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Incorporating Tax Free--Basic Requirements under Section 351 of the International Revenue Code

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corporation" to exempt the corporation from income tax by electing to include the corporation's currently taxable income in their own personal returns, provides a means for eliminating one of the objections to the corporate form, namely that of double taxation of corporate income. However, the severe limitations upon the application of these provisions and the possibility of future changes in the law restrict their usefulness.[3]

Attention must also be given to the continuing success of the Commissioner of Internal Revenue in litigating cases involving the "collapsible corporation" issue, with the consequent treatment of gain to shareholders upon sale of stock or liquidation of the corporation as ordinary income. These cases forcibly demonstrate the need for caution in using a corporation for tax saving purposes.[4]

Another pre-incorporation decision which has received increasing attention is whether to have one corporation or multiple corporations. This decision also involves resolution of a related question: whether to use a parent-subsidiary relationship or that of sister corporations? Here again caution must be exercised because of the continuing efforts of the Commissioner of Internal Revenue in attacking the tax advantages of multiple corporations under the same or related ownership.[5]

II

INCORPORATING TAX FREE — BASIC REQUIREMENTS UNDER SECTION 351 OF THE INTERNAL REVENUE CODE

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The basic statutory rules for the tax-free transfer of a business or property to a new corporation are found in section 351 of the Internal Revenue Code. As a fundamental principle, it should be kept in mind that this rule, like certain others in the Internal Revenue Code providing for *tax-free* exchanges, is an *exception* to the *general rule* of the tax law that every exchange for a consideration (in money or money's worth)

3. The provisions of Subchapter S are discussed in greater detail at pp. 225-43.

4. See Sugarman, *Tax Problems Incident To The Disposition of Corporate Owned Real Estate and Collapsible Partnership Provisions*, 11 WEST. RES. L. REV. 230, 238-44 (1960); see discussion pp. 336-38.

5. See Calkins, Coughlin, Hacker, Kidder, Sugarman & Wolf, *Tax Problems of Close Corporations: A Survey*, 10 WEST. RES. L. REV. 9, 15-16 (1959); Katcher, *Tax Problems Incident to The Acquisition of Real Estate — Determining the Form of the Acquiring Entity, The Method of Acquisition, and the Type of Financing*, 11 WEST. RES. L. REV. 145, 152-54 (1960).

is to be treated like a sale which may give rise to taxable gain (or loss) based on the difference between the value of the consideration received and the basis of the property exchanged.[1] Therefore, since provisions for tax-free exchanges upon incorporation are an exception to this general rule, it is necessary that there be careful adherence to the statutory provisions providing such exception.

The statutory scheme for the tax-free exchange of property for stock in connection with the organization of a new corporation is in two parts: the provision for the tax-free transfer of property in exchange for stock, and the tax-free issuance of stock in exchange for the property. Section 351(a) of the Code provides the general rule for the tax-free transfer for stock as follows:

> (a) GENERAL RULE. 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 (as defined in section 368(c)) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property.

The other side of the transaction, namely the issuance by the corporation of its stock in exchange for property, is covered by section 1032(a) of the Internal Revenue Code, which reads as follows:

> (a) NONRECOGNITION OF GAIN OR LOSS. No gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation.

To complete this general statutory scheme, other rules are prescribed. The transferor, who receives stock in exchange for his property, substitutes the adjusted basis of the property transferred as the basis for the stock received on the exchange.[2] The corporation receiving the property continues to use, as its basis for the property, the basis which the property had in the hands of the transferor-stockholder.[3] This treatment of basis is consistent with the concept that the exchange of property for stock under section 351 is merely a transformation of the form of ownership which is not a sufficient realizing event to give rise to tax; therefore, the basis of the property involved is not adjusted, and potential gain at the time of the exchange, reflected in the actual value of the property above its basis, may be subjected to tax at a later date. Thus, the matter of basis is extremely important, for, as shall be seen from later discussion, it poses

1. INT. REV. CODE OF 1954, § 1002 (Hereinafter cited as §), (recognition of gain or loss on a sale or exchange). See also § 1031 (non-recognition of gain or loss on certain types of exchanges).

2. § 358.

3. § 362.

at the outset an important decision: Is it better to transfer property to the corporation in a tax-free exchange which may shift a future tax to the corporation? Or should the transaction be qualified as a taxable exchange which, while it may result in an immediate tax to the transferor, can provide future tax benefits?[4]

There are exceptions to the general basis rules, as set forth above, which arise when the transaction is not a simple transfer of property solely in exchange for stock or securities as prescribed under the general rule of section 351. If the transferor receives, in addition to stock or securities permitted to be received under the general rule, other property or money, then gain is recognized to the transferor, but not in excess of the amount of money received plus the fair market value of the other property received.[5] However, if such money or other property received (in addition to stock or securities) is worth less than the property transferred to the corporation, no loss is recognized to the transferor.[6]

Where the corporation receiving the property assumes a liability or acquires the property subject to a liability, then other special rules apply.[7] Since this topic will be explored in greater detail in another article,[8] only brief reference will be made to it here. In general, the assumption of liability by the corporation is not considered, for the purposes of section 351, as additional consideration or as a payment of "other property" by the corporation to the transferring shareholder; but the shareholder's basis for his stock is reduced to the extent of the assumption of such liability.[9] This is an application of the general rule that the shareholder's basis for the stock received is decreased by the fair market value of property and money he receives in addition to stock, and is increased by the amount of gain which is recognized on the exchange. Thus, to the extent that the shareholder receives "other property" which results in a tax, the shareholder acquires a new basis for such other property equal to its fair market value (the basis on which the tax would be determined).[10]

SATISFYING THE TECHNICAL REQUIREMENTS OF SECTION 351

If a tax-free incorporation is desired, how can one be sure that he has complied with the statutory provisions which determine that result? This requires a careful analysis of the statutory terms and a testing of their

4. See discussion pp. 209-10.
5. § 351(b)(1).
6. § 351(b)(2).
7. § 357.
8. See discussion pp. 197-98.
9. § 358.
10. § 358(a)(2).

application to the particular facts of the case. The task is complicated by the interdependence of the terms of the statute.

"Transfer of Property"

The first phrase of importance is "transfer of property." The term "property" is the key word because it is the exchange of "property" for "control" of the corporation that gives rise to tax-free treatment. Thus, the question frequently arises as to whether there is a tax-free exchange of property under section 351 where some of the shareholders pay money for stock and the other shareholders exchange property for stock. The Internal Revenue Service formerly took the position that money was not "property" for this purpose and hence in determining "control" the shareholders transferring property (other than money) did not have a tax-free exchange unless they had the requisite control themselves. However, the courts have held, and the Internal Revenue Service has now agreed, that money does qualify as "property" for purposes of section 351; therefore, where both money and property are transferred in exchange for stock, the exchange is tax-free if the transferors together, including those paying in only money, have the necessary control.[11]

Other types of "property" which qualify under section 351 are creditors' claims,[12] stock or securities in another corporation,[13] stock options,[14] installment obligations and accounts,[15] and other intangibles such as goodwill, know-how, and trade secrets.[16] However, if these latter, intangible items are not clearly defined as property, the stock issued may be treated as issued for services, which are not "property."[17] The treatment of stock issued for services is discussed in detail in another article.[18]

11. Halliburton v. Commissioner, 78 F.2d 265 (9th Cir. 1935); G.C.M. 24415, 1944 CUM. BULL. 219. See also Rev. Rul. 57-296, 1957-2 CUM. BULL. 234 (acquisition not a "purchase" under § 344(b)(2)).

12. Helvering v. Cement Investors, Inc., 316 U.S. 527 (1942); Gage Bros. & Co., 13 T.C. 472 (1949), *acq.*, 1950-1 CUM. BULL. 2; Alexander E. Duncan, 9 T.C. 468 (1947), *acq.*, 1948-2 CUM. BULL. 2; Rev. Rul. 57-296, 1957-2 CUM. BULL. 234. *But cf.* United States v. Santa Inez Co., 145 F.2d 667 (9th Cir. 1944), *cert. denied*, 324 U.S. 879 (1944); Civic Center Fin. Co. v. Kuhl, 83 F. Supp. 241 (E.D. Wis. 1948), *aff'd per curiam*, 177 F.2d 706 (7th Cir. 1949) (latter two cases treat the transfer and the issuance of stock as separate transactions).

13. G.C.M. 7285, IX-1 CUM. BULL. 181 (1930). See also § 317(a). In the case of a transferor-corporation, property may include treasury stock. 3 MERTENS, FEDERAL INCOME TAXATION § 20.47 (1957).

14. But note that a transfer under § 351 is a "disposition" under § 421.

15. Treas. Reg. § 1.453-9(c)(2) (Hereinafter cited as Reg.), (no income upon disposition of installment obligation under § 351); G.C.M. 4196, VII-2 CUM. BULL. 241 (1928).

16. *Cf.* Huckins v. United States, 60-1 U.S. Tax Cas. ¶ 9394 (S.D. Fla., Apr. 1, 1960); Sidney V. Levine, 24 T.C. 147 (1955), *acq.*, 1956-1 CUM. BULL. 4; George S. Mepham, 3 B.T.A. 549 (1926), *acq.*, V-2 CUM. BULL. 2 (1926).

17. § 351(a) (last sentence).

18. See discussion pp. 194-96.

Transfers of certain types of property may give rise to special problems under section 351. For example, the taxpayer is required to walk a "tight rope" where the property transferred to the corporation is a contract involving services rendered by the transferor. The courts have recognized that such contracts may be transferred to a corporation in a tax-free exchange for stock under the provisions of section 351. In such a transaction, the uncollected service fees do not constitute taxable income to the transferor.[19] But it can be expected that the Internal Revenue Service will scrutinize any such transfers carefully and may successfully argue in some cases that the transferor constructively received the income that may have already been earned on such contracts.[20]

The transferor's method of accounting may also have tax consequences in connection with the transfer of property to the new corporation. Thus, a cash-basis taxpayer, who transfers a service contract to a cash-basis corporation, may not be taxed on uncollected service fees (unless the doctrine of constructive receipt applies);[21] but if the transferor-shareholder is in a business using the completed contract method of accounting, then there is authority for imposing tax on the transferor on income earned under such contract, but unrealized at the time of the transfer of the contract to the corporation.[22]

Where there is a transfer from a cash-basis taxpayer to an accrual-basis corporation of receivables that were not taxed to the transferor as income because he had not yet received payment, it might be argued that they should not be taxed to the transferee-corporation either; with the accrual method, such amounts would properly have been accrued in a prior period. Obviously, however, the Internal Revenue Service will not permit such income to go untaxed. The sound practice would be to have the accrual basis transferee-corporation report the income upon receipt of the contracts or property, even though it has not yet received the cash.[23]

The accounting treatment involved may also give rise to some additional problems and disadvantages, because the corporation is a new taxpayer and not the same entity as the shareholders who established it. Thus, if the "Lifo" inventory method was used by the business prior to

19. Fontaine Fox, 37 B.T.A. 271 (1938); Thomas W. Briggs, 15 CCH Tax Ct. Mem. 440 (1956). See also Commissioner v. Montgomery, 144 F.2d 313 (5th Cir. 1944); Roberts Co., 5 T.C. 1 (1945).

20. H. Lewis Brown, 40 B.T.A. 565 (1939). Care must also be taken to avoid the corporate pitfall of a personal holding company under §§ 541-47.

21. Thomas W. Briggs, 15 CCH Tax Ct. Mem. 440 (1956).

22. Standard Paving Co. v. Commissioner, 190 F.2d 330 (10th Cir. 1951).

23. This frequently will be advantageous because it may permit the new corporation to pick up the income in a possibly lower tax bracket than that of the individual transferor-stockholder, while the individual will have the benefit of the expense deductions giving rise to the income.

incorporation, it may not be used by the new corporation unless it specifically so elects.[24] In the case of a business which was using one of the new, fast methods of depreciation (such as double declining balance depreciation), which are applicable only to new, depreciable property, the benefits of such methods are lost when the property is transferred to the corporation, since the property is not new when received by the transferee-corporation.[25] Other ramifications of the accounting method are discussed in a subsequent article concerning the elections to be made by the new corporation.[26]

The requirement that there be a "transfer" of property can give rise to further problems. For example, it has been argued that the assignment of patent rights to a corporation in exchange for stock will be tax-free if it is a transfer equivalent to a sale of all right, title and interest to the patent; but if the corporation merely receives a license, then the transaction does not fall within the purview of section 351 and the licensor may be in receipt of ordinary income to the extent of the value of the stock received.[27] In other situations it is important to determine whether the "transfer" was a loan or a transfer under section 351. Where a corporation makes a payment to the transferors, there will be no tax consequences if the corporation is merely repaying a loan of assets, but the payment may be taxable as a dividend if the assets were first made available as a transfer rather than as a loan.[28] However, in some cases it may be advantageous that the transfer be a taxable sale rather than tax-free under section 351. The possibilities and advantages of such a transaction are discussed in a later article.[29]

"One or more persons," "in control" of the "corporation," "immediately after" the exchange

Another requirement under section 351 is that "one or more persons" must be "in control" of "the corporation" "immediately after" the exchange. These terms must be considered both separately and together in order to obtain the full meaning of the statutory requirement.

It is clear under the statutory interpretations that "one or more persons" includes individuals, trusts, estates, partnerships, associations, com-

24. Textile Apron Co., 21 T.C. 147 (1953).

25. Reg. § 1.167(c)-1(a)(6).

26. See discussion p. 208.

27. Claude Neon Lights, Inc., 35 B.T.A. 424 (1937), *acq.*, 1944 CUM. BULL. 5 (held "transfer" of property); *cf.* Halliburton Oil Well Cementing Co. v. Wiseman, 60-1 U.S. Tax Cas. ¶ 9328 (N.D. Okla. March 2, 1960).

28. Moll v. Carey, 57-1 U.S. Tax Cas. ¶ 9497 (N.D. Ohio 1957) (held repayment of loan).

29. See discussion pp. 209-10.

panies, or corporations.[30] It is equally clear that in determining whether such "one or more persons" have control, such control is determined by the ownership within the transferors as a group.[31] It is not necessary that each member of the group transfer property to the corporation at the same time and receive stock in exchange concurrently. The test applied by the Internal Revenue Service is basically that the transfers and the exchanges between the members of the group and the corporation must be part of one plan or transaction occurring over a reasonable period consistent with orderly procedure.[32] Thus, where the transfers and the issuance of the stock are not to take place at the same time for all members of the group, it is advisable to have some plan in writing, or other evidence to establish that the exchanges were part of a plan constituting one transaction in which the stock necessary to constitute control was acquired by the particular group.

The term "control" is a term which is precisely defined as, "the ownership of stock possessing at least 80 per cent of the total combined voting power of all classes of stock entitled to vote and at least 80 per cent of the total number of shares of all other classes of stock of the corporation."[33] Control is determined only with respect to outstanