Co. v. Commissioner, 109 F.2d 479, 488 (1st Cir.), *cert. denied*, 310 U.S. 650 (1940).

> The statute evidences a recognition that the transaction therein described effects a change in form, but not in substance, of the beneficial interests of the transferors in the transferred property. The transaction described in the statute lacks a distinguishing characteristic of the sale, in that, instead of the transaction having the effect of terminating or extinguishing the beneficial interests of the transferors in the transferred property, after the consummation of the transaction the transferors continue to be beneficially interested in the transferred property and have dominion over it by virtue of their control of the new corporate owner of it. . . . It is apparent that property owners do not gain or lose by transferring their properties solely in exchange for all the capital stock of a corporation brought into existence to take over the property where such stock is apportioned between the transferors in accordance with their respective beneficial interests in the transferred property.[49]

In corporate law, this same substance, different form rationale is of limited validity. A single transferor exchanging property for 80% of the outstanding voting stock of a corporation most nearly fulfills this rationale.[50] Even in that situation, however, the transferor may have relinquished substantial control over the transferred property depending on the debt financing of the corporation and the rights, pursuant to these debt agreements, of corporate creditors to corporate assets.[51] In addition to creditors' general rights of priority over shareholders in claims on corporate assets during liquidation or bankruptcy,[52] for example, creditors' consents may have to be obtained, in accordance with certain loan covenants, prior to the mortgaging or sale of a corporate asset or the payment of a corporate dividend.[53]

The same substance, different form rationale has even less validity when the transaction involves a group of transferors exchanging property for 80% of the voting stock of the corporation. Most states' corporate codes require, as the requisite vote at shareholders' meetings, a majority of the outstanding shares present or represented at the meeting and entitled to vote.[54] The quorum

49. 70 F.2d at 657–58.

50. The holder of 80% of the outstanding stock of a corporation usually has control over the activities of the corporation. *See* notes 54–57 *infra* and accompanying text.

51. H. HENN, LAW OF CORPORATIONS 254–55 (2d ed. 1970).

52. *Id.* at 816–17.

53. To protect debenture holders who usually rank as general creditors, the debentures and/or the indenture contain provisions that limit the corporation's borrowings, dividend payments, and additional issuance of its stock and require the maintenance of a special ratio of current assets to current liabilities. *Id.* at 283–84.

54. *Id.* at 374.

requirement for shareholders' meetings is usually a majority of the shares outstanding and entitled to vote at the meeting.[55] A majority of the outstanding shares entitled to vote, therefore, satisfies the minimum requisite vote. In most small corporations, however, all shares outstanding and entitled to vote often are present or represented by a proxy at the shareholders' meeting, particularly if there is dissension among shareholders. Thus, in a small corporation, only the ownership of a majority of the outstanding shares would assure a shareholder control over the corporation.[56] Since many states require or permit the corporation's articles of incorporation to mandate even greater voting requirements, such as two-thirds of the outstanding shares, a majority of shareholders may be able to exercise only limited control over the management or disposition of corporate assets.[57]

A member of the transfer group qualifying for the control test who receives less than a majority of the outstanding shares entitled to vote usually has relinquished effective control over the transferred property. Actual control over the use and disposition of corporate property rests with the holder or holders of the majority of the outstanding shares entitled to vote. The minority shareholder in a small corporation may reverse this relative powerlessness by creating a voting agreement or voting trust with other shareholders to combine their voting power and obtain the equivalent of majority control.[58] Voting agreements and trusts, however, are used infrequently and often vest the actual power to vote the shares in a non-shareholder third party trustee.[59]

The same substance, different form rationale is analogous to the "continuity of interest" rationale supporting the nonrecognition provisions for reorganizations—a doctrine which also has been criticized by scholars.[60] Originally, the nonrecognition pro-

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55. *Id*; N. LATTIN, THE LAW OF CORPORATIONS 361 (2d ed. 1971).

56. *See* notes 54–55 *supra* and accompanying text.

57. A majority shareholder may lack the requisite voting power to compel the disposition of corporate assets and may discover that the terms of the corporation's loan agreements require the approval of certain creditors for the sale of all or substantially all of the corporate assets or any merger or consolidation of the corporation. *See* note 53 *supra*.

58. H. HENN, *supra* note 51, at 389–95.

59. *Id.* at 391–93.

