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Organization of a Corporation:
New Considerations Under the
Internal Revenue Code of 1954

Norman A. Sugarman

BUSINESS AND personal transactions must be evaluated today in the
light of many new concepts and rules under the Internal Revenue Code of
1954. The considerable importance of taxation makes the new Code a
necessary adjunct in the legal preparation for such transactions. However,
the new Code is a codification of tax rules, the arrangement and relation-
ship of which is determined primarily from the viewpoint of the imposition
and collection of taxes. Therefore, where the tax Code is sought to be
used as a guide for advance planning of transactions, a quite different co-

ordination of its many provisions may be neces-
sary. This is particularly
the case where the frame-
work within which the
transaction is planned

evolves from another field
of law or business considerations not originating with tax motives.

The organization of a corporation is one of those transactions in which
business considerations, corporate law and tax law must be coordinated.
The possible tax implications of the decisions to be made are not all nicely
laid out in the Internal Revenue Code for such a transaction; they must
be pieced together from concepts and rules organized quite differently for
tax purposes. Moreover, a pattern of coordination of tax rules developed
for such a transaction under the prior law may now be outmoded, and even
dangerous, as a result of the changes made by the 1954 Code. Yet the

1Pub. Law 591, approved Aug. 16, 1954. All references to the "Code" and to
sections of the law are, unless otherwise indicated, references to the Internal Reve-
nue Code of 1954 and to sections therein. References to the Internal Revenue Code
of 1939 and sections therein will be so indicated. All references to Congressional
committee reports will, unless otherwise indicated, be to such reports under the 1954
Code as follows: Report of House Committee on Ways and Means on H. R. 8300,
of Senate Finance Committee on H. R. 8300, S. Rep. No. 1622, 83rd Cong. 2nd
Sess. (cited herein as S. Rep.—); Conference Committee report on Internal Rev.
Rep.—).
tax implications of decisions made upon the organization of a corporation may have far-reaching effects in determining the subsequent success or failure of the business. With this in mind, this article will seek to coordinate the new tax rules under the 1954 Code as they relate to the decisions to be made at this crucial period in undertaking a business.

This analysis, like any interpretation of the new Code at this time, must be made at this time virtually without the benefit of Treasury regulations and the development of rulings and court decisions which may cast greater light on the law and its application at a later time. However, realistic factors dictate the need for current identification, to the extent practical, of the new tax considerations and problems under the 1954 Code upon organizing a corporation. Such is the purpose to be served by this paper. It is not possible, of course, to discuss here all of the tax decisions to be made during the business life of a corporation or to cover the detailed tax problems that may arise on organization of certain specialized types of corporations. Attention will be given, however, to the tax aspects of the choice of the corporate form of organization, the treatment of organizational expenses, the acquisition of assets by the corporation, and various other problems arising from early tax decisions that are required to be made by a new corporation.

I. The Choice of the Corporate Form of Organization

The Internal Revenue Code of 1954 made several changes that should be taken into account in determining whether a business should be organized as a corporation or in some other form, such as a partnership or sole proprietorship. However, it is still basically sound advice that the determination of the form of the business organization should not turn solely on tax considerations, but should be grounded largely on the nature of the business operations.

From a tax standpoint, one of the principal advantages of the corporate form is the ability of the corporation to accumulate capital at the price of only the corporation income tax and without subjecting the earnings to tax in the hands of the owners of the business. This advantage is particularly heightened if the owners of the business intend to pass their stock

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2 This paper will not attempt to cover special problems in organizing, for example, an exempt corporation or foundation (§§ 501 et. seq.); foreign personal holding companies (§§ 551 et. seq.); insurance companies (§§ 801 et. seq.); regulated investment companies (§§ 851 et. seq.). Special problems exist in the organization of foreign corporations. See § 367 requiring advance Treasury approval in order for the tax free exchange provisions on organization of a foreign corporation to apply; § 1491 imposing additional tax on transfers to a foreign corporation to avoid income tax.

on to their heirs. The heirs can, under the income tax laws, obtain such stock at a "stepped up" basis which freezes the retained earnings into the value of the stock as tax free "cost" to the heirs for tax purposes. This "cost," including such retained earnings, may be recovered by the heirs without income tax.\footnote{\textsuperscript{4}}

One of the big specters hanging over attempts to accumulate capital in the corporate form in the past has been section 102 of the Internal Revenue Code of 1939, which imposed a penalty "additional" surtax on corporations accumulating surplus beyond the "reasonable needs of the business." While section 102 was applied only sporadically by the Revenue Service in the past,\footnote{\textsuperscript{6}} the new Code will make it even more difficult for the Revenue Service to assert the penalty surtax successfully in the future. Now, restated as sections 531-537 of the new Code, this provision contains four principal changes intended to limit the possible application of the penalty tax: (a) the burden of proof as to whether accumulations are unreasonable is shifted to the Government if the taxpayer submits a timely statement of reasons for accumulation, (b) a base amount of $60,000 of retained earnings cannot be considered as an unreasonable accumulation, (c) the penalty tax is to be imposed only with respect to that portion of retained earnings determined to be unreasonable, and (d) the "reasonable needs of the business" are defined to include the reasonably anticipated needs of the business, with the result that the corporation need not have an immediate need for the funds, nor is it intended to be penalized if subsequent events develop that in fact the retention was not necessary.\footnote{\textsuperscript{8}}

The net effect of these changes is that this penalty surtax is not likely

\footnote{\textsuperscript{4}§ 1014 of the new Code continues generally the rule of the prior law that the basis of property acquired from a decedent is the value at date of death (or at or within one year after death if elected for estate tax purposes) and expands this rule to cover certain pre-death transfers subject to estate tax. Of course, the value of the stock at death may be subject to estate tax, but § 303 permits certain redemptions of stock to pay estate tax under which the corporation virtually pays the estate tax without income tax liability to the estate or heirs for the value of the stock so realized.}

\footnote{\textsuperscript{6}See Barker, \textit{Recent Section 102 Developments}, 11 N.Y.U. INST. ON FED. TAX. 97 (1953). Recent cases in which § 102 was imposed include \textit{Bride v. Comm'r.}, F.2d — (8th cir. 1955); \textit{Al Goodman, Inc.}, 23 T.C. — No. 39 (1955); \textit{Kerr-Cochran, Inc.}, T. C. Memo, 1955-90 (April 15, 1955); \textit{Egan, Inc.}, T. C. Memo, 1955-117 (May 9, 1955). However, F. L. 367, 84th Cong., 1st Sess., amends the 1939 Code to apply the principle of the 1954 Code retroactively.}

\footnote{\textsuperscript{8}See \textit{Summary of the Provisions of the Internal Revenue Code of 1954 as Agreed to by the Conferences}, by the Staff of the Joint Committee on Internal Revenue Taxation 73-74 (1955). But as to the $60,000 minimum credit, see § 1551 which authorizes the Revenue Service to eliminate such credit in the case of a new corporation formed by transfer of property from another corporation which (or the stockholders of which, or both) controls the transferee, unless the transferee establishes by a clear preponderance of the evidence that the securing of such credit was not a major purpose of such transfer. This is a new provision.}
to be applied except in the most flagrant cases. The corporate tax advisor will still, however, be wise to see to it that the corporate records reflect any bona fide plans for future acquisitions and expansion.7

Another oft cited disadvantage of the corporate form of organization has been the "double taxation" of corporate earnings when distributed as dividends. The Internal Revenue Code of 1954 takes a step in the alleviation of the tax at the individual shareholders' level. The first $50 of dividends from domestic corporations is, with limited exceptions, excluded from the income of individuals.8 A credit is also allowed against the individual shareholder's tax in the amount of 4% of the included dividends from the same sources.9

While the new Code seeks to check some abuses in the corporate field, it does not adversely affect the basic advantages of the corporate form.10 More significantly, it provides increasingly important advantages in the corporate form through the tax benefits available to the owners of a business who are also employees. The benefits of corporate deductions of funds set aside for retirement under a qualified pension trust, profit-sharing or stock bonus plan11 are already well-known; these benefits are not available in a partnership because the partners are not "employees," but are available where a corporation establishes such a plan which includes employee-stockholders.12 Major tax benefits under the new Code that may be spe-

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7See S. Rep. 318: "However, where the future needs of the business are uncertain or vague, or the plans for the future use of the accumulations are indefinite, the amendment does not prevent application of the accumulated earnings tax."

8§ 116.

9§ 34. Where the stock of a new corporation is to be held by a corporation, consideration must be given to the 85% deduction (formerly credit) for dividends received by corporations, § 243, and related rules §§ 244-246. These follow the pattern of the prior law, except under § 246 which for a year in which a corporation has a net operating loss allows the deduction for dividends received without the limitation to 85% of taxable income. Also new § 301 which specifies that a dividend in property (other than money) shall be generally treated as a distribution and shall have a basis to the distributee corporation in the amount of the adjusted basis of the distributing corporation. If, however, fair market value is less, such value is used for these purposes.

10Chief of such abuses sought to be curbed by imposition of ordinary income tax instead of capital gains are (a) redemptions of stock equivalent to a dividend while retaining an interest in the corporation through members of the family, a corporation, trust, partnership or estate (§ 302); preferred stock bailouts (§ 306); and collapsible corporations (§ 341). Other provisions limit certain net operating loss carryovers (§§ 269, 381 (c) (1) and 382) and provide adjustments required by changes in method of accounting (§ 481). In many respects these provisions provide patterns for continuation of the transactions sought to be curbed. There are probably many years of legislative tinkering ahead on these subjects.

11§§ 401 et seq.

12But cf., Kintner v. United States, 216 F. 2d 418 (9th Cir, 1954), in which the court treated a medical partnership as a corporation for Federal income tax purposes.
cially provided for employee-stockholders are tax free medical expense reimbursement for the employee and his family, exclusion from the tax base of up to $100 per week of regular compensation if received on account of personal injury or sickness, tax free death benefits paid in the amount of $5,000 to his estate or surviving beneficiaries, acquisition of additional ownership in the business at bargain prices, without income tax on the benefit derived, through the exercise of restricted stock options, and exemption from the estate tax of the value of a survivorship annuity for the widow or other beneficiaries of the employee-stockholder provided under a qualified pension, stock bonus or profit-sharing plan.

At the same time, the new Code, through amendment and clarification of rules in regard to corporate reorganizations, distributions and liquidations, provides for greater flexibility in corporate organizations and the withdrawal by an owner of his interest in the business. For example, a stockholder may shift all or part of his interest from common stock to preferred stock tax free in a recapitalization, and thereby provide a protected and tax advantageous investment for his family after his death. On the other hand, some rules have been tightened and, particularly in the "collapsible corporation" area, new rules of as yet unknown effect have been provided so that caution is still an appropriate byword.

A word should also be said as to the new rules relating to partners and partnerships. The Code now spells out in considerable detail the rules for determining the income of partners, including the effect of partnership terminations and distributions. These rules codify the existing law to some extent, provide greater certainty, and offer various options for alloca-

Future legislation will probably include limited deductions for individual retirement plans (see Hearing before House Ways and Means Committee on Individual Retirement Act, H.R. 9, H.R. 10, June 27, 1955) and a broadening of the discretion of corporations in classifying employees for pension trust and profit-sharing plan purposes (see § 501(e) (3) of the 1954 Code (H.R. 8300) as passed by the House which, however, was rejected in the Senate pending further study. S. Rep. 53).

18 § 105 (b).
19 § 105 (d).
20 § 101 (b).
21 § 421.
22 § 2039.
23 Subchapter C of the Code, §§ 301-395. This is not to suggest that the rules in this area are now all crystal clear and logical in their application. See, for example, the report of the Committee on Taxation, Association of the Bar of the City of New York, on weak spots in the corporate sections, 2 J. of Tax. 322 (1955).
26 Subchapter K of the Code, §§ 701-771.
tion of items among the partners, but they do not change the fundamental considerations as to the advantages or disadvantages of the partnership form.\textsuperscript{22} Section 1361 of the Code, however, does permit an election by certain unincorporated businesses to be treated as domestic corporations for tax purposes. The provision is extremely limited. It is available only where the enterprise is owned by not more than 50 individuals, no one of whom has more than a 10% interest. Capital must be a material income producing factor, or 50% or more of the gross income must consist of profit derived from trading as a principal or buying and selling real property, stock, securities, or commodities for the account of others. Moreover, the benefits of the pension trust provisions are not available with respect to a partner or proprietor.\textsuperscript{23} The election is generally irrevocable unless the interests of the owners originally electing to be treated as a corporation have declined to 80% or less. Under these circumstances, it is expected that this provision will have little practical use by unincorporated businesses.

\section{II. Organizational Expenses}

A provision added by the 1954 Code as an aid to new corporations authorizes the amortization and deduction of organizational expenses. The provision, however, is limited in its application, and the timing of expenditures may require particular attention if the benefits of the new deduction are to be obtained at all.

The general concept of the new provision, section 248, is to permit a corporation to elect to treat organizational expenditures as deferred expenses to be deducted ratably over a period of not less than 60 months. Under the prior law, organizational expenses were considered capital in nature and were not deductible. They could be amortized only when their useful life could be definitely determined by a reference to a limited term of existence specified in the corporate charter. Since corporate life generally is perpetual, organizational expenses could be recovered for tax purposes, if at all, only in the year of liquidation.\textsuperscript{24}

The amortization of the organizational expenditures must be affirmatively elected by the corporation. Under the proposed regulations of the Treasury Department the election is to be made in a statement attached to the taxpayer's return for the taxable year in which it begins business.\textsuperscript{25}


\textsuperscript{23}§ 1361 (d).

\textsuperscript{24}Treas. Dept. Regs., 118 § 39.24 (a)-2. See also Summary by Joint Committee Staff, supra, note 6, at pages 26-27.

\textsuperscript{25}Treas. Dept. Regs. (proposed) § 1.248-1 (C), 20 Fed. Reg. 2618, 2623. Regulations under the 1954 Code are being issued piecemeal. They will be eventually published in volumes by subject (e. g., income tax).
The proposed regulations also provide that the statement will constitute a valid election only if the return and statement are timely filed (not later than the due date, including any extensions, of the return).\textsuperscript{26} In making the election the corporation must select a period of not less than 60 months over which it will amortize its organizational expenses and such period may not be subsequently changed. The period must begin with the month in which the corporation began business.

Under the proposed regulations the expenditures to which the new provision is applicable are only those which were paid or incurred before the end of the month in which the corporation begins business.\textsuperscript{27} The statute does not, by its terms, contain such a limitation. The interpretation in the Treasury Department regulations appears derived from the nature of the statute, as one dealing with organizational expenditures, from the definition of this phrase in the statute as expenditures which are “incident to the creation of the corporation,” and from the fact that the statute requires the period of amortization to begin with the month in which the corporation begins business. The regulations would seem to recognize as amortizable organizational expenditures those paid or incurred within the first month of the business, although actually paid or incurred after the corporation began business, but would not recognize such expenditures paid or incurred in the second or any subsequent month of the corporation’s business life. The limitation in the regulations hardly seems to be required as an administrative matter since the corporation’s return in which it is to make the election will generally not be due until the fifteenth month of its business life and the Code contains liberal provisions for extensions of time for filing the return.\textsuperscript{28}

If the proposed regulations are finally adopted by the Treasury Department and sustained, a corporation on a cash basis would have to pay within the first month of its operations all of the organizational expenditures that it intends to amortize, if the usual meaning of the term “paid” is applied.\textsuperscript{29} The accrual basis taxpayer will likewise have to be prepared to establish those of its organizational expenditures which were incurred prior to the end of the first month of the corporation’s business.

Careful identification of items may also be necessary to qualify expenses as deductible under section 248. The phrase “organizational expenditures” is defined in the statute to mean expenditures:

\textsuperscript{26} Ibid.

\textsuperscript{27} Id. § 1.248-1(a) (2).

\textsuperscript{28} § 6081(b) authorizes an automatic three months extension for filing corporation returns under procedures prescribed by Treasury Regulations.

\textsuperscript{29} Sec. 7701(a) (25) provides that “‘paid or incurred’ . . . shall be construed according to the method of accounting upon the basis of which the taxable income is computed under subtitle A” (the income tax subtitle).
(1) incident to the creation of the corporation;
(2) chargeable to capital account; and
(3) of a character which, if expended incident to the creation of a corporation having a limited life, would be amortizable over such life.

The Congressional committee reports indicate that this definition includes expenditures for legal services to obtain the corporation charter, fees paid to the state of incorporation, expenses of temporary directors of the corporation, etc. However, expenditures connected with the reorganization, unless incident to the creation of a corporation, are not subject to the provisions of section 248. Moreover, expenses of issuing shares of stock, such as commissions, professional fees and printing costs, are said to be a reduction of the proceeds derived from the issue and are properly chargeable against the paid-in capital, hence are not to be treated as organizational expenditures under section 240.30 The proposed regulations of the Treasury Department even tighten up on these rules. Thus, under the proposed regulations, expenditures connected with the reorganization of a corporation, unless directly incident to the creation of a corporation, are not organizational expenditures. Moreover, expenditures connected with the transfer of assets to a corporation are excluded by the proposed regulations from organizational expenditures.31

It is quite obvious that the incentive provided by amortization of organizational expenditures is very limited, and unless the statute is carefully followed will result in little or no benefit to the corporation.

III. Transfer of Property in Exchange for the Corporation Stock

The new Code continues to permit the organization of a corporation tax free by transferring property to it for the controlling interest. This recognizes, as did the prior law, the concept of continued ownership of property in the corporate form without recognition of gain or loss for tax purposes.

The general rule is contained in section 351 which provides that:

no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control . . . of the corporation.32

“Control” is defined in the new Code in the same manner as under the prior

31 Treas. Dept. Regs. (proposed) § 1.248-1(b).
32 Corresponds generally to § 112(b)(5) of the 1939 Code.
law, namely the ownership of at least 80% of the voting stock and at least 80% of the total number of shares of all classes of stock of the corporation.38

The tax free nature of the exchange brings into play the well-established rules for basis of the property transferred on the exchange.34 In general, the person or persons receiving the stock or securities on the exchange will have a substituted basis for the stock and securities so received; the transferee corporation receiving the property has a carryover basis. The statute also has special rules, similar to those under the prior law, for adjusting basis by reason of the receipt by the stockholders of property (other than stock or securities) with respect to which gain is recognized.35

The new Code provides some additional rules for the purposes of clarification and certainty, such as where a corporate transferor distributes to its shareholders part or all of the stock which it receives in the exchange. Under the new Code the fact that the corporation receiving the stock distributes it to its shareholders does not affect the determination of whether the corporation had control immediately after the exchange of its property for stock.36

However, the most important change in section 351 is the elimination of the "proportionate interest" test. Section 112(b)(5) of the old law provided that the tax free treatment of an exchange of property for stock or securities would be recognized only where the amount of the stock and securities received was substantially in proportion to the interest in the property of each transferor prior to the exchange. The elimination of this proportionate interest test will provide greater freedom for the initial transferors of property to a corporation in selecting their respective stock interests. It is intended to remove troublesome valuation questions and the possibility that a slight disproportion might vitiate the whole tax free nature of the exchange for all such stockholders.37

Despite the clarifying purpose and comparative simplicity of the language of section 351, there are, however, a number of new—and perhaps unexpected—tax implications that should be considered before the transfer of assets to a newly organized corporation. The most important of these are as follows:

A. Possible Tax Consequences to the Distributees in a Disproportionate Exchange

The purpose of the elimination of the proportionate interest test was to
permit the exchange of property for stock to be treated as tax free without controversy as to whether the controlling stock was distributed in proportion to the interest contributed. Nevertheless the committee reports and the proposed regulations give fair warning that there is the likelihood of other tax consequences to the transferors on the exchange. In the case of a disproportionate exchange, the Revenue Service may look through the transaction and treat it as if the stock and securities had first been received in proportion and then the transferors had made such transfers or exchanges among themselves as led to the ultimate non-proportionate receipt of stock or securities. The committee reports indicate that Congress intended that the non-proportionate distributions will be taxed in accordance with their true nature "to the extent . . . that the existing disproportion between the value of the property transferred and the amount of the stock or securities received by each of the transferors results in an event taxable under other provisions of this Code." The possible tax consequences upon a disproportionate exchange, as indicated by the committee reports and the proposed regulations, are as follows:

1. **Taxable Gift**

One possible effect is a taxable gift from one transferor to the other transferor. An illustration in the committee reports is the case of a family situation in which a father makes the major transfer of property to a corporation with the son, who also is a transferor, receiving a disproportionately greater amount of the shares of the corporation.

It is likely that the possibility of a taxable gift resulting in such situations will be more of a threat than an actuality, except in unusual cases. The committee reports and the proposed regulations indicate that the mere disproportionate exchange will not give rise to a gift. Even in the example given, the possibility of a gift tax is limited by the statement in the committee reports and proposed regulations that the gift tax provisions will apply "if it is determined that A, the father, made a gift to B, the son." Moreover, it is likely that the possibility of assertion of a gift tax will be limited to family situations.

2. **Compensation**

A second possible tax consequence on a disproportionate exchange is the treatment of some part of the stock or securities received as compensation. This may arise under two different circumstances.

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28 *Ibid*; Treas. Dept. Regs. (proposed) § 1.351-1(b) (1).
30 See § 351(d) (3).
31 Treas. Dept. Regs. (proposed) § 1.351-1(b) (1).
32 See § 351(d) (4).
One circumstance may be where one of the transferors has rendered service to the corporation. The statute expressly recognizes this situation by a new provision in section 351(a) to the effect that stock or securities issued for services to the transferee corporation is fully taxable as compensation upon receipt. This is in line with the general policy of the statute that the receipt of stock or securities as compensation for services will not vitiate the application of the tax free provisions in respect to the remaining portion of the transaction.

Another possibility of compensation, however, arises from the disproportionate receipt of stock or securities being treated as payment of compensation by one transferor to the other. Thus, where B rendered services to A, and on the exchange by A and B of property for the stock of the new corporation, B receives stock in excess of the proportionate value of the property transferred by him, the excess may be treated as an amount received as compensation for services rendered. In such case the recipient of the services may also have gain or loss on the exchange in the difference between the basis to him of the shares received and their fair market value at the time of the exchange. Consistency would also require adjustment of the basis of the stock of the shareholders if the exchange is so reconstructed.

3. Discharge of Obligation

Another possibility of gain or income on a disproportionate exchange arises where the exchange has the effect of satisfying an obligation of one of the parties. This is cited in the committee reports on section 351 but is not referred to in the proposed regulations.

B. Gain on Receipt of Other Property or Money

Where the exchange is not solely for stock or securities, section 351 will continue to apply, but gain may be recognized in the amount of money and the fair market value of other property which is received. In this respect the new Code carries over the provisions of section 112(c) of the prior law. The Code also continues the rule of section 112(e) of the prior law to the effect that no loss will be recognized.

The rule is that if in addition to the stock or securities received, other property or money is received, then gain, if any, is recognized but not in excess of the amount of money received plus the fair market value of such other property received.

43 Supra, note 38.
44 But there is no indication that a transfer of property for less than 80% of the stock will be reconstructed to over 80% for purposes of qualification under section 351 where a disproportionate part of the stock (over 20%) was issued to another for services.
45 Treas. Dept. Regs. (proposed) § 1.351-2(d) contains a cross-reference from sec-
The new Code also continues the rule of the prior law that liabilities assumed are not to be treated as "other property or money" for the purpose of determining the amount of realized gain that is to be recognized under section 351. However, the new law carries over in section 357(b) the provisions of the prior law under which the assumption of liability shall be considered as money received by the taxpayer upon the exchange, if it appears that the principal purpose of the taxpayer with respect to the assumption or acquisition of the liability was to avoid Federal income tax on the exchange, or if there was not a bona fide business purpose. The proposed regulations do not indicate any change in the law or interpretations in the applications of this provision.\textsuperscript{46}

C. GAIN OR INCOME UPON TRANSFER OF PROPERTY WITH LIABILITY IN EXCESS OF BASIS

A new provision of the Code provides this possibility for the recognition of gain or income upon an exchange which otherwise would be tax free under section 351. This new provision is in section 357(c) which may result in unexpected gain or income upon the transfer of property to a newly formed corporation. Under this provision, if the sum of the amount of the liabilities assumed plus the amount of the liabilities to which the property is subject, exceed the total amount of the adjusted basis of the property transferred, then the excess is considered as gain from the sale or exchange of a capital asset or property which is not a capital asset, as the case may be.

An example illustrating the application of this provision is as follows: An individual purchased land for $20,000. Subsequently, upon the discovery of minerals in the land, he borrows $100,000 secured by a mortgage upon the property. Prior to any payments on the mortgage, he transfers the property to a corporation in a transaction to which section 351 applies. In such case, whether or not the corporation assumes the mortgage, the transferor will be subject to tax on $80,000 representing the excess of the

\textsuperscript{46}Treas. Dept. Regs. (proposed) § 1.357-1(c).
liability over the basis of the property in his hands. From a tax viewpoint, reduction of the liability to the amount of the basis of the property prior to the transfer would be advisable in order to avoid the gain or income that would otherwise result under section 357(c).

D. RECEIPT OF PREFERRED STOCK IN AN EXCHANGE UNDER SECTION 351

In an exchange under this section, stock, including preferred stock, may be received tax free. This has particular significance because of the general taint that is put on preferred stock by section 306 when distributed as a stock dividend. In general, "section 306 stock" may be disposed of by sale or redemption at the price of ordinary income tax instead of capital gains tax. This penalty does not attach to preferred stock received on organization of a corporation, unless it is received in exchange for "section 306 stock" or for property considered as "section 306 stock." Accordingly, if the initial transferors contemplate a subsequent distribution of preferred stock, it is advisable to give consideration to the issuance of such stock in connection with the section 351 exchange on organization of the corporation. A note of caution must be added, however, that a redemption of the preferred stock by the corporation at a later date may result in ordinary income under section 302, unless voting stock is also redeemed in a disproportionate redemption that is subject only to the capital gains tax.

The issuance of bonds may also be accomplished more favorably from a tax viewpoint upon the organization of the corporation than later in its life. At a later date a distribution of securities or an exchange of stock or property for securities may give rise to gain or a dividend. Under section 351 the transfer of property upon organization of the corporation for stock or securities is tax free. In fact, the transfer of property for securities pursuant to this section affords a means, in effect, for the disposition of property for a secured obligation with postponement of the recognition of gain, so long as the requisite stock control is obtained by the transferor or transferors. Here, also, caution must be experienced, lest the "securities" be considered as "stock" in a too thin capitalization.

IV. ACQUISITIONS OF ASSETS OF ANOTHER CORPORATION

Our discussion thus far has been concerned largely with the mechanics of the transfer of property by individuals to a new corporation to undertake a new business. The transfer of assets from one corporation to an-
other may be accomplished by the same mechanics or by more complex means depending upon business and tax considerations. A corporation may establish a subsidiary to operate a new business, or a division of an existing corporate business, by a transfer of assets in exchange for stock or securities pursuant to section 351 without tax consequences to the transferor corporation. The principal effect to the new corporation is that, in general, the basis of the assets so acquired is, in the hands of the new corporation, the same as the basis of the assets in the hands of the transferor.

On the other hand, a corporation may be formed to acquire assets of an existing but unrelated corporation, and in such case the mechanics used may depend upon the basis for depreciation and other tax attributes which the owners of the new corporation desire to acquire. In general, as we shall see, the results will vary depending upon whether the assets are acquired in a "tax free exchange" or by "purchase." A generalization, however, is not safe in this area, and under the new Code there are rules that must be carefully followed, as well as some problems that make it difficult to follow the rules.

A. CORPORATE REORGANIZATIONS

A new corporation may be organized under circumstances constituting a "reorganization" under the Internal Revenue Code. The 1954 Code contains the same six general categories of transactions as did the prior law that are defined as "reorganizations" for the purposes of the income tax. In general, the concept of the law is to permit tax free adjustments of corporate structures, made in one of the particular ways specified in the Code, as required by business exigencies and which affect only a readjustment of continuing interests in property under modified corporate forms. Four of the specified types of reorganizations may be applicable or used in the organization of a new corporation. The symbols by which these reorganizations are known (derived from their subparagraph designations under section 368(a)(1)) and their principal characteristics are:

(B) The acquisition by one corporation, solely for its voting stock, of stock in another corporation if immediately after that acquisition the acquiring corporation has control of the other corporation.

(C) The acquisition by a corporation for its voting stock of substantially all the properties of another corporation.

(D) The transfer by a corporation of assets to a controlled corporation followed by a distribution of stock or securities of the controlled corporation.

Treas. Dept. Regs. (proposed) § 1.368-1.
(F) A mere change in identity, form or place or organization. The new Code provides some changes in the rules for a reorganization, but in general keeps the basic concepts of the prior law. This means that the gloss on the statutory definitions derived over the many years of administrative and judicial interpretation must still be taken into account in determining whether a particular transaction falls within or without the reorganization provisions.

Two concepts of the prior law are of particular importance and are still a part of the basic approach in the application of the statutory provisions. One of these is the requirement of a continuity of interest. The Treasury Department regulations provide that, except in a divisive type of reorganization, a continuity of interest on the part of the persons who directly or indirectly were the owners of the enterprise prior to the reorganization is necessary. However, the new Code does contain one definite rule modifying the application of the continuity of interest concept under the prior judicial doctrines. Under section 356 of the Code, securities cannot be received tax free in exchange for stock. Another basic concept carried over from the prior law is that the transaction in order to qualify as a tax free reorganization must have a business or corporate purpose.

Given the requisite continuity of interest and business purpose, the new Code points the way for corporate readjustments on a tax free basis if the specific provisions of the Code are followed. In determining whether a new corporation should be organized and acquire stock or assets in a “reorganization,” it is necessary to understand the consequence of coming within the statutory provisions for a tax free reorganization. In general, the consequences are as follows. If there is a reorganization under section 368, no gain or loss is recognized to shareholders or security holders who exchange their stock or securities solely for stock or securities in the reorganized corporation, or in another corporation, a party to the reorganization. A corporation which is a party to the reorganization also has no gain or loss upon the exchange of property in pursuance of the plan of reorganization solely for stock or securities in another corporation, a party to the reorganization.

If the exchange is not solely for property permitted to be received tax free, then the exchange still will be considered tax free (i.e., with the consequences of a tax free reorganization), but the “boot” provisions will apply.
to the other property and money received on the exchange. Section 356(a) provides the rules for the recognition of gain in such cases upon the receipt of additional consideration by the distributee, and section 361(b) has a similar rule upon the receipt of other money or property by the corporation. In any event, losses are not recognized on the exchange.

In general, the assumption of liabilities or the acquisition of property subject to a liability is not treated as money or other property received on the exchange. As previously indicated, however, this rule will not apply where there is a tax avoidance purpose. Moreover, gain or income may be recognized to a corporation where property is exchanged for stock or securities and the liability to which the property is subject exceeds the basis of the property.\(^{58}\)

A final general consideration in connection with the tax free nature of the reorganization, which is of particular importance to the new corporation, is the carryover of basis. In general, the distributees of stock or securities take, as their basis, the same basis as that of the property exchanged,\(^{59}\) and the property acquired by the corporation in connection with the reorganization takes as its basis the same basis as that in the hands of the transferors.\(^{58}\)

With the above general understanding of the consequences, it may be desired to place assets or stock in a new corporation in a tax free reorganization for the reasons that the transferor corporation or its stockholders do not want taxable gain recognized on the transfer or desire to continue their investment by owning stock in the new corporation. Moreover, the owners of the new corporation may desire to carry over a high basis of the assets acquired from the old corporation. On the other hand, if the stockholders of the old corporation are willing to realize on their investment and pay the tax (capital gains tax, generally), or the owners of the new corporation desire a (higher) basis commensurate with the price paid for the assets transferred to the new corporation, then it is important that the transaction not take the form of a "reorganization" under section 368.

No attempt will be made here to discuss the background of the interpretation of the old provisions of the Code or all of the consequences of tax free reorganizations. Rather, viewed with our objective of considering the method and effect of the organization of a new corporation, the provisions on corporate reorganizations will be considered in four broad categories.

\(^{58}\) § 357(c).

\(^{59}\) § 358.

\(^{58}\) § 362.
1. Reincorporation

Reincorporation of an existing corporation is generally covered by the (D) and (F) types of reorganizations under section 368. These subdivisions encompass transfers to a new corporation controlled by the old corporation or its shareholders and transfers that involve a mere change in identity, form or place of organization. There is no substantial change under the new Code affecting these comparatively simple transactions. One particular consequence that should be noted, however, in establishing a new corporation under these provisions as distinguished from establishing a new corporation under section 351, is the effect of the issuance of "section 306 stock" and securities to the transferors on the exchange. As previously indicated, taxable gain or income consequences may occur on such issuances; whereas stock or securities may be received tax free upon initial transfers for property upon organization of a new corporation under section 351.

2. Transfers to a Subsidiary Corporation

The organization of a subsidiary and the acquisition of assets by it may fall under a (C) or (D) type of reorganization. In a (C) reorganization, the law contains a new rule designed to permit the tax free transfer of assets by a corporation to a subsidiary of the corporation issuing stock for the assets. Thus, under the new law, all of the assets of corporation T may be transferred to corporation S, a subsidiary of corporation P, solely in exchange for voting stock of corporation P.

The language of the new provision is so specific in some respects that it has the effect of continuing to exclude from the definition of reorganization a case in which the assets are acquired by a subsidiary in exchange for voting stock of both the parent corporation and the subsidiary. The language of the Code would also seem to be inapplicable to cases where, for stock of the parent, the subsidiary acquires 80% or more of the stock of another corporation (as distinguished from assets); and such an acquisition would not be tax free, on the principle under the prior law that the transferor did not receive stock from a "party to the reorganization" (the parent corporation). The law, both old and new, provides that in determining whether the exchange is solely for stock, the assumption by the acquiring corporation of a liability of the transferor, or the fact that the property acquired was subject to a liability, shall be disregarded. The proposed regulations, however, continue to point out that this provision is designed for the single

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Footnotes:

59 Through the application of § 356.
60 Treas. Dept. Regs. (proposed) § 1.368-2 (d) (1).
purpose of determining whether the exchange is solely for stock and that the provision will not prevent the Revenue Service from examining the character of the transaction to determine whether or not the assumption of the indebtedness so colored the whole transaction as to place it outside the purposes and assumption of the reorganization provisions.62

Another clarification in a (C) reorganization has been provided in cases where the assets are acquired not only for voting stock but also for other property. In such a case the transaction will still be a reorganization under (C) if the acquiring corporation acquires solely for voting stock property having a fair market value which is at least 80% of the fair market value of all of the property of the other corporation.63 This rule clarifies the situation where some stockholders must be paid off in cash. In these cases, however, special attention must be paid to the assumption of liabilities. The proposed regulations contain a rule that for the purpose of determining whether 80% of the property of the corporation has been acquired for voting stock, a liability assumed or to which the properties are subject is considered money paid for the properties.64 Accordingly, if the corporation whose assets are acquired has extensive liabilities, then the payment of some money or property in addition to stock for the assets may have the effect of taking the whole transaction out of (C).

It should also be noted that the law contains a provision that if a transaction is described in both (C) and (D), then it shall be treated as described only in (D).65 The purpose of this provision is to bring into effect the requirements of (D) with respect to distributions of stock or securities received on the exchange, which will be applicable in the divisive type of reorganization.

3. Control Reorganizations

Acquisitions of stock or assets in the new corporation may also be accomplished in a reorganization under (B) or in a reorganization under (C). Under (B) a corporation acquires in exchange wholly for all or part of its voting stock the stock of another corporation, and immediately after the acquisition the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition). This repeats substantially the language of the corresponding provision of the prior law except for the rule indicating that it is immaterial whether the acquiring corporation had control immediately before the acquisition so long as it has control of such other corporation after the

62 Treas. Dept. Regs. (proposed) § 1.368-2(d) (1).
63 § 368 (a) (2) (B).
64 Treas. Dept. Regs. (proposed) § 1.368-2(d) (2).
65 § 368 (a) (2) (A).
acquisition. The purpose of this change is to eliminate the problem that existed under the prior law with respect to so-called "creeping reorganizations." The new Code makes it clear that a (B) reorganization takes place where the controlling stock is acquired in a single transaction or in a series of transactions. Thus, a series of exchanges of voting stock for the stock of another corporation resulting in control of such other corporation will be tax free if in pursuance of a plan of reorganization. However, the proposed regulations require that the series of transactions resulting in control take place over a relatively short period of time, such as 12 months.

(C) reorganizations are those involving asset acquisitions in corporate reorganizations. This provision applies to the acquisition by one corporation, in exchange solely for all or part of its voting stock, of substantially all the properties of another corporation. Except for the provision previously described as to the acquisition of assets by a subsidiary of the corporation issuing the stock, the new Code carries over substantially the same provisions as the old law.

4. Divisive Reorganizations

Section 368(a)(1)(D) treats as a reorganization a transfer by a corporation of all or part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders or any combination thereof, is in control of the corporation to which the assets are transferred. There is, however, an additional proviso, namely that the transaction will qualify as a reorganization only if, in pursuance of a plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355 or 356.

It may be noted that if the distribution of the stock does not take place as required by the proviso for a (D) reorganization, the transaction nevertheless stands as a transfer of assets for stock which may make the exchange tax free under section 351 as far as the corporation is concerned. However, the requirement that the distribution be made in a transaction which qualifies under section 354, 355 or 356 has an important meaning. Section 354, which treats the exchange of stock or securities for stock or securities as tax free, applies in a (D) reorganization only where the acquiring corporation acquires substantially all the assets of a single corporation. In other words, where there is the transfer of the assets of the corporation, pursuant to the plan of reorganization, to two or more corporations, then the tax treatment to the distributees of the stock or securities received in the exchange is determined under sections 355 and 356.

67 Treas. Dept. Regs. (proposed) § 1.368-2(c).
66 § 354 (b)
Actually, if there is a "spin off" of assets to a new corporation, the rules for tax free receipt of the stock of the new corporation by the shareholders of the pre-existing corporation are governed entirely by section 355. A discussion of these rules would take us far afield at this point; but it is sufficient for the present purposes to indicate that if a new corporation is to be formed by division of an old corporation and the stock distributed to the shareholders, the rules of section 355 must be followed to provide a tax free receipt of the new stock.

For purposes of the present discussion, the most important change under the new Code in a (D) reorganization is the fact that disproportionate exchanges are permitted. This is in accordance with the concept previously stated under section 351 upon the transfer of property to a corporation in exchange for stock or securities. Thus, the statute does not require control in the same proportion after the reorganization as it was before.\(^6\) This recognizes as a reorganization the transfer by a corporation which operates two different lines of businesses of the assets of the two businesses into separate corporations in exchange for all the stock of such corporations. However, as pointed out in connection with section 351, certain unexpected side effects may occur in the treatment of the shareholders without regard to the qualification of the plan as a plan of reorganization.\(^7\)

**B. PURCHASE OF ASSETS**

As previously indicated, there may be both practical business reasons and tax reasons for a corporation to purchase assets rather than to acquire stock of a corporation or its assets in a tax free reorganization. The principal advantage to the new corporation usually is that the basis of the assets so acquired will be the cost of the assets to the new corporation which may give it a higher basis for depreciation deductions, and hence return on its investment, than if it acquired the assets with a carryover basis. The objective here is to bring the transaction under the general rule (section 1012 of the Code) that the basis of property is the cost of such property.

Generally, there are two methods of acquiring assets by "purchase" under the Internal Revenue Code. One is the direct route of the purchase of assets. If, however, the purchase is by means of an exchange, then it will not be treated as a purchase if the exchange is tax free. Therefore, to obtain a new cost basis upon the acquisition of assets by a new corporation, the acquisition must fall outside the provisions for tax free organization or reorganization, as already described. Similarly, attention must be given to provisions relating to other nontaxable exchanges. Under section 1031, if property held for productive use in trade or business or for investment

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\(^6\) See S. Rep. 274.

\(^7\) *Ibid*; see also § 356(f) and Treas. Dept. Regs. (proposed) § 1.356-5.
is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment, the exchange is tax free. This provision does not apply to the exchange of stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in actions, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest.

The second method of acquiring assets by "purchase" is to buy stock for the purpose of liquidating the corporation to acquire its assets. The new Code provides a specific pattern which if followed will treat the acquisition of stock followed by a distribution of assets as a purchase of assets. The pattern, as prescribed in section 334(b)(2), is designed to eliminate the confusion that existed under the prior law where an intent test prevailed as to whether the acquisition of assets was a tax free liquidation of a subsidiary (with a carryover basis) or a purchase of assets (with a new cost basis). Under section 334(b)(2), the corporation acquiring the stock, and subsequently the assets, will take as the basis for the assets the adjusted basis of the stock with respect to which it obtained a distribution of the assets.

The rules of the new stock basis provision specify a definite procedure as follows: the acquiring corporation must obtain at least 80% of the total combined voting power of all classes of stock entitled to vote, and at least 80% of the total number of shares of all other classes of stock (except non-voting stock which is limited and preferred as to dividends) by purchase. It must acquire such stock by purchase during a period of not more than 12 months. The corporation, the assets of which are sought, must adopt a plan of liquidation not more than two years after the acquisition by the acquiring corporation of the requisite 80% control. The assets must be distributed in complete liquidation and in pursuance of the plan of liquidation so adopted.

Despite the substitution of these mechanical tests for intent under the new statute, there are a number of problems of interpretation in these new provisions of the Code. The statute does not require that all of the stock of the corporation be acquired within the 12-month period, but that 80% of the stock be acquired in that period. Accordingly, if the acquiring corporation owns some stock of the distributing corporation prior to the beginning of the 12-month period, the acquisition may still come under section 334(b)(2) as long as 80% of the stock is acquired during the 12-month period. The provision, however, would not be applicable if the acquiring corporation acquired or possessed more than 20% of the stock prior to the beginning of the 12-month period. The Treasury's proposed regulations do not indicate the Department's position where the corporation had previously acquired more than 20% and then sold some of the stock and reacquired a total of 80% within the 12-month period. Such a case,
however, would seem to provide a literal compliance with the statute. The proposed regulations, however, do make it clear that the date for determining whether 80% was acquired within the 12-month period (and the date for beginning the 2-year period for adoption of a plan of liquidation) is not the date of the acquisition of the last stock acquired by the corporation but the last date in a 12-month period at which the point of 80% ownership of stock was reached.\textsuperscript{71}

The basis of the assets in the hands of the acquiring corporation also presents some problems. The basis of the assets is to be determined by using the basis of the stock of the acquiring corporation, including stock which was not acquired by purchase and not acquired within the 12-month period.\textsuperscript{72} Also, the basis is to be adjusted by all distributions received by the parent corporation from the subsidiary prior to the adoption of the plan of liquidation and after the beginning of the 12-month period. In general, under the regulations the basis is to be reduced by distributions.\textsuperscript{73} It is also particularly important to give attention to the liabilities of the subsidiary, for an increase in liabilities prior to liquidation may have the effect of reducing the basis to be allocated to assets.\textsuperscript{74} This may have serious tax consequences if the liabilities are incurred for depreciable property since under the proposed regulations, allocation of the basis of the stock is to be made to the assets in accordance with their net fair market values on the date received.

Another problem in obtaining the full benefits of the stock basis rule is to assure that the stock is acquired by "purchase" as defined in section 334. "Purchase" is defined\textsuperscript{75} to exclude the acquisition of stock with a carryover basis. It is also defined to exclude the acquisition of stock that the corporation is already considered to own constructively under the new rules for attribution of ownership under section 318. In general, under these rules, a corporation is considered to own the stock owned by its controlling shareholder (50% control). However, the workings of the attribution rule are so complex that section 318 is a necessary check point before undertaking the acquisition or disposition of stock under section 334(b)(2) and many other sections. For example, a purchase from a minority stockholder may turn out not to be a "purchase" under section 334(b)(2), because 50% stock ownership is attributed to him by reason of stock owned by members of his family, his partners or another corporation in which he is a 50% shareholder.\textsuperscript{76}

\textsuperscript{71} Treas. Dept. Regs. (proposed) § 1.334-1 (c)(3).
\textsuperscript{72} Id, § 1.334-1 (c)(1).
\textsuperscript{73} Id, § 1.334-1 (c)(4).
\textsuperscript{74} Ibid.
\textsuperscript{75} § 334 (b)(3).
\textsuperscript{76} The problem is even more complicated in cases under §§ 304 and 382(a)(3),
There remains the problem of whether the acquisition of assets through the stock purchase route of section 334(b)(2) will always result in the basis provided for under that section even though the end result of the transaction may have been accomplished through another route, such as one of the reorganization provisions. For example, Corporation X may purchase stock of Corporation Y from various individuals and then liquidate Y for its assets. If the stockholders of Y turn around and buy stock in X, will the transaction be treated as if X had issued its stock to Y in exchange for Y's assets pursuant to a tax free reorganization, whereupon Y distributed the X stock in liquidation in exchange for its stock? Under these circumstances the acquiring corporation would continue to argue that it is entitled to a basis determined with respect to the purchase of stock, whereas the stockholders who had acquired stock in the transferee corporation may argue that in effect the transaction should be regarded as a tax free exchange of stock for stock under section 354. In view of the specific nature of the new rules under the Code and the overriding intent that certainty should be obtained if the statutory formula is followed, this situation is one in which the form of the transaction, unless clearly a fiction, should control.\textsuperscript{77}

C. LIQUIDATION AND REINCORPORATION

The organization of a new corporation to conduct a business previously carried on by a corporation being liquidated is a common business event. The owners of the new corporation may purchase the assets of the old corporation rather than acquire them in a tax free exchange, in order to obtain a basis for such assets reflecting their current value or cost to the new owners. Where some stockholders of the liquidated corporation are also stockholders of the new corporation, a particular problem arises as to whether the desired objective of a "stepped up" basis can be obtained.

The proposed regulations of the Treasury Department provide that "A liquidation which is followed by a reincorporation, or which is preceded by an incorporation of part of the assets of the liquidating corporation, may, however, have the effect of the distribution of a dividend or of a transaction in which gain is recognized only to the extent of "other property."\textsuperscript{78} It is apparent, under this provision of the proposed regulations that the

\textsuperscript{77}In Edward A. Langanbach, 2 B.T.A. 777 (1925), it was held on similar facts that the transaction was not an exchange of stocks.

\textsuperscript{78}Treas. Dept. Regs. (proposed) § 1.331-1(b).
Treasury Department would scrutinize the acquisition of assets by a new corporation to determine whether in fact the new corporation is merely the old corporation and that no true liquidation of the old corporation occurred. Presumably, if the transaction is treated as a continuance of the old corporation which makes a distribution in redemption of part of its stock, the determination of whether the distribution gives rise to capital gain or a dividend will be governed by section 302 of the new Code. Another possibility is that the transfer of assets in a reincorporation will be treated as a reorganization; with the consequent carryover of basis to the new corporation.

These possibilities pose a real problem where a new corporation is desired to be formed with assets from an old corporation, and where shareholders putting new money into the corporation insist upon the basis of the assets reflecting their investment of new money rather than the old basis of the assets based upon investments of many years ago. The new Code throws no light on how the investors in the new corporation may be assured of a return on their investment based upon recognition of a basis of assets in the new corporation commensurate with their investment. However, the legislative history of the new Code indicates that the problem with which both the Congress and the Treasury were concerned existed where shareholders owning 50% or more of the stock of a liquidated corporation transferred 50% or more of the assets to a new corporation in which they owned 50% or more of the stock.

The bona fides of the parties in establishing a new corporation, where

79 Under the prior law, the B.T.A. in Daniel Kelly, 10 B.T.A. 141 (1928), treated the stockholders as realizing a taxable gain on a distribution from the "liquidating corporation," as if they had merely exchanged their stock in the old company for stock of the new corporation plus other property. In a more recent case the Tax Court treated a similar transaction as a reorganization with the stockholders receiving the equivalent of a dividend within the meaning of § 112(c)(2) of the 1939 Code. Isabella M. Sheldon, 6 T.C. 510 (1946).

80 Milton H. Bickley, 1 B.T.A. 544 (1925).

81 See § 357 of H.R. 8300, 83rd Cong. 2nd Sess., as passed by the House. The provision was dropped with the following conference committee explanation (Conf. Rep. 41):

"(i) Liquidation followed by reincorporation. The House bill in section 357 contained a provision dealing with a device whereby it has been attempted to withdraw corporate earnings at capital gains rates by distributing all the assets of a corporation in complete liquidation and promptly reincorporating the business assets. This provision gave rise to certain technical problems and it has not been retained in the bill as recommended by the accompanying conference report. It is the belief of the managers on the part of the House that, at the present time, the possibility of tax avoidance in this area is not sufficiently serious to require a special statutory provision. It is believed that this possibility can appropriately be disposed of by judicial decision or by regulation within the framework of the other provisions of the bill."
there are new shareholders at least in part, should determine whether the
corporation will be recognized as a new corporation. Where the same
stockholders carry over to the new corporation the courts have recognized
the new corporation only where there is a break in the continuity of the
transaction, which is particularly evidenced by the right of the stockholders
to choose whether or not to invest in the new company. A clue may also
be found in cases in which the courts have passed on the continuity of inter-
est question where assets are transferred from an old corporation to an-
other corporation in which stockholders of the old corporation control the
acquiring corporation. Thus, in the *Reilly* case where stockholders, who
made up 68.93% of the stockholders of the old corporation, acquired 100%
of the stock of the new corporation, and the new corporation acquired sub-
stantially all the assets of the old corporation, a reorganization was held to
result. Accordingly, if a sufficient percentage of interest is owned by new
stockholders (something more than the 31.07% present in the *Reilly* case)
the principles of the prior law would give a basis for recognition of the
new corporation acquiring assets from the old corporation as a separate
entity with a basis reflecting the current investment. However, the Treas-
ury has shied away from any particular percentage that would provide a
line of demarcation. On one hand a requirement of at least 50% new
shareholdings, as provided in the House version of the 1954 Code, was
abandoned; on the other hand, in a recent case, the Revenue Service un-
successfully urged that there was a partial liquidation of the old corporation
and a transfer of assets to the new corporation (rather than a reorganiza-
tion) even though 72% of the shareholders of the old corporation owned
100% of the stock of the new corporation.

It is clear that the new Code has not provided any light in the matter of
formation of a successor corporation where some of the stockholders of the
predecessor also have an interest. While the purchase of stock and acquisi-
tion of assets under section 334(b) (2) seems to provide a formula for
obtaining a new basis commensurate with the investment, nevertheless the
pitfalls in the application of section 334(b) (2) may provide unexpected
disadvantages. Particularly, the need exists for clarification of the relation-
ship of sections 302 and 304 to such cases. Looking at the broad purpose
of section 334(b) (2), however, it should be possible to establish a new

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82 U. S. v. Arcade Co., 203 F.2d 230 (6th Cir. 1953); Henricksen v. Bracks &
Molz, 137 F.2d 632 (9th Cir. 1943).
83 *Reilly Oil Co. v. Com'r.*, 189 F.2d 382, (5th Cir. 1951). See also *Toklan Roy-
alty Corp. v. Jones*, 58 F. Supp. 967 (D. Okla., 1944), where 75.5% of shareholders
of old corporation owned 100% of stock of new.
84 See note 81, *supra*.
85 *James G. Murrin, 24 T.C.—No. 57 (1955).*
86 See note 76, *supra*. 
corporation that will purchase the stock of an existing corporation and obtain a new basis for the assets sought and acquired from the old corporation.

V. Carryover of Tax Attributes from a Predecessor to a New Corporation

A decision as to the acquisition of assets from an already existing corporation, may involve many considerations in addition to those of the tax basis of assets and other factors already discussed. The carryover of other tax attributes from one corporation to another may also dictate the wisdom or method of acquiring certain assets. The problems and decisions involved in the carryover of such tax attributes are not solely matters arising in the case of new corporations. However, their importance may be crucial and hence the possibilities, particularly in the case of a new corporation, cannot be overlooked.

A. Carryover of Certain Items from a Predecessor Corporation

One of the most important changes in the corporation income tax under the 1954 Code is that providing for the carryover of certain attributes for tax purposes where there is a tax free transfer of the assets from one corporation to another corporation. This provision, section 381, clarifies and restates "carryover" concepts previously established by interpretation and provides new rules where there was doubt or a void under the prior law. The importance of this section in the organization of the new corporation is that the benefits of the provision may indicate the wisdom of the new corporation obtaining the assets of an old corporation in a tax free exchange to which the section applies. On the other hand, the burdens of the section may dictate that the acquisition should not fall under section 381.

Section 381 applies only where there is an acquisition of assets of a corporation in one of the following categories of cases:

(1) The tax free liquidation of a subsidiary where there is a carryover of the basis of the assets of the subsidiary to the parent corporation.

(2) A transfer of assets in a statutory merger or consolidation, or a transfer of substantially all the assets to another corporation in exchange for voting stock (pursuant to a plan or reorganization qualifying under (C) or (D) of section 368(a)(1)), or a mere change in identity, form, or place of organization (an (F) reorganization). It is important to note that section 381 does not apply to a divisive reorganization, but rather applies only where the assets are transferred to a single corporation.

Section 381, as recently amended, contains 18 categories of tax attri-

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87 Public Law 74, enacted June 15, 1955, repealing § 452 of the 1954 Code, relating to prepaid income, and section 381(c)(7) which provided a carryover liability for an
Attributes which are required to be carried over where there is an acquisition to which section 381 applies. The most important of these is that relating to net operating losses, and by reason of its importance, and also the necessity to consider other related sections, a separate discussion of the acquisition of a loss corporation will be undertaken later.88

Attributes involved in the other 17 items are listed and discussed briefly below:

1. Earnings and profits.89 A deficit in earnings and of profits of the old corporation cannot be used to offset earnings and profits of the acquiring corporation accumulated prior to the acquisition. The statutory provision, in effect, confirms the prior judicial interpretation.80 This rule is comparatively unimportant in the case of a newly organized corporation. More importantly in such a case, the statute does not prevent the deficit in earnings and profits of the transferor corporation from reducing subsequent earnings and profits of the new corporation. For the year in which the acquisition occurs, the deficit of the transferor corporation may be applied to reduce that part of the earnings and profits of the acquiring corporation which is attributable to the period after the acquisition. The part so attributable is determined under a mathematical formula in the statute, which is the ratio of the number of days of the year after the date of acquisition to the total number of days in such a year. The purpose and effect in the case of a new corporation acquiring substantially all the assets of an old corporation in a tax free exchange is to continue the earnings and profits pictures without benefit or detriment from the exchange.

2. Capital loss carryover.91 The acquiring corporation is allowed to deduct a short term capital loss on account of any capital loss carryover which the transferor corporation would have been entitled to had it not transferred the property. The law permits a five-year carryover of capital losses,92 but one of those years may be lost under the provisions of section 381 if the acquisition takes place on a date other than at the end of a taxable year of the acquiring corporation. This is for the reason that the taxable year of the transferor corporation is required to end on the date of distribution or transfer, and the first year of carryover to the acquiring corporation is the first taxable year of the acquiring corporation ending after the date of distribution or transfer. Thus, if the transferor corporation and the

acquiring corporation where the predecessor had elected to defer reporting of prepaids income under § 452.

88 *Infra, 365 et. seq.*
89 § 381 (c) (2).
90 *Com'r. v. Phipps, 336 U.S. 410 (1949).*
91 § 381 (c) (3).
92 § 1221.
acquiring corporation are both on a calendar year and the acquisition takes place prior to the end of the year, the taxable year of the transferor ending with the transfer and the taxable year of the acquiring corporation ending after the transfer will each count as a taxable year. Hence two taxable years will be counted, even though they may span only a 12-month period.

3. Method of accounting. The acquiring corporation is required to use the method of accounting used by the transferor corporation. This may prove to be a disadvantage since a new corporation is ordinarily entitled to establish any suitable method of accounting. The only exception under section 381 is in a case where there were several transferor corporations that used different methods of accounting. In such case, the method to be adopted is to be determined under regulations prescribed by the Treasury Department. The acquiring corporation may, in addition, request approval of the Treasury Department for a change in the method of accounting from that used by the transferor corporation. If permission is granted to make the change, the acquiring corporation may find itself required to report, as income, items attributable to the transferor corporation and which would be omitted from income if the method of accounting was elected as a new corporation and without taking into account the methods of accounting employed by the transferor.

4. Inventories. The rule with regard to the carryover of inventory methods under the new Code is the same as that with regard to methods of accounting generally. Thus, if the transferor corporation used the LIFO method, the acquiring corporation is required to use the LIFO method, and on the same basis on which such inventories were taken by the transferor corporation. The same exceptions are applicable here as described in the case of the method of accounting.

5. Method of computing depreciation allowance. If the transferor corporation used one of the new methods of depreciation prescribed by the 1954 Code, the acquiring corporation is required to use the same method with regard to property which has a carryover basis to the acquiring corporation. Thus, if, with respect to such properties, the transferor corporation used the double declining balance method, the sum of the digits method, or another "consistent" method, as provided in section 167(b)(2), (3) and (4), the acquiring corporation is required to use such method. There appears to be nothing in section 381, however, that would prevent the acquiring corporation from exercising the same option as was available to

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84 § 381 (c) (4).
85 See § 481.
86 § 381 (c) (5).
87 § 381 (c) (6).
the transferor corporation to elect to change from the double declining balance method to the straight line method in accordance with section 167(e). Also, if the transferor corporation used the straight line method, there would be nothing to prevent the acquiring corporation from electing one of the new methods with respect to newly acquired properties, assuming the requirements of section 167 are otherwise met.

6. Installment method. According to the approach described above to accounting methods generally, an acquiring corporation is required to continue to report on the installment basis receipts from installment obligations as if it were the transferor corporation, if the transferor had elected to report on the installment basis. This rule, of course, applies only to obligations acquired from the transferor. Some disadvantages may result under this treatment if section 381 is applicable to the acquisition where it is not desired to use the installment method generally. Since the installment method is a method of accounting, it would seem that, if the acquiring corporation acquires installment obligations with respect to which the transferor used the installment method, the acquiring corporation is required to use the installment method consistently with regard to all installment obligations, including those sales of personal property on the installment method made by it, unless permission is obtained from the Commissioner to discontinue the installment method. Of course, the installment method is not required with respect to sales on open account. If the new corporation desires to change from the installment method, which it is otherwise obligated to pursue, permission may be granted by the Commissioner upon condition that the corporation take into income for the year of the change, any unreported income on installment accounts receivable at the close of the preceding year, as well as the income for the year of the change as computed under the new basis. A new corporation acquiring installment obligations as part of the assets from another corporation in a transaction to which section 381 is not applicable does not have this handicap. The new corporation may adopt the installment method, in such case, in its first return and no profits on uncollected amounts need be reported until they are collected. Thus, in the case of dealers in personal property, the desirability of continuing or abandoning the installment method may be a factor in the method of acquisition of the assets of another business which has installment obligations.

7. Amortization of bond discount or premium. The application

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99 § 453 (c) (9).

100 Sec. 453 (c) provides relief where there is a change from the accrual method to the installment method but is not applicable to a change from the installment method.

101 § 381 (c) (9).
of section 381 may affect the income or deductions of the acquiring corporation where the transferee assumes the liability for bonds of the transferor corporation which were issued at a premium or discount. The acquiring corporation stands in the shoes of the transferor for the purpose of determining the amount of amortization allowable as a deduction or includible in income with respect to such discount or premium.

8. **Exploration and development expenditures.**\(^{102}\) If the acquiring corporation acquires a mine or mineral deposit, and the transferor corporation had elected to deduct exploration and development expenses ratably out of the production of such mine or mineral deposit, pursuant to sections 615 or 616, the acquiring corporation stands in the shoes of the transferor corporation with respect to the right to such deduction. Under section 615, a deduction is not allowed for any taxable year if in any four preceding years such a deduction was taken by the taxpayer, or by the individual or corporation that transferred the mineral property to the taxpayer. Here, again, it appears that the acquiring corporation will lose a taxable year for the purpose of counting the number of taxable years (four in this case) if the acquisition takes place during the year, since the taxable period of the transferor corporation ending with the acquisition is treated as a taxable year, and the taxable period of the acquiring corporation ending after the transaction constitutes another taxable year (even though the entire period of these two taxable years would, but for the acquisition, be a single taxable year).\(^{103}\)

9. **Contributions to pension plans, employees' plans, and stock bonus and profit sharing plans.** For the purpose of determining the amount deductible under section 404 for contributions to such plans, the acquiring corporation stands in the shoes of the transferor corporation. This provision will not excuse the transferor corporation from making its contributions or payments within its taxable year (shortened by reason of the termination on the transfer) or, if not so made, will not entitle the acquiring corporation to the deduction for the contribution to the trust or fund for the year of transfer unless payment is made by the acquiring corporation within the time for filing the transferor corporation's return for its last taxable year.\(^{104}\) Additional problems, beyond the scope of this paper, exist in the matter of carryover of other attributes of a qualified plan from a transferor corporation to the acquiring corporation; and problems involving the treatment of employees of the transferor corporation as employees of the

\(^{102}\) § 381 (c) (10).


acquiring corporation and qualification of the plan as a plan of the acquiring corporation must be given attention.

10. *Recovery of bad debts, prior taxes or delinquency amounts.* The acquiring corporation is required to include in income recoveries of bad debts, prior taxes, and delinquency amounts, to the same extent that the transferor corporation would have been required to include such amounts but for the transfer. If a new corporation acquires such rights in an acquisition that does not come under section 381, it may have a cost basis with respect to such rights which will place it taxwise in a better position than if section 381 applied.

11. *Involuntary conversions.* Section 1033 of the Code provides, in effect, that gain from the involuntary conversion of certain property may be postponed where the proceeds are reinvested in similar property within one year (with authority in the Commissioner to extend the period). The acquiring corporation stands in the same shoes as the transferor corporation with respect to the postponement of such gain. However, here again, the period for the conversion may be shortened in the case of the acquiring corporation. Actually, it begins with the date of disposition of the converted property (or the earliest date of the threat or imminence of requisition or condemnation) and ends one year after the close of the first taxable year in which any part of the gain upon the conversion is realized. Accordingly, if the transferor corporation received the proceeds of the involuntary conversion, the one-year period may end 12 months after the date of the transfer of its assets to the acquiring corporation (the end of its taxable year resulting from such transfer), rather than 12 months after the date of the taxable year of the transferor corporation would have closed but for the transfer.

12. *Certain obligations of the transferor corporation.* The Code permits the acquiring corporation to deduct amounts arising out of an obligation of the transferor paid or accrued by the acquiring corporation after the date of transfer, provided the obligation is assumed by the acquiring corporation, provided also that the obligation gives rise to a liability after the date of transfer and such liability if paid or accrued by the transferor after such date would have been deductible in computing its taxable income, and provided the obligation is not reflected in the amount of consideration

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105 § 381(c) (12).
106 § 381(c) (13).
107 H.R. Rep. A141 and S. Rep. 282 refer to the acquiring corporation standing in the shoes of the transferor if "property or stock" is transferred to the acquiring corporation. Read literally this explanation would make the provision (§ 381(c) (13)) inapplicable and unnecessary because the nonrecognition requirements would have been satisfied prior to the transfer. The statute is not so limited.
108 § 381(c) (16).
transferred by the acquiring corporation to the transferor corporation for the property of the transferor corporation.

The last limitation is particularly important to watch because it may have the effect of denying the deduction where, in valuing assets acquired for stock (in a tax-free exchange), payment by the acquiring corporation of prior obligations of the transferor was taken into account. The provision is apparently directed at the situation where the payment of such obligations is part of the cost of acquisition and should be treated as part of the capital cost by the acquiring corporation rather than as a deductible expense when paid. The provision is ambiguous, however; and if the statute is broadly construed as applicable to all liabilities subsequently paid by the acquiring corporation that might be traceable to an obligation of the transferor, then the acquiring corporation will not stand in the shoes of the transferor, and expenses paid after the acquisition and which would normally be considered as deductible will become nondeductible. It should be noted, however, that the carryover provision is applicable only to "obligations" and not liabilities of the transferor corporation and it is unlikely as a practical matter that the assumption of "obligations" would be reflected in the consideration from the acquiring corporation. One such case might be that involving the acquisition of a corporation that was obligated under warranties given on the sale of its merchandise. The ambiguity of the provision requires special attention to the record being made on a transfer. 109

13. Mine tailings. Section 381(c) (18) permits an acquiring corporation to claim percentage depletion on so-called mine-tailings transferred to it just as if it were the transferor corporation.

14. Charitable contributions. The new Code permits a corporation which makes charitable contributions in excess of the limit of 5% of its taxable income for the year to carry over such excess to the two succeeding taxable years as deductions, with certain limitations. 110 Section 381(c) (19) is designed, in general, to place an acquiring corporation under section 381 in the same position as the transferor corporation with respect to the right to a deduction of the excess of charitable contributions. However, this provision does not operate in the same manner as

109 While the term transferor has been used in the text to include both a transferor corporation and a corporation making distribution on liquidation, the limitation in § 381(c) (16), in cases where the obligation is reflected in the consideration, is limited literally to transferor cases. No mention is made, as in other subdivisions, to the "distributor." No reason seems to exist for the distinction other than that actually the case may only arise where there is a transfer, rather than a distribution in liquidation qualifying under § 381.

110 § 170(b) (2).
other carryover provisions under section 381. The provision authorizes the carryover to the first two taxable years of the acquiring corporation which begin after the date of the transfer. No proration is required where the transfer takes place during a taxable year (unlike the rules with respect to net operating loss and capital loss carryovers where such a proration is required). Moreover, since the carryover is to the first two years beginning after the acquisition, the period following the transfer, to which there is a carryover, is apparently not shortened but may be lengthened. The taxable year of the acquiring corporation in which the acquisition takes place receives no carryover; rather the carryover is to the two following years.

15. Certain attributes of personal holding companies. Although outside the scope of this paper, it may also be mentioned that section 381 provides for the carryover of certain attributes and items with respect to a personal holding company where there is an acquisition under section 381. These are: the dividend carryover under section 564, deficiency dividend deduction under section 547 and the deduction for certain indebtedness incurred before January 1, 1934 as provided in section 545(b)(7).

The above items serve as a check list indicating benefits and burdens upon an acquisition which qualifies under section 381. It is apparent that an acquisition under that section may provide additional deductions that would not be available to a corporation which acquired assets in a transaction that did not fall under the section. On the other hand, many of the provisions are highly technical and it may be a long time before it is determined whether the particular item results in a benefit or a burden. As shall be seen in the following discussion in connection with net operating losses, there are other factors that may also have to be reckoned with, particularly the provisions of section 269, which give the Commissioner broad power to disallow deductions, credits, or other allowances where the principal purpose of an acquisition is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit or other allowance which a person or corporation would not otherwise enjoy.

B. AVAILABILITY OF A PREDECESSOR’S LOSS CARRY OVER TO A NEW CORPORATION

The fact that a net operating loss of one year may be carried over and deducted against income for as many as five successive years is of particular importance to a new corporation. It provides the incentive

111 This may be explained by the fact that the provision was added in conference. See Conf. Rep. 39.

112 See § 381(c)(14), (15) and (17).
that future profits will first be available to recoup early losses, rather than to pay the tax collector. A similar incentive and even greater protection of investment would exist if such deductions might be available in the case of a new business envisioning immediately profitable years. Thus, in embarking on a business venture, the organization of the business may involve whether to form a new corporation in the usual way or to undertake the business in such a way as to obtain a loss carryover deduction from an already existing corporation. In general, there are two methods for obtaining such a net operating loss carry over. One is to acquire control of a loss corporation and operate through such corporation. The other is to transfer the assets—and the loss carry over—of the loss corporation to another corporation in a tax free transfer qualifying under section 381. There are limitations under the statute, however, that require caution and attention to detail if the benefits of the loss deduction are to be realized. The statutory plan is, in general, as follows:

(a) An acquiring corporation obtaining substantially all the assets of a loss corporation in a tax free transfer may carry over losses as provided in, and subject to the limitations of, section 381 (particularly subsection (c) (1)), section 382(b) and section 269.

(b) An old corporation may be acquired and continued by new interests with the benefits of its loss carry over, subject to the limitations provided in section 382(a).

Before undertaking a review of the statutory plan, it is well to reiterate that in determining whether to obtain the benefits of a loss carry over to a new business operation, sight must not be lost of the benefits in burdens of other tax attributes that may also be carried over.113

1. Carry Over of Net Operating Loss Upon Acquisition of Substantially All the Assets of a Loss Corporation in a Tax Free Liquidation or Reorganization

As previously indicated, section 381 applies to certain types of acquisitions of assets of a corporation, the principal characteristic being the transfer of substantially all the assets of a corporation to another corporation where there is a carry over of basis of the assets so transferred. If section 381 is applicable, the acquiring corporation may succeed

113 Other tax attributes that may be “picked up” in the case of a corporation that may be otherwise acquired cheaply, because the old management desires to sell out rather than sustain further losses, include some of the carryover attributes previously described in reference to § 381, a previous good earnings record or invested capital for possible excess profits tax purposes, and a high basis of assets. Sec. 334(b) prescribes the method for obtaining a carryover of basis of assets from a corporation the stock of which is acquired to obtain assets; in general the acquiring corporation must wait two years to liquidate the transferor corporation in order to carry over the basis of its assets.
to, and take into account, the net operating loss carry over of the transferor corporation. There are, however, certain limitations upon the availability and benefit of this net operating loss carry over to the acquiring corporation.

Section 381 does not apply where the acquiring corporation obtains assets by purchase, i.e., with a basis determined with reference to the acquiring corporation's cost, rather than a carry over basis. Thus, the net operating loss carry over is not available to an acquiring corporation that acquires 80% or more of the stock of a corporation and liquidates the corporation within 2 years after completing such 80% acquisition, as provided under section 334(b)(2). Therefore, in seeking a loss corporation, if the stock is acquired first, by purchase, rather than the assets in exchange for voting stock, the benefits of the net operating loss carry over will be available to the new management only after, and if, it continues to operate the loss corporation as a separate corporation for at least 2 years, and then, of course, further limitations under the statute must still be reckoned with as stated below.

If the assets of the transferor corporation are acquired in a transaction to which section 381 applies, then as previously indicated, the period to which the net operating loss may be carried over could be reduced. This result can be prevented if the transferor corporation and the acquiring corporation each have the same taxable period and the transfer of assets occurs on the last day of that period.

Another limitation on the net operating loss carry over is that only part of the net operating loss carry over may be available to the acquiring corporation for the taxable year in which the acquisition takes place. Under the statute, the amount of the net operating loss deduction attributable to the carry over for the first taxable year of the acquiring corporation to which the loss may be carried over is limited to the amount of taxable income of the acquiring corporation after the acquisition. This limitation is the proportion of the taxable income (determined without regard to a net operating loss deduction) of the acquiring corporation which the number of days in the taxable year after the date of acquisition bears to the total number of days in the taxable year.

Another limitation applies for purpose of computing the carry overs to taxable years after the taxable year in which the acquisition occurred. For this purpose the year of acquisition is divided into two parts, each of which is treated as a taxable year. The purpose of this division of the year of

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114 § 381 (c) (1).
116 § 381 (c) (1) (B).
117 § 381 (c) (1) (C).
acquisition is twofold. First of all, the "post acquisition part" is treated as the "prior year" for purposes of determining carry overs to subsequent years. This is consistent with the treatment of such "post acquisition part" as the first taxable year of the acquiring corporation to which the net operating loss carry over applies for that year. The second reason for this division of the acquiring corporation's taxable year is exemplified by the case in which the acquiring corporation itself suffered a loss for a prior year. A net operating loss carry over from a loss year of the acquiring corporation is first carried to the pre-acquisition part year, and then the remainder, if any, is carried to the post-acquisition part year. This division of the acquiring corporation's first taxable year does not affect the number of years of the carry over, for such year is still regarded as only one for purpose of determining the number of years to which a loss may be carried over. However, as previously noted, the total period of a carry over may be shortened by reason of partially overlapping taxable years of the transferor corporation and acquiring corporation being treated as separate taxable years.

Another important limitation that should be noted is that following an acquisition under section 381 a net operating loss cannot be carried back from the acquiring corporation to the transferor corporation. Thus in the case of a newly formed acquiring corporation, a net operating loss in its first year of operation cannot be carried back to obtain a refund of taxes paid by the predecessor but can only be carried forward.

If new interests are desirous of obtaining only some of the assets of a loss corporation (those which they believe may be operated profitably) the availability of the net operating loss carry over to an acquiring corporation will depend upon whether the acquisition is one which comes under section 381. As previously indicated, the substance of section 381 is that the acquiring corporation acquires substantially all of the assets of the transferor corporation. The concept of "substantially all" the assets has been subject to judicial interpretation in the determination of the tax free reorganizations, and there are a number of decisions under the prior law which indicate the difficulty of attempting to strip an old company of its surplus assets by transferring them into another corporation in exchange for stock prior to transfer of assets in a reorganization.

Section 355 of the new Code facilitates the division of a corporation and consideration may be given to its use where new interests are desirous of obtaining some of the assets of a corporation and some stockholders of the

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119 § 381 (b) (3).
old corporation desire to retain and operate other assets in a new corporation. Section 355 permits shareholders to exchange tax free the stock in an existing corporation for stock of a corporation formed by the transfer of assets constituting a separate business that has been operated for at least 5 years. For example, if A and B are the stockholders of the X-Y Corporation and the X assets are spun off to a new corporation in exchange for all of its stock, such stock may be distributed by the X-Y Corporation to A in exchange for and in cancellation of A's stock in X-Y. Will the X-Y Corporation as a continuing corporation still possess the net operating loss that may be transferred to an acquiring corporation in an acquisition under section 381? At this point reference must be made to section 382, since section 382 would prevent or limit the carry over by the continuing corporation (X-Y Corporation) and the acquiring corporation if certain changes in operations and ownership take place.

Before considering section 382, however, it might be pointed out that apparently there would be nothing to prevent the loss corporation from selling such of its assets as are not desired or needed in the further conduct of a continuing trade or business, so long as there is the requisite continuity of ownership of the business as required by section 382(a). Some question may be raised as to whether a sale of part of the assets of a corporation in anticipation of acquisition of the balance of the assets by another corporation for stock, will prevent the transaction from qualifying under section 381. Here the timing and the bona fides of the transfers may be important. Nevertheless, there is no reason in principle to prevent a corporation from selling or exchanging surplus assets for money or property, all of which is added to the balance of the assets when transferring substantially all of its assets to the acquiring corporation. There should be no question that the acquiring corporation can acquire substantially all of the assets for its stock in a transaction qualifying under section 381 and then subsequently dispose of those assets so acquired that are no longer needed for the business, unless it resells such assets to the stockholders of the transferors corporation.191

Under section 382(b), a carry over to the acquiring corporation will be reduced unless the stockholders of the loss corporation end up with at least 20% of the stock of the acquiring corporation immediately after the acquisition. The 20% requirement is with reference to the fair market value of the outstanding stock of the acquiring corporation. For each percentage point less than 20% which is held by the stockholders of the loss corporation, the carry over is reduced by 5 percentage points.192 Thus, if the old stockholders end up with 19%, only 95% of the carry over from

192 § 382(b) (2).
the loss corporation is available to the acquiring corporation. No attempt will be made here to delineate all of the fine points of the rules in section 382(b). It is obvious that section 382(b) provides not only a warning, but also a formula for transferring the net operating loss carry over to an acquiring corporation, and the parties that would seek to obtain the carry over for an acquiring corporation must follow the statutory formula in detail.

2. Net Operating Loss Carry Over in the Old Corporation Acquired by New Interests

Section 382(a) provides special limitations on the continued benefits of the net operating loss carry over where there is a change in the ownership of a corporation and its trade or business. In general, section 382(a) will deny net operating loss carry overs from prior taxable years if all of the following events or conditions occur:

1. The 10 largest stockholders at the end of the year own 50% or more of the fair market value of the stock.
2. One or more of the 10 largest stockholders increased the stock owned by him by at least 50 percentage points as compared with that owned by him at the beginning of the taxable year or the beginning of the prior taxable year.
3. The 50 percentage point increase is attributable to either a purchase (directly or indirectly) of stock or a redemption of stock, other than a redemption to pay death taxes.
4. The corporation has not continued to carry on a trade or business substantially the same as that conducted before any change in the percentage ownership of the fair market value of such stock.

Application of these limitations under section 382(a) indicates the difficulties of attempting to spin off part of the assets of a business and retain the net operating loss carry over for the retained part of the business. Thus, in the previous example of the X-Y Corporation, the net operating loss will no longer be available to the corporation or to its transferee if the remaining stockholder ("B" in the example) increases his stock ownership by 50 points and the trade or business is changed by the spin off of the X assets. Where there are several stockholders in a corporation who wish to retain their interest in the corporation, the 50% test may not prove too much of an obstacle under section 382(a).

The continuation of the business substantially the same as that conducted before, is actually the crucial point in the application of section 382(a). A change in stock ownership is immaterial, so long as the trade or business remains substantially the same. On this point the Senate committee report indicates that "if the corporation continued to carry on sub-
stantially the same business, the limitation would not be applicable even though the corporation also added a new trade or business."

Despite its seemingly strict rules, section 382(a) will not eliminate a net operating loss where new interests acquire the stock and change the business, if the acquisition is accomplished by an exchange of stock rather than a "purchase." Thus, if a new corporation exchanges voting stock for the controlling (80%) stock of the loss corporation, the limitations on loss carryovers in the old corporation under section 382(a) will not apply.

This points up the differences in the limitations in obtaining the benefits of a carryover by continuing the old corporation and in transferring the assets to a new corporation.

If the assets of the loss corporation are acquired for stock, the stockholders of the loss corporation must obtain 20% in value of the stock of the acquiring corporation in order for the acquiring corporation to obtain the full loss carryover (although it may lose part of the period of the carryover as previously explained).

If the stock of the loss corporation is purchased and it is continued as a separate corporation, the full benefit of the loss may be retained as long as the same business is continued, even though a new business is added and the old stockholders are eliminated completely.

If the stock of the loss corporation is purchased and the business is changed, the loss carryover from prior years will be completely eliminated if the new owners purchase as much as 50 percentage points of the stock of the corporation over a two-year period.

If the controlling (80%) stock of the loss corporation is acquired solely for voting stock, the full benefit of the loss carryover will be retained whether or not the business is retained. (Note that there may be considerable difference between the consideration given to obtain the stock required for control of a corporation and the use of its loss under section 382(a) and the 20% in value of the stock of the acquiring corporation.

\[\text{s}^\text{S. Rep. 53.}\]

\[\text{s}^\text{S} \text{ 382(a) (4). It should also be noted that a "purchase" of stock from a person whose holdings would be attributed to the purchasing corporation is not considered a purchase. Stock of a loss corporation owned by a shareholder of the purchasing corporation will be attributed to the purchasing corporation regardless of how small the interest of the shareholder in the purchasing corporation. (The usual requirement of 50% stock ownership for attribution does not apply under \text{§ 382 (a)}. (See \text{§ 382(a) (3) ). Therefore, where the purchasing corporation and the loss corporation have any common shareholders, the possibilities of a "purchase" and the application of the limitations under \text{§ 382(a) will be restricted. If, for example, A owns all the stock of the loss corporation and only one share of the purchasing corporation, there will be no "purchase" within the meaning of \text{§ 382(a).} }\]
required to be given to the old stockholders for a full carry over of loss under section 382(b).

The net effect is that the statute contains formulas and rules which may produce seemingly arbitrary and capricious results to the unwary. Therefore, careful planning and examination based upon the actual facts of each case is required in order to produce results consistent with sound business decisions.

3. Limitation on Carry Overs in Acquisitions for the Purpose of Avoiding Tax

Section 269 of the Code carries over the principle of the rule under the prior law that was adopted to check acquisitions of loss corporations to reduce the World War II excess profits tax. As retained in the 1954 Code, this provision stands as an additional possible threat or overlapping, in cases in which sections 381 and 382(b) apply, where a corporation acquires the assets of another corporation which is expected to provide a net operating loss carry over to the acquiring corporation.

Section 269 authorizes the Commissioner of Internal Revenue to disallow a deduction, credit, or allowance not otherwise available in cases where control of a corporation is acquired principally for the purpose of tax evasion or avoidance. This provision was of little effect (except possibly as a threat) under the prior law because of the burden on the administrators of establishing that tax avoidance was the principal purpose of the acquisition. In fact, the predecessor provision of the prior law was not successfully upheld in any case that reached the courts, although in one case the Government was successful where it relied not only on this provision but also on the broad authority of the Commissioner under section 45 of the 1939 Code to disregard the existence of a new corporation controlled by the transferor corporation.

The 1954 Code is intended to give the Commissioner a little more chance to apply his authority to disallow benefits where the principal purpose of an acquisition is tax avoidance. The new law provides a rebuttable presumption that the principal purpose of tax evasion or avoidance exists if the consideration paid for the acquisition is substantially disproportionate

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125 § 129 as added by § 128(a) of the Rev. Act of 1943.
126 Com'r v. Chelsea Products, Inc., 197 F.2d 620 (3rd Cir. 1952); J. E. Dilworth Co. v. Henslee, 98 F. Supp. 957 (D. C. Tenn. 1951); Commodores Point Terminal Corp., 11 T.C. 411 (1948); Alprosa Watch Corp., 11 T.C. 240 (1948); Alcorn Wholesale Co., 16 T.C. 75 (1951); Berlands, Inc., 16 T.C. 182 (1951); WAGE, Inc., 19 T.C. 249 (1952). See also I.T. 3757, 1954 Cum. Bull. 200 (creation of a subsidiary as a Western Hemisphere Trade Corporation to obtain the benefits of favorable treatment of such corporations does not constitute tax avoidance under § 129 of the 1939 Code.)
to the sum of the adjusted basis of the property and the tax benefits acquired. The purpose of this provision is to assist the Government in its burden of proof where the acquiring corporation pays less than the aggregate of the tax basis of the property and the tax value of other benefits such as the net operating loss carry over.\textsuperscript{128} Literally, however, the presumption would be equally applicable in cases where the acquiring corporation paid more than the aggregate of these items, but its application in such cases is not necessary nor intended.

Since the presumption under the new law is rebuttable, section 269 remains only a threat and not a rule for disallowing net operating loss carry overs. It can still be expected, therefore, that the Government will use section 269 principally in those cases at which it has other weapons at hand such as that the transfer to the new corporation was a sham, or that the existence of the new corporation is suspect and the allocation of income and deductions between the new corporation and the old corporation may be rearranged under the broad authority of the Commissioner under section 482 (section 45 of the old law) where necessary to prevent evasion of taxes or clearly to reflect the income.\textsuperscript{129}

Moreover, the enactment of section 382 (b) provides a pattern for acquiring the full benefits of a net operating loss carry over where a 20\% or greater interest in the new corporation is maintained by the owners of the old corporation. Section 382 (b) would seem to stand on its own feet in permitting the full carry over (or a reduced proportionate part of the carry over where less than a 20\% interest is held by the shareholders of the old corporation). Nevertheless, the Senate committee report contains the warning that "the fact that the limitation under this section [section 382 (b)] does not apply shall have no effect upon whether 269 applies."\textsuperscript{130} Logically it would seem that section 269 would be unnecessary in view of the specific safeguards under section 382 (b). At least a case in which a limitation under section 382 (b) does apply should be reasonably safe from section 269.

\section*{VI. Other Tax Problems and Decisions to Be faced In A New Corporation}

The preceding discussion has covered basic problems and methods in the organization of a new corporation, including its acquisition of assets necessary to the conduct of business. There are, however, many other

\textsuperscript{130} S. Rep. 284.
problems and decisions to be made that may prove very costly if overlooked; there are also other benefits that may determine the choice between otherwise available alternative methods of organization.

The matters to be discussed below are not all applicable solely to new corporations. Accordingly, the purpose here is not to present a complete discussion of all ramifications of the problems but rather to present an outline of considerations that should be taken into account in determining to operate through a new corporation.

A. Thin Incorporations; Collapsible Corporations

Problems involving "thin incorporations" and the "collapsible corporation" are still to be reckoned with under the 1954 Code. These problems have become of major importance in recent years. The 1954 Code does not change the basic nature of the problems but a check list of danger points on organization of a new corporation under the new tax law would be incomplete without reference to them.

The two subjects have in common only the fact that the foundation for problems — or the avoidance of problems — in these fields may be laid on the organization of the corporation. The thin incorporation problem generally arises in cases in which stockholders take debt paper in addition to stock for their investment in the corporation. Where the debt is in proportion to stock holdings and the need for a greater amount of capital than was paid in for stock alone may reasonably have been anticipated, the debt paper may be questioned as to whether it, in fact, does not represent a stock interest. Of course, these factors alone will not generally be sufficient to determine the matter; but they are among the most important to be aware of in organizing a corporation.

The thin incorporation problem is a "sleeper" in that it will generally not arise until later in the corporation's life, such as when a deduction for interest on the debt is questioned on examination of a return. It may also arise upon examination of the stockholder's returns if payments of principal on the debt are made and the Revenue Service asserts such payments are dividends. The problem may also arise if a business bad debt loss is claimed, which the Revenue Service asserts is to be treated only as a capital loss on worthlessness of stock.

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130 See Bryson, Stockholder Loans: "Thin" Capitalizations, 8 N.Y.U. Inst. On Fed. Tax 752, 741 (1950); Sam Schnitzer, 13 T.C. 43 (1949); aff'd per curiam, 183 F. 2d 70 (9th Cir. 1950).

131 Bryson, Ibid.

132 See cases collected in Rabin, Fat Advantages of the Thin Corporation, 32 Taxes 572 (1954).

133 But see Rabin, Ibid.

134 See §§ 165(g) and 166.
The 1954 Code did not provide any formula for determining when a corporation is too thinly capitalized. On the other hand, the provisions of section 351 may be taken to encourage the issuance of bonds on organization of a corporation because of the elimination of the requirement for a tax free exchange under the prior law that stock and securities be issued in proportion to the property transferred to the corporation. Efforts to take advantage of this change in law by the issuance of a higher proportion of bonds where stock normally would be issued may give rise to new applications of "thin incorporation" rules.

The treatment of collapsible corporations in the statute has been substantially expanded since the provision was first added in 1950. At one time, it might have been considered a highly limited problem restricted to certain temporary corporations manufacturing, producing or constructing property. Later modifications, particularly those made in section 341 of the 1954 Code, require awareness of the provision in organizing a new corporation.

A basic fact is that any corporation that may have to be liquidated in three years may present problems as a collapsible corporation. The penalty is that the shareholders may be considered in receipt of ordinary income on the liquidation or sale of their stock.

The fact that a taxpayer may have ordinary income on sale of stock, and not solely on the unusual event of liquidation, points up the possibility of an unexpected application of the collapsible corporation provisions. This is particularly the case under the 1954 Code. A collapsible corporation is defined as one formed or availed of principally for the manufacture, construction, or production of property, for the purchase of "collapsible assets" (i.e., "section 341 assets") or for the holding of stock in a corporation so formed or availed of, with a view to converting ordinary income, to which the corporation would be entitled, to capital gain in the hands of the shareholders upon sale of their stock or on liquidation. This definition suggests the obvious need for protecting the record of a corporation upon organization, and particularly in its early life, so that the purposes under section 341 cannot be ascribed to it.

However, the new Code adds a presumption that a corporation is a col-

\[\text{\footnotesize\textsuperscript{236}}\text{The House attempted a definition of "securities" in \$ 312(c) of H.R. 8300, but this was dropped in the general return, in the bill as finally enacted, to the pattern of the 1939 Code on the subject of corporate distributions and reorganizations.}\]

\[\text{\footnotesize\textsuperscript{237}}\text{See supra, 345.}\]

\[\text{\footnotesize\textsuperscript{238}}\text{\$ 117(m) of the 1939 Code, as added by \$ 212 of the Rev. Act. of 1950.}\]

\[\text{\footnotesize\textsuperscript{239}}\text{See \$ 341(b) (3) and (d) (3).}\]

\[\text{\footnotesize\textsuperscript{240}}\text{\$ 341(a).}\]

\[\text{\footnotesize\textsuperscript{241}}\text{\$ 341(b) (1).}\]
lapsible corporation if the fair market value of its collapsible assets is 50% or more of the fair market value of its total assets and 120% or more of the adjusted basis of its collapsible assets.142 In addition, the new law includes as collapsible assets, property used in trade or business of a kind that, upon a sale, would give rise to capital gain, but not including such property used in connection with the manufacture, construction, production or sale of collapsible assets.143 Thus, property used in the trade or business by a service corporation may be collapsible assets and may unexpectedly give rise to the application of the presumption under section 341.144

On the other hand, section 341 has some rather broad escape clauses. It does not apply to stockholders owning 5% or less in value of the stock.145 It does not apply to gain realized after holding the property three years.146 Most interestingly, and despite the presumption of what constitutes a collapsible corporation, the section does not apply at all if 30% or more of the gain is attributable to non-collapsible assets.147 In other words, up to and including 70% of the gain realized by a shareholder may be attributable to collapsible assets, but section 341 will not require any part of the gain to be treated as ordinary income.148 Nevertheless, there are obvious valuation and attribution problems in the application of these escape provisions; accordingly, advance warning of the possibilities under section 341 is frequently a necessary part of the advice to be given upon organization of a new corporation.

B. SALES TO A NEW CORPORATION BY SHAREHOLDERS

The acquisition of assets by a new corporation in a tax free exchange has previously been described as the normal method under which a corporation acquires the assets or property with which it will begin to do business, including the acquisition of assets from a predecessor corporation. In such tax free exchanges the new corporation will carry over the basis of the assets so acquired.

Where the new corporation also acquires assets by purchase from its

142 § 341 (c).
144 § 341 (d) (1). But note that certain rules for constructive ownership of stock apply as provided in the last sentence of § 341 (d).
145 § 341 (d) (3).
146 § 341 (d) (2). This is the same as under the 1939 Code § 117 (m) (3) (B), as added by § 326 (b) of the Revenue Act of 1951.
147 However, the proposed regulations would allocate basis first to the non-collapsible assets thus increasing the gain attributable to collapsible assets for purpose of the 70% rule. See Treas. Dept. Regs. (proposed), § 1.341-4 (c) (2).
shareholders, several other problems may arise. The first of these problems is to determine whether the acquisition was a purchase or an exchange or a capital contribution. Important effects will ride on these decisions both from the standpoint of the shareholder and the corporation (such as with regard to the basis of the assets so acquired). The second of these problems arises where a recognized sale is made, but, for reasons of tax policy, the statute may deny a loss on the sale by the shareholder or treat his gain as ordinary income.

A transfer of property to a corporation as a contribution to capital gives rise to no gain or loss to the contributor,\textsuperscript{149} and results in a carryover of basis of the property in the hands of the corporation.\textsuperscript{150} Ordinarily upon organization of a corporation, a transfer of property to it for its controlling stock (80\%) cannot be regarded as a "sale" for tax purposes but will be regarded, under Section 351, as a tax free exchange. A bona fide sale may be made by shareholders to a corporation, but where tax advantages ensue therefrom the treatment of the transaction as a sale is likely to be suspect. If the sale is for cash, the sale will be treated as a sale rather than as a tax free exchange.\textsuperscript{151} However, if the sales price is more than the fair market value of the property,\textsuperscript{152} or if the shareholder receives other property in addition to stock on the exchange, a taxable dividend may result.\textsuperscript{153} Whether a purported "sale" will be so treated will, in the final analysis, depend upon the true nature of the transaction.\textsuperscript{154}

The new Code may make it more difficult for the Commissioner to treat as sales certain types of transfers of property to controlled corporations. This results from the elimination of the proportionate interest test. For example, property may be transferred to a corporation in exchange for stock and long term securities without recognition of gain to the transferor under section 351. The receipt of the long term securities may have the purpose and benefits of a sale, as far as the transferor is concerned, but the reporting of gain is deferred in accordance with the terms for payment of the securities. It cannot be expected that this device will succeed where

\textsuperscript{149} But there may be gift tax consequences, i.e., a taxable gift to the corporation of the other shareholders. S.F. Heringer, 21 T.C. 607 (1954); F. B. Thompson, 42 B.T.A. 121 (1940); but cf. R. H. Scanlon, 42 B.T.A. 997 (1940).

\textsuperscript{150} § 362(a) (2).


\textsuperscript{152} Cf. Castle, 9 B.T.A. 931 (1927).

\textsuperscript{153} § 356(a) (2). See also discussion supra, note 45.

\textsuperscript{154} In Böckle, 20 B.T.A. 784 (1930), a "sale" ordered by the Probate court of property of minor devisees to the corporation was treated as a tax-free exchange, no cash being involved.
the new corporation is a mere "dummy," but where the corporations operates a bona fide business the validity of the obligation should be recognized.

Sales to a controlled corporation for purposes of creating a deductible loss, or for purposes of creating a gain which will give the corporation a stepped up basis, have been attacked in prior revenue acts and receive but little amplification in the Internal Revenue Code of 1954. Section 267 disallows deductions for losses from sales or exchanges of property, directly or indirectly, between shareholders and a controlled corporation. In relation to such transfers, the new Code adds a provision disallowing a deduction in the event of transfer between the fiduciary of a trust and a corporation more than 50% owned by or for the trust, or by or for a person who is a grantor of the trust.

Section 1239 of the new Code continues the rule added in 1951 that treats as ordinary income the gain on the sale of depreciable property to a corporation controlled by a sole stockholder or his family. The purpose of this provision is to limit the benefits of sales to a controlled corporation for the purpose of giving the corporation a stepped up basis for depreciation purposes. The deterrent effect under this provision, however, is limited. Moreover, its application is very narrow since it is restricted to cases in which an individual, his spouse, his minor children and minor grandchildren own more than 80% in value of the stock of the corporation. Thus, the statute has no application where 20% or more of the stock is owned by others, including such others as the principal stockholder's brother or other relatives outside the classes listed in the statute. Perhaps the real deterrent to such transaction is the interminable argument that will result with the Internal Revenue Service as to the value of the property sold to the corporation, and the possible application by the Commissioner of his

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156 Cf. Hollywood, Inc., 10 T.C. 175 (1948) (transferee treated as independent of the transferors and its promise to pay treated as consideration in addition to stock transferred). But as to the dangers of bonds issued in a thin incorporation, see supra, 374 et. seq.


158 Previously § 117 (o) of the 1939 Code as added by § 328 of the Rev. Act of 1951.

159 In the case of a married individual in the 50% bracket (before income splitting) the capital gains tax and the ordinary income tax are the same. If the new double declining balance depreciation is available to a second or subsequent user with respect to property completed after December 31, 1953, the income tax on the transferor-shareholder may be less than the benefits of increased depreciation to the corporation.

157 See supra, 377.
authority to reallocate income in order to prevent evasion or properly to reflect the income.

C. CONTRIBUTIONS TO CAPITAL

A further word should also be said about the provisions of the new Code as to the effect of contributions of capital. As previously indicated, section 118 provides that gross income of a corporation does not include any contribution to its capital. This merely states the law as developed under the prior Code without the benefit of a statutory provision.161 More important, the new Code now provides a specific rule with respect to the basis of contributions to the capital of a corporation made other than by a shareholder.162 Under this new rule, if the contribution is in property other than money, the basis of the property in the corporation's hands is zero. If the contribution from the non-stockholder is in money, the basis of property acquired or held by the corporation is reduced by the amount of the contribution.163 These rules constitute a reversal of the doctrines enunciated by the Supreme Court in the Brown Shoe Company case.164 The statute, however, by no means settles the problems in the field because it does not define a "contribution." Thus, there is still room for argument by the Government or a corporation that certain "contributions" were payments for services or for sales, where it may be of interest to the particular party to make the argument.165

D. DISALLOWANCE OF SURTAX EXEMPTION AND ACCUMULATED EARNINGS CREDIT

In establishing a new corporation to carry on a department or activity of an old corporation, attention must be given to the provisions of section 1551 which disallows the $25,000 surtax exemption unless the taxpayer can establish by a clear preponderance of the evidence that the securing of such exemption was not a major purpose of such transfer. The statute applies the same test with regard to the $60,000 accumulated earnings credit, which is available to corporations as a defense against the tax on accumulated earnings.166 This is another provision that stands as a threat to taxpayers, but which is difficult of successful application by the Com-

162 § 362(c), applicable only to contributions on or after June 22, 1954.
165 In Detroit Edison Co. v. Com'r., 319 U.S. 98 (1943), the Supreme Court held that payment for transmission lines by customers did not give the taxpayer a basis for depreciation of such lines. But what if the corporation had reported such payments as income?
166 See § 335(c) as discussed supra, 335-336.
An adequate record of a business purpose in establishing a new subsidiary appears to be a sufficient defense to the threatened disallowance of the surtax exemption, as it has been in the cases of attempted disallowance of loss carryovers.\textsuperscript{167}

\section*{E. STOCK OPTIONS}

The organization of a new corporation may create problems in the case of employees who had options to purchase stock of the old corporation. If their rights are to be preserved, special attention must be given to section 421 of the new Code which spells out in detail rules on this subject, and particularly new rules in the event of corporate reorganizations and similar transactions.

Under the prior law uncertainty existed because an employee was required to be an employee of the corporation granting the option, or of the parent or the subsidiary thereof, at the time the option was exercised, if he was to obtain the benefits of the statutory provisions treating the exercise of a restricted stock option as a non-taxable event. The new law continues the general principle that the individual, at the time he exercises the restricted stock option, must be an employee of either the corporation granting such option, a parent or subsidiary thereof, or he must exercise the option within three months after he ceases to be such an employee.\textsuperscript{168} In addition, it is sufficient, under the new law, if the employee, within the time provided, is an employee of a corporation, or a parent or subsidiary of such corporation, issuing or assuming a stock option by reason of a corporate merger, consolidation, acquisition of property or stock, separation, reorganization, or liquidation.\textsuperscript{169} The effect of the statute is to permit the assumption of the old option or substitution of a new option whenever necessary to preserve the rights of an employee by reason of such a corporate transaction. There are two limitations under the statute, however.\textsuperscript{170} One is to the effect that the aggregate spread between the option price and the value of all stock subject to the option must stay the same. The second is that the new

\begin{footnotesize}
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\item \textsuperscript{167} Alcorn Wholesale Co., 16 T.C. 75 (1951); Berlands, Inc., 16 T.C. 182 (1951). An interesting possibility under the new Code arises from the combination of the $60,000 minimum credit for the accumulated earnings tax and the provision (§ 543) (a) (7) ) that rents of in excess of 50\% of gross income do not constitute personal holding company income. A new corporation may be formed with assets consisting solely of securities and rental property and so long as the rents are more than 50\% of gross income and no more than $60,000 is accumulated, the income will be subject only to the regular corporation rate. The Revenue Service, however, may demand a business purpose in such cases.
\item \textsuperscript{168} § 421 (a) (last sentence).
\item \textsuperscript{169} § 421 (g).
\item \textsuperscript{170} Ibid.
\end{itemize}
\end{footnotesize}
ORGANIZATION OF A CORPORATION

option, or the assumption of the old option, does not give the employee additional benefits which he did not have under the old option.

Despite these changes, the new law leaves a pitfall in cases in which an employee with a stock option becomes an employee of a new subsidiary. It is true that generally the benefits of the statute are available if the employee, at the time of exercise of the option granted by the parent corporation, is an employee of a subsidiary corporation. However, the statute defines parent and subsidiary corporations as those having such relationship at the time of the granting of the option. Accordingly, should an employee of the parent corporation shift his status to that of an employee of a subsidiary formed or acquired after the granting of the stock option by the parent, there is danger that the benefits of section 421 will not be available because the subsidiary will not be a "subsidiary" within the meaning of that section of the law. To prevent loss of the statutory benefits it may be necessary to keep a dual employment (i.e., with the parent as well as subsidiary) or have the parent corporation renew the option after the subsidiary is formed or acquired.

F. OPTIONS AND ELECTIONS THAT ARE AVAILABLE TO A NEW CORPORATION

In the discussion of section 381, consideration was given to certain tax attributes that are required to be carried over to a corporation acquiring the assets of another corporation. In connection with that discussion, it is pointed out that the carryover of such attributes may confer benefits and burdens and that these may be determinative in making a decision as to whether or not an acquisition may be completed in such form that it would qualify under section 381. In addition to the tax attributes under section 381 there are other decisions as to tax items which a new corporation will be required to make before filing its first income tax return. As indicated, some of these decisions may be made for it by the provisions of section 381. Listed below are corporate options and elections which, assuming they are not made by section 381, would be required to be made or should be considered before filing the first return of the new corporation:

(1) Selection of a taxable year. A new corporation may select its annual accounting period, which must be the period on the basis of which it regularly computes its income in keeping its books. The election is

§ 421(d)(2) and (3).

As previously indicated, no attempt has been made to cover problems of special type corporations, such as personal holding companies which have elections and options under §§ 545, 547, 563, and 565, and regulated investment companies (as to which see §§ 853, 855). Corporations engaged in the business of farming should also see § 175 (soil and water conservation expenditures) and § 77 (loans from the Commodity Credit Corporation).
made by filing the first taxable year return on the method so selected. Under the new Code a 52-53 week year may be selected (section 441).

(2) Establishment of a method of accounting (section 446). In addition to the cash or accrual method, the corporation may give consideration to adopting the installment method (section 453), the reserve for bad debt method (section 462), the LIFO inventory method (section 472), the election to accrue real property taxes ratably (section 461(c)), and the option to report the increase in redemption price of certain non-interest bearing obligations issued at a discount (section 454).

(3) The election to exclude income resulting from discharge of indebtedness (section 108).

(4) Depreciation methods. These include: election to use the double declining balance method of depreciation; the sum of the digits method; or a similar consistent method in lieu of the straightline method of depreciation (section 167); the election for 60 months' amortization of emergency facilities (section 168). A subsidiary election here is whether the beginning date of the 60-month amortization shall be the month following the month in which the facility was completed or acquired, or the succeeding taxable year (section 168(b)). (See also section 169 relating to amortization of grain storage facilities).

(5) The election to deduct charitable contributions in the year of authorization instead of the year paid, when paid on or before the 15th day of the third month following the close of the taxable year of authorization (section 170).

(6) The election with respect to amortizable bond premiums (section 171).

(7) The election to capitalize circulation expenditures, that is those to establish, maintain, or increase the circulation of a newspaper, magazine, or other periodical (section 173).

(8) The election to amortize research or experimental expenditures. The election may be made without the consent of the Commissioner for the first taxable year for which such expenditures are paid or incurred (section 174).

(9) The election to amortize organizational expenses, as previously discussed (section 248).

(10) The election to capitalize taxes and carrying charges as are chargeable to capital account instead of deducting them (section 266).

(11) Various options available with respect to natural resources under sections 263(c), 611, 612, 613, 614, 615, 616 and 631.

(12) The election to treat foreign taxes as a credit rather than as a deduction (section 901). Related to this is the election as to the year in which the credit may be taken (section 905).
(13) The election to defer gain on involuntary conversions (section 1033). (See also section 1071 under which a taxpayer may treat as an involuntary conversion a sale or exchange to effectuate the policy of the Federal Communications Commission).

(14) The election to file a consolidated return (section 1501). Related to this is the election by the affiliated corporations as to the allocation of tax (section 1552).

(15) Application for extension of time for filing return (section 6081(b)).

(16) The election to use the wage bracket tables instead of the percentage method in withholding income tax from wages of employees (section 3204).

(17) The election to pay tax in installments (section 6152).

(18) The election to report items on the return in whole dollar amounts (section 6102).

VII. Conclusion

On balance, it can be said that the Internal Revenue Code has not materially simplified the tax problems in organizing a new corporation. There are a number of new provisions that eliminate troublesome questions under the prior law, such as the elimination of the proportionate interest rule (section 351) and the addition of the rule treating transfers of assets to a subsidiary in exchange for the parent corporation's stock as a tax free reorganization (section 368(a)(1)(C)). These, however, like many of the new provisions discussed, are of general application and not solely directed to problems in establishing new corporations. The one provision specifically directed to aid new corporations, the amortization of organizational expenses, is so hedged as to be of limited benefit.

The new rules, and the problems thereunder, relating to new corporations mirror the overall strength and weakness of the new Code. On the one hand, mechanical tests added in the new Code will provide a clear tax road where transactions can be shaped to fit the tax formula so given. On the other hand, where the transaction is complex and does not fit neatly into the groove of a particular statutory provision, the problems of interpretation under the new Code are just as severe as under the prior law, and in some cases the results may be even more mysterious because of the presence of the mechanical formulae and new language. In a word, the tax law suffers from the complexities of our society and the attempts to write more and more rules to fit complex situations. It is still true that in the organization of a corporation, as well as in most complex problems, the tax law is complicated and each step requires the most careful check lest unforeseen results occur.