60. B. BITTKER & J. EUSTICE, *supra* note 3, at 14–17 to -18. *See also* Ruppert, *Proposed Treasury Regulation Section 1.368-1(d): The Continuity of Business Enterprise Test*, 29 DE PAUL L. REV. 723 (1980); Note, *Boot Distributions in Corporate Reorganizations: Dividend Equivalence and the Continuity of Interest Doctrine*, 32 U. FLA. L. REV. 119 (1979). The Internal Revenue Service has recently amended Treas. Reg. § 1.368–1(b) and has added Treas. Reg. § 1.368–1(d) to provide that to satisfy the continuity of enterprise test, the

visions for both reorganizations and transfers of property to corporations were contained in section 202 of the Code.[61] The Service has explained the rationale for these nonrecognition provisions for reorganizations in the following manner:

> The purpose of the reorganization provisions of the Code is to except from the general rule [of recognition of gain or loss from the exchange of property] certain specifically described exchanges incident to such readjustments of corporate structures made in one of the particular ways specified in the Code, as are required by business exigencies and which effect only a readjustment of continuing interest in property under modified corporate forms.[62]

The continuity of interest doctrine has a multifaceted character depending on whether it is applied at the corporate or shareholder level.[63] The doctrine and its application have been criticized roundly.[64] Recently, Professor Wolfman observed that the development of the doctrine has resulted in the "application of arbitrary, complex, if not Byzantine, rules that give lip service to a continuity doctrine that emerged in the early 1930's almost accidentally and has grown monstrously and mindlessly for close to 50 years."[65]

The limited validity of the same substance, different form rationale and the problems surrounding application of the control requirements of section 351 described above, raise the possibility that the section's "practical nature is cloaked with a theoretical doctrine."[66] The legislative history of section 351 provides some guidance as to the "practical concerns" which prompted Congress to enact the predecessor of section 351.

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acquiring corporation must continue the historic business of the acquired corporation or use a significant portion of the acquired corporation's historic business assets in a continuing business. [1981] 3 STAND. FED. TAX REP. (CCH) ¶ 2550.

61. Act of Feb. 24, 1919, ch. 18, § 202, 40 Stat. 1058. For the history of this section, see notes 67–85 *infra* and accompanying text.

62. Treas. Reg. § 1.368–1(b) (1955).

63. B. BITTKER & J. EUSTICE, *supra* note 3, at 14–17 to –18.

64. Hellerstein, *Mergers, Taxes, and Realism*, 71 HARV. L. REV. 254 (1957); Jacobs, *Reorganizing the Reorganization Provisions*, 35 TAX L. REV. 415 (1980); Sandberg, *The Income Tax Subsidy to "Reorganizations,"* 38 COLUM. L. REV. 98 (1938); Wolfman, *"Continuity of Interest" and The American Law Institute Study*, 57 TAXES 840 (1979). *But see* Dane, *The Case for Nonrecognition of Gain in Reorganization Exchanges*, 36 TAXES 244 (1958).

65. Wolfman, *supra* note 64, at 840.

66. Professor Surrey made the charge that the concept of realization masks practical concerns with theoretical doctrine. Surrey, *The Supreme Court and the Federal Income Tax: Some Implications of the Recent Decisions*, 35 ILL. L. REV. 779, 787 (1941).

III. Legislative History of Section 351

The first proposal regarding nonrecognition for transfers of property to corporations in exchange for corporate stock or securities was contained in a revenue bill submitted to the full Senate by the Senate Committee on Finance on December 6, 1918.[67] The Senate Report's introduction to the proposed bill stated that the bill differed substantially from another bill submitted several months earlier by the House Committee on Ways and Means because of two intervening events—the cessation of World War I and the enactment of legislation prohibiting the sale of alcoholic beverages.[68] The Senate Report explained the financial and tax effect of the cessation of World War I in this manner:

> Taxes which can be easily borne amid the feverish activity and patriotic fever of war times, are neither so welcome nor so easily sustained amid the uncertainties, the depreciating inventories, and the falling markets which are apt to mark the approach of peace. Repressive taxes which in time of war are justified for the very reason that they diminish the demand for labor, capital, and raw material, are for the very same reason obnoxious and undesirable in times of peace. The cessation of war, therefore, brought with it not only the opportunity but the necessity of reducing the large tax budget which the House had voted.[69]

The Senate bill terminated the war-profits tax and greatly reduced excess profit taxes. The Senate Report explained that these tax reductions were prudent "[d]uring this period of reconstruction" as a stimulant for business, "particularly new business."[70] The bill included a provision, section 202(b), which established the rule for "determining taxable gains" derived from the exchanges of property. Section 202(b) required that the fair market value of property received be treated as the amount realized.[71] The original version of section 202(b), however, as proposed by the Senate, provided for the nonrecognition of gain or loss in two types of exchanges: First, when, in connection with the reorganization or consolidation of a corporation, a person receives new stock or securities of no greater aggregate par value than the stock or securities exchanged; and second, "when a person receives in place of property stock of a corporation formed to take over such

67. S. Rep. No. 617, Pt. 1, 65th Cong., 3d Sess. 1, 5–6 (1918).
68. *Id.* at 1.
69. *Id.* at 2.
70. *Id.* at 3.
71. *Id.* at 5.

property."[72] The latter exception would appear to provide nonrecognition of gain or loss primarily on any transfer of property to a newly formed corporation. According to the Senate Report, the purpose of these nonrecognition provisions was "to negative the assertion of tax in the case of certain purely paper transactions."[73] In Senate floor debate on the bill, these provisions were referred to as a "cushion to ease off the taxes."[74] In the bill enacted by Congress, however, the nonrecognition provision for transfers of property to certain corporations was deleted without any recorded explanation, but the nonrecognition provision for reorganizations and consolidations was retained, without definition of those terms.[75]

In 1921, the nonrecognition provisions of section 202 were substantially revised and the predecessor of section 351 was enacted.[76] The revised section 202 provided that gain or loss should be recognized upon exchange of property if the property received in the exchange had a "readily realizable market value." Furthermore, the section specifically provided for nonrecognition in enumerated situations even if the property received in the exchange had a readily realizable market value.[77] The enumerated situations included the receipt of stock or securities in exchange for stock or securities in a reorganization and the receipt of stock or securities in exchange for property transferred to a corporation when the transferor was in control of the corporation after receipt of the stock.[78] The 1921 Revenue Act deleted the 1918 Revenue Act par value restrictions on stock received in a reorganization and defined reorganization to include a merger, consolidation, recapitalization, the mere change in identity, form, or place of a corporation's organization, the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the

72. *Id.* at 5–6.

73. *Id.* at 5.

74. S. REP. No. 617, Pt. 5, 65th Cong., 3d Sess. 3 (1918). The minority report described these nonrecognition provisions:

> They have been called "relief provisions" or "cushion provisions."
>
> They should be called "trap-door provisions," as they will prove a ready and convenient exit for disappearing revenues and serve to facilitate the escape of the corporations from just taxation.
>
> They found favor with the committee in a desire to afford relief to a limited number of corporations which appeared to suffer hardship in the application of the general rule . . . .

75. Revenue Act of 1918, ch. 18, 40 Stat. 1057.

76. Revenue Act of 1921, ch. 136, § 202(c)(3), 42 Stat. 227.

77. *Id.* § 202(c).

78. *Id.* § 202(c)(2)–(3).

total number of shares of all other classes of stock of another corporation, and the acquisition by one corporation of substantially all the assets of another corporation.[79] The term "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 a corporation. This definition is similar to the definition found today in section 368(a).[80]

In addition to the same substance, different form rationale, concern for the taxpayer's liquidity also has served as a rationale for nonrecognition provisions for both corporate reorganizations and transfers of property to a corporation. The nonrecognition provision in revised section 202 for exchanges, where the property received had no "readily realizable market value," could be interpreted to be substantial evidence of a congressional concern with the liquidity of the asset received by the taxpayer and the fear that requiring payment of tax on a "paper" transaction might create undue financial hardship for the taxpayer.[81] Liquidity, however, generally has not been a determinative factor in the concept of realization in other areas of tax law.[82] Moreover, it is equally plausible that this nonrecognition provision was motivated by a desire to prevent the recognition of loss, particularly in cases where the property received is the stock of a small corporation, with restrictions on the resale of the stock that would reduce its market value and/or make valuation of the stock difficult to ascertain.[83] In the Revenue Bill of 1924, the exception for property received in an exchange which has no "readily realizable market value" was deleted because of the great difficulty in interpreting the provision and the uncertainty it created. The other nonrecognition provisions, however, were retained.[84] Indeed, if the pri-

79. *Id.* § 202(c)(3).

80. I.R.C. § 368(a).

81. In Portland Oil Co. v. Commissioner, 109 F.2d 479 (1st Cir.), *cert. denied*, 310 U.S. 650 (1940), the court stated that in exchanges qualifying for § 351 nonrecognition, "the taxpayer has not really 'cashed in' on the theoretical gain, or closed out a losing venture." *Id.* at 488.

82. M. CHIRELSTEIN, FEDERAL INCOME TAXATION 69-71 (2d ed. 1979). *See generally* Roehner & Roehner, *Realization: Administrative Convenience or Constitutional Requirement*, 8 TAX L. REV. 173 (1953); Surrey, *supra* note 66.

83. In explaining the revisions to § 202 proposed by the Revenue Bill of 1921, the Senate Report stated that the revision relating to transfers of property would "considerably increase the revenue by preventing taxpayers from taking colorable losses in wash sales and other fictitious exchanges." S. REP. No. 275, 67th Cong., 1st Sess. 11-12 (1921).

84. S. REP. No. 398, 68th Cong., 1st Sess. 13-14 (1924). The Report gave the following reasons for deletion of the exception:

Great difficulty has been experienced in administering this provision. The quesmary concern had been the taxpayer's liquidity, an easy measure of that liquidity would have been whether the stock received by the taxpayer in the exchange or reorganization was traded in the over-the-counter market or on a securities exchange.[85]

The provision for nonrecognition on transfers of property to a controlled corporation was a departure from the general rule of taxability of property exchanges—a rule which persists today with limited exceptions.[86] Both the House and Senate Reports recommending passage of these revisions to section 202 justified the exceptions to the general rule as being necessary to facilitate "business readjustments" and prevent the recognition of colorable losses.[87] Both the Senate and House Reports contained almost identical statements that the revisions would "by removing a source of grave uncertainty, not only permit business to go forward with the readjustments required by existing conditions but [would] also considerably increase the revenue by preventing taxpayers from taking colorable losses in wash sales and other fictitious exchanges."[88] Neither report defined the necessary business readjustments or discussed the rationale for the 80% control requirement.[89] The floor discussion of the bill's provisions focused on the mechanical operations of the proposed revisions to the reorganization provisions.[90]

The legislative history of the Revenue Acts of 1918 and 1921 shows that the predominant congressional concern in enacting the nonrecognition provisions for both reorganizations and certain

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> tion 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. . . . It appears best to provide generally that gain or loss is recognized from all exchanges and then except specifically and in definite terms those cases of exchanges in which it is not desired to tax the gain or allow the loss. This results in definiteness and accuracy and enables a taxpayer to determine prior to the consummation of a given transaction the tax liability that will result therefrom.

Id.

85. For a discussion of a proposal using the nonmarketability of the stock and securities received as the criteria for nonrecognition of gains realized in connection with a merger, see Hellerstein, *supra* note 64, at 281-85.

86. B. BITTKER & J. EUSTICE, *supra* note 3, at 14-3 to -6.

87. S. REP. No. 275, 67th Cong., 1st Sess. 11-12 (1921); H.R. REP. No. 350, 67th Cong., 1st Sess. 10 (1921).

88. H. R. REP. No. 350, 67th Cong., 1st Sess. 10 (1921). *See* note 83 *supra*.

89. The control requirement could have been a compromise of nonrecognition treatment of property transfers to corporations. *See* Thompson, *supra* note 3, at 44. Additionally, the control requirement could have been designed to limit nonrecognition treatment to small or closely held corporations. *See* text accompanying notes 93-98 *infra*.

90. 61 CONG. REC. 5123-5376 (1921).

transfers of property to corporations was the need to stimulate the economy after World War I by both removing any tax disincentives and providing tax incentives for a variety of corporate activities, including corporate combinations and the incorporation of ongoing or new businesses. This increased flexibility for corporate activities provided by the federal tax law had its analogy in contemporaneous developments in the state corporate law area. In describing the increased emphasis on utility during the early 1900's as the legitimating factor for corporate law, Professor Hurst observed:

> The movement of policy from the 1890's into the 1930's carried the utilitarian attitude about as far as it could go: if the law of corporate organization was legitimated by its utility to business enterprise, legitimacy would be most fully achieved if the law empowered businessmen to create whatever arrangements they found most serviceable. The new style of corporation statutes in effect judged that corporate status had no social relevance save as a device legitimized by its utility to promote business. The obverse of this judgment was that regulation of business activity was no longer to be deemed a proper function of the law of corporate organization. The function of corporation law was to enable businessmen to act, not to police their action. . . . In substance through the new pattern of corporation acts prevailing opinion accepted the proposition that the legitimacy of corporation law lay simply in serving vigorous promotional will in developing and consolidating business enterprise.[91]

In an unsuccessful congressional attempt in 1934 to abolish the nonrecognition provisions for reorganizations and transfers of property to certain corporations, it was acknowledged that these provisions originally were enacted to prevent taxation from "seriously interfering with business."[92]

The concepts of continuity of interest and controlled corporations may have been convenient theories to rationalize the policy goals of the nonrecognition provisions. Definitional differences between these two concepts, however, reveal distinct approaches and effects. The 80% control requirement applicable to transfers of property to a corporation, for example, usually prevents public corporations with a large number of shares and shareholders from using the provision.[93] The control definition thus limits the appli-

91. J. HURST, THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES 1780–1970, at 70–71 (1970) (footnotes omitted).

92. H.R. REP. No. 704, 73d Cong., 2d Sess. 8–9 (1933).

93. *See* note 20 *supra* and accompanying text.

cability of section 351 primarily to closely held corporations with few outstanding shares and few shareholders.[94] As a result, section 351 potentially encourages the development of small businesses[95] by removing most of the tax disincentives to incorporating a going concern or a new business and providing favorable tax treatment for certain transfers of property to corporations.

In contrast, the nonrecognition provisions for corporate reorganizations are more readily available to both publicly and closely held corporations.[96] In view of the rejection of the 1918 proposal for nonrecognition on transfers of property to *any* newly formed corporation and the enactment, in 1921, of a nonrecognition provision for property transfers *only to* controlled corporations, it is possible that the 80% control requirement was selected, in part, as a means of restricting favorable tax treatment to small corporations.[97] The absence of any control requirements in the analogous nonrecognition provision for transfers of property to a partnership in exchange for a partnership interest possibly may be explained by the absence of any publicly held partnerships.[98] Thus, the nonrecognition provision for property contributions to partnerships also may have been intended to apply only to small business enterprises.

IV. Public Policy Promoting Small Businesses

The promotion of small businesses has been a dominant theme in the economic legislation enacted during the twentieth century. The Small Business Act of 1953, for example, sought to preserve and expand the free enterprise system through the development of small businesses.[99] Section 631(a) of the Act states:

> It is the declared policy of the Congress that the Government should aid, counsel, assist, and protect, insofar as is possible,

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94. *See* notes 20–21 *supra* and accompanying text.

95. *See* notes 14–22 *supra* and accompanying text. This promotion of small businesses is consistent with other federal tax provisions favoring small corporations. *See* notes 101–06 *infra* and accompanying text.

96. Many of the reorganization provisions do not contain the 80% control requirement or any analogous requirement. *See* note 15 *supra*.

97. *See* note 89 *supra*.

98. Section 721 simply provides: "No gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership." I.R.C. § 721. This difference in tax treatment of transfers of property to a partnership and a corporation has been criticized as having no sound basis in tax policy. *See* Thompson, *supra* note 3, at 39–42.

99. Small Business Act of 1953, 15 U.S.C. §§ 631–650 (1976).

> the interest of small-business concerns in order to preserve free competitive enterprise, to insure that a fair proportion of the total purchases and contracts or subcontracts for the Government . . . be placed with small-business enterprises, to insure that a fair proportion of the total sales of Government property be made to such enterprises, and to maintain and strengthen the over-all economy of the Nation.[100]

In addition, the promotion of small businesses has been a recurrent theme in federal tax law. The enactment of Subchapter S[101] of the Code in 1958, treating, with certain limitations, some closely held corporations as partnerships for tax purposes, was designed to allow businesses to select their legal forms absent undue tax influence, to aid small businesses by taxing the corporation's income to shareholders who were in lower brackets than their corporations, and to permit the shareholders of corporations suffering losses to offset such losses against individual income from other sources.[102] A further indication of the congressional intent to aid small businesses is found in section 1244—a 1958 provision allowing certain favorable tax treatment to shareholders of small corporations.[103] The purpose of this section was to "encourage the flow of new funds into small business" and to position shareholders of small corporations "on a more nearly equal basis with . . . proprietors and partners."[104] The Revenue Act of 1978 also cut corporate tax rates[105] specifically to encourage the growth of small businesses by providing relatively greater tax relief to these small corporations than large ones.[106]

Concern for the development of small businesses has not waned in recent years. In fact, such concern has shaped the impact of securities regulation on the activities of small businesses. The Small Business Investment Incentive Act of 1980 states, as one of its purposes, "a substantial reduction in costs and paperwork to diminish the burdens of raising investment capital (particularly by small business) . . . ."[107] In its report on the Act, the House Committee on Interstate and Foreign Commerce stated

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100. *Id.* § 631(a).

101. I.R.C. §§ 1371–1379.

102. B. BITTKER & J. EUSTICE, *supra* note 3, at 6–2.

103. I.R.C. § 1244 (individual shareholders may treat losses on small business stock as ordinary losses).

104. H.R. REP. No. 2198, 85th Cong., 2d Sess. (1958), *reprinted in* 1959-2 C.B. 709, 711.

105. I.R.C. § 11.

106. Thompson, *supra* note 3, at 6.

107. Small Business Investment Incentive Act, Pub. L. No. 96-477, § 505, 94 Stat. 2275 15 U.S.C. § 77s(c) (Supp. III 1979).

that it was "well aware of the slowing of the flow of capital to American enterprise, particularly to smaller, growing businesses, that has occurred in recent years."[108]

The Securities and Exchange Commission also has recognized the potential for securities regulations to have the "effect of inadvertently impairing capital formation by small businesses."[109] Recently, the Securities and Exchange Commission adopted measures to ease the burden of regulation on small businesses to enable such companies to raise needed capital.[110]

In light of the established public policy to promote and foster the development of small businesses, it is logical to structure and apply section 351 in a manner more compatible with this goal. The present application of this nonrecognition provision impedes, rather than facilitates, its use by small corporations. The continued existence of the current version of section 351 directly contravenes the declared congressional purpose behind that provision.

V. CONDITIONING NONRECOGNITION TREATMENT ON CORPORATE NET WORTH

The present control requirement in section 351, as interpreted by the Service and the courts, contradicts the underlying congressional concern to promote small businesses,[111] because it is so burdensome on small corporations.[112] For this reason, the present control requirement test, which determines an entity's eligibility for nonrecognition treatment on its transfer of property to a corporation in exchange for stock, should be abandoned. Furthermore, statutory revision must supplement any changes in administrative or judicial interpretation of the control requirement.

The best test for eligibility is simply whether the corporation receiving property in exchange for its stock is a small corporation. This test would promote small corporations—the primary motivation behind the legislative enactment of section 351's predecessor.[113] Moreover, such a test would reflect legislative concern with

108. H.R. REP. No. 1341, 96th Cong., 2d Sess. 20 (1980).

109. U.S. SECURITIES AND EXCHANGE COMMISSION & U.S. SMALL BUSINESS ADMINISTRATION, Q&A: SMALL BUSINESS AND THE S.E.C. 2 (1980).

110. *Id.* at 5-12.

111. *See* notes 93-98 *supra* and accompanying text.

112. *See* notes 22-45 *supra* and accompanying text.

113. *See* text accompanying notes 84-90 *supra*.

the financial viability of small businesses and reduce governmental regulation of such businesses.

Unlike the ambiguous and complicated terms of the present control requirement, the term "small corporation" has been used precisely in an established body of case law and administrative interpretations. For small corporations, often unable to afford extensive legal consultation, such a precise definition would be more advantageous than trying to resolve the complexities of the 80% control requirement.[114]

Of the areas of case law from which to choose, state corporate law, however, cannot adequately define a small corporation. Although many states have attempted to provide different corporate code provisions for small or closely held corporations, no commonly accepted definition of a small corporation has emerged.[115] In 1958, it was observed that "[t]he term 'close corporation' or 'closely held corporation' has no clearly defined meaning in the law of the various American jurisdictions."[116] More recently, in 1975, it was stated that "the term 'close corporation,' like 'obscenity,' seems incapable of precise definition."[117] Likewise, Professor O'Neal, in his treatise on close corporations, noted that "[t]he term 'close corporation' has been defined in various ways."[118] Another authority on the taxation of closely held corporations concluded, after consideration of the variations in state corporate law, that "[n]o all-inclusive and all-exclusive definition of a closely held corporation is possible."[119]

There are, however, two definitions of a small corporation which are available in areas of federal tax law outside section 351. First, section 1371(a), relating to Subchapter S corporations, de-

114. *See* notes 22–45 *supra* and accompanying text.

115. The use of the term "close corporation" has been criticized as "inaccurate because a 'close corporation' is not necessarily a small enterprise nor even one having comparatively few stockholders . . . ." Israels, *The Close Corporation and the Law*, 33 CORNELL L.Q. 488 (1948). *See* notes 116–19 *infra* and accompanying text.

116. Scott, *The Close Corporation in Contemporary Business*, 13 BUS. LAW. 741, 741 (1958).

117. Ginsberg, *The Need for Special Close Corporation Legislation in Illinois*, 25 DE PAUL L. REV. 1, 10 (1975).

118. F. O'NEAL, CLOSE CORPORATIONS § 1.02 (1971).

119. T. NESS & E. VOGEL, TAXATION OF THE CLOSELY HELD CORPORATION 1–5 (3d ed. 1976).

fines a "small business corporation."[120] Only such defined small business corporations can use the provisions of Subchapter S, which generally permit such corporations to be taxed as though they were conducting their activities as partnerships.[121] The definition of a small business corporation includes a domestic corporation with only one class of stock outstanding and no more than 25 shareholders, all of which are individuals, estates, trusts, and United States residents.[122] This definition is narrow to avoid the administrative complexities and large costs to the Treasury which arise from a large number of shareholders and to prevent abuse of the loss pass-through provisions is available to Subchapter S corporations.[123] By contrast, section 351's nonelective nonrecognition provisions, though generally advantageous to shareholders, often can harm the affected shareholder by prohibiting the recognition of losses. Although limiting small corporations to such a small number of shareholders restricts the special tax treatment of Subchapter S provisions to closely held corporations, it also excludes corporations with a large number of shareholders which are recognized as closely held corporations.[124]

Secondly, in another context, the Code defines a small business corporation without reference to the number of shareholders. Section 1244 permits shareholders of a small business corporation to deduct from ordinary income a loss on the stock of the corporation, subject to certain limitations.[125] A small business corporation is defined generally in section 1244 as a corporation with capital of one million dollars or less, reduced by the amount of any liability assumed or to which the corporation's property is subject.[126] This definitional requirement must be met when the

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120. "[S]mall business corporation means a domestic corporation which is not a member of an affiliate group . . . and which does not—

(1) have more than 25 shareholders;

(2) have as a shareholder a person (other than an estate and other than a trust . . .) who is not an individual;

(3) have a nonresident alien as a shareholder; and

(4) have more than one class of stock.

I.R.C. § 1371(a). *See* B. BITTKER & J. EUSTICE, *supra* note 3, at 6–1 to –42.

121. I.R.C. § 1372(b).

122. *Id.* § 1371(a).

123. *Id.* § 1374. The provision allowing the corporation's net operating losses to be passed through to the shareholders is particularly advantageous. *Id.* § 1374(a).

124. T. NESS & E. VOGEL, *supra* note 119, at 1–4. "Prior to 1955, the huge Ford Motor Company was, under almost any definition, a closely held corporation." *Id.* at 1–3 n.9 (rev. ed. 1972).

125. I.R.C. § 1244(a). *See* B. BITTKER & J. EUSTICE, *supra* note 3, at 4–43 to –49.

126. I.R.C. § 1244(c)(3).

stock, on which the loss is claimed, is issued. In addition, the corporation must meet certain requirements restricting the amount of passive income when the loss is sustained.[127] This restriction generally prevents a shareholder from obtaining a deduction from ordinary income pursuant to section 1244 if the corporation's primary activity is investment which, if made by a shareholder in his or her individual capacity, constitutes a capital loss.[128] Thus, the restrictions on passive income are inappropriate for the purposes of a section 351 definition of a small corporation since section 351 does not provide favorable tax treatment for a loss on a corporation's stock.[129]

These two definitions of a small corporation have an analogue in the definition of a corporation subject to the registration requirements of the Securities Exchange Act of 1934 (the 1934 Act).[130] Section 12(g) of the 1934 Act requires a corporation to register its equity securities if its total assets exceed one million dollars and a class of equity securities is held by 500 or more owners of record.[131] Corporations meeting these criteria are often referred to as public corporations, as opposed to nonpublic or private corporations.[132] Registration of a public corporation's equity securities is required even though the corporation has never sold its securities pursuant to a registered public offering, the securities are not traded in the over-the-counter market, and the securities are not listed on a securities exchange.[133] Once the securities are registered, the corporation is subject to the 1934 Act's periodic reporting requirements[134] and its proxy and tender

127. *Id.* § 1244(c)(1)(C). Passive income is that income derived from "royalties, rents, dividends, interests, annuities, and sales or exchanges of stocks or securities." *Id.*

128. B. BITTKER & J. EUSTICE, *supra* note 3, at 4–47.

129. Section 351 prohibits the recognition of loss. I.R.C. § 351(b)(2).

130. Securities Exchange Act of 1934 § 12(g), 15 U.S.C. § 78*l*(g) (1976). *See generally* 3 H. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW § 3.03 (1972).

131. Securities Exchange Act of 1934 § 12(g), 15 U.S.C. § 78*l*(g) (1976).

132. 5 L. LOSS, SECURITIES REGULATION 3120 (2d ed. Supp. 1969). *See* W. KLEIN, BUSINESS ORGANIZATION AND FINANCE 93–94 (1980); T. NESS & E. VOGEL, *supra* note 119, at 1–2 n.2.

133. Securities Exchange Act of 1934 § 12(g), 15 U.S.C. § 78*l*(g) (1976).

134. Securities Exchange Act of 1934 § 13(b), 15 U.S.C. § 78m(b) (1976). The principal reports required by this section include yearly and quarterly reports as well as monthly reports upon the occurrence of certain material events. Registration under the 1934 Act also subjects the company's officers, directors, and certain shareholders to the short-swing provisions of § 16(b). This section requires specified insiders to return to the company any profits derived from a purchase and sale or sale and purchase of the company's securities made within a six month period. 15 U.S.C. § 78p (1976).

offer regulations.[135] As applied to small corporations, the benefits of these requirements were deemed outweighed by the costs, and thus, section 12(g)'s definitional provisions were specifically designed to exclude small corporations.[136] Thus, the securities laws, in effect, define a small corporation as one which does not meet section 12(g)'s capital and shareholder number requirements.[137]

The 1934 Act's restriction on the number of shareholders as a criterion for a public corporation is related to the primary purpose of the securities laws—the protection of investors through various disclosure requirements.[138] In circumstances of large numbers of shareholders, and the attendant atomization of ownership, antifraud protection may require supplementation by itemized dis-

135. Section 14(a) of the 1934 Act, 15 U.S.C. § 78n(a) (1976), makes it unlawful to solicit proxies in violation of the Securities and Exchange Commission rules and regulations. The commission has adopted extensive regulations controlling proxy solicitations. 17 C.F.R. §§ 240.14a-1 to .14a-12 (1976). Tender offers are also subject to Securities and Exchange Commission regulations. *See* 15 U.S.C. § 78m(d) (1976); 17 C.F.R. § 240.13d (1976).

136. 5 L. Loss, *supra* note 132, at 2712-13, 3117-20.

137. The Securities and Exchange Commission recently has proposed definitions of the terms "small business" and "small organization" for purposes of the Regulatory Flexibility Act which requires the commission to evaluate its regulations, to weigh their impact on small business entities and to consider alternative requirements if there is a "significant economic impact" on such entities. Pub. L. No. 96-354, § 603(c), 94 Stat. 1164 (1980). *See* SEC Securities Act Release No. 6302, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,857 (March 20, 1981). Under the 1934 Act, the proposed definition of "small business" and "small organization" would include any "person" whose total assets on the last date of its most recent fiscal year were $2.5 million or less. *Id.* Different definitions of "small business" and "small organization" are proposed for the various securities statutes. The proposed rules, for example, would classify, for purposes of the Investment Company Act of 1940 and the Investment Advisors Act of 1940, an investment company as "small" if it had net assets of $50 million or less as of the end of its most recent fiscal year. *Id.* Other definitions are proposed for the Securities Act of 1933, the Trust Indenture Act of 1939, and the Holding Company Act of 1935. None of these proposed definitions contain a criterion based on the number of shareholders; the proposed definitions' determinative factors relate either to total assets or revenues. The commission explained the absence of a criterion relating to the number of shareholders in the following way:

> Supporters of the number of shareholders as a criterion felt that it demonstrated investor interest in a company and thus was determinative of the need for continuing disclosure. With respect to assessing compliance burdens, however, several commentators stated that assets represent a simple and functional criterion for measuring an issuer's size in relation to the cost of complying with securities regulation. Thus, it would appear that an asset test would be the most appropriate indicator of a "small business" or "small organization" for purposes of identifying those companies for which a proposed or adopted rule under the reporting or disclosure provisions of the Securities Exchange Act may have a disproportionate compliance burden.

Id.

138. *Id.* at 3119.

closure provisions.[139] As with the shareholder limitation contained in the Subchapter S definition of a small business corporation, the shareholder criterion in the public corporation definition serves a purpose unrelated to the concerns of section 351.[140]

There would be a disadvantage to including a shareholder limitation in the definition of a small corporation for the purposes of section 351. The commonly accepted notion of a closely held corporation includes a corporation with a relatively large number of shareholders.[141] A corporation in which 20% of the stock, for example, is held by a large number of persons but in which a controlling block of stock is held by a few persons is generally regarded as a small or closely held corporation.[142] This pattern of share ownership may be achieved in a corporation controlled by a few persons, such as family members, which has encouraged, through various fringe benefit plans, purchases of the corporation's stock by the corporation's employees.[143] Such stock purchase plans for corporate employees have been encouraged in other areas of tax law.[144] A shareholder limitation in the definitional provisions of section 351 might penalize corporations that

139. *Id.* at 3118–19.

140. *See* notes 123–24 *supra* and accompanying text.

141. T. NESS & E. VOGEL, *supra* note 119, at 1–2 to –3.

142. *Id.*

143. In such a situation, public trading in the stock may not have developed. Ginsberg, *supra* note 117, at 14–15 & n.58.

144. Since the Revenue Act of 1921, "qualified" deferred compensation plans, including certain stock bonus plans, profit-sharing and thrift-and-savings plans, have been given special federal tax treatment. In general, such "qualified" plans allow: (1) the employer to take a current deduction for contributions, while employees defer taxation on the contributions until benefits are paid; (2) the plan to realize, without taxation, income and gains from its investment; and (3) its participants potential eligibility for special income and estate tax treatment on their distributions. A stock bonus plan, for example, allows annual employer contributions of 15% or less of the aggregate compensation of all participants. Distributions from the plans are in the employer's stock. Profit-sharing plans and thrift plans can also be used as vehicles for the acquisition by employees of their employers' stock. In addition, there are a number of special plans for selected employees with varying degrees of favorable tax treatment: stock option plans, performance-share plans, phantom-stock plans and restricted-stock plans. A more broadly based employee stock option plan, an employee stock purchase plan under § 423, permits purchase of the employer's stock at a discount of as much as 15% of the current market price. Bachelder & Siegal, *Comparison of ESOP with Other Types of Employee Stock Ownership Arrangements*, in EMPLOYEE STOCK OWNERSHIP PLANS 573–71 (J. Bachelder ed. 1979). A qualified employee stock ownership plan under the Employee Retirement Income Security Act of 1974, 29 U.S.C. §§ 1001–3381 (1976), permits an employee to borrow from or on the credit of the employer to purchase securities of the employer. EMPLOYEE STOCK OWNERSHIP PLANS, *supra*, at 4. Moreover, employee stock ownership plans which qualify as Tax Reduction Act Employee Stock Plans permit contributing employers to elect to take up to an additional 1.5% investment tax credit. *See* McSweeny, *Changes Made by the Temporary and Final TRASOP Reg-*

have participated in those plans by making section 351 inapplicable, or the limitation might discourage such participation.[145]

Concern with the financial viability of small businesses mandates a definition that focuses on a corporation's net worth rather than on the number of shareholders. If Congress were to rewrite section 351 to substitute for the control test section 1244's[146] one million dollar net worth definition of a small business, then the problems of interpreting the test for section 351 applicability would be reduced and the uniformity of the tax provisions would be enhanced.[147]

VI. CONCLUSION

Over sixty years ago, Congress adopted a requirement of corporate control for shareholders to obtain nonrecognition of any gains incurred in the exchange of property for a corporation's stock. The control requirement was adopted somewhat arbitrarily as a way to restrict the favorable nonrecognition tax treatment for property transfers to small corporations. This control requirement has been rationalized by a same substance, different form theory, which may have been a convenient way to justify the practical congressional concern motivating the favorable tax treatment—the promotion of small corporations.

The control requirement, however, which currently is imposed under sections 351 and 368(c), is unduly restrictive and presents substantial obstacles to small corporations and potential transferors of property to such corporations attempting to qualify for section 351's nonrecognition treatment. The control requirement should be replaced with a simple provision making section 351's nonrecognition provisions applicable to small corporations through the use of section 1244's net worth definition of small corporations. This simplification of section 351's provisions would facilitate the acquisition of assets by small corporations—a goal of continuing importance in American public policy.

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ulations, in EMPLOYEE STOCK OWNERSHIP PLANS, *supra*, at 529–52; Rhodes, *Investment Tax Credit ESOP (TRASOPs)*, in EMPLOYEE STOCK OWNERSHIP PLANS, *supra* at 481–528.

145. If a corporation participating in an employee stock purchase plan has a large number of employees, the corporation may be viewed as having a large number of shareholders even though control still remains in a few persons. *See* T. NESS & E. VOGEL, *supra* note 128, at 1–2 to –3; Ginsberg, *supra* note 117, at 14–15 & n.58.

146. I.R.C. § 1244(c)(3).

147. *See* notes 22–45 *supra* and accompanying text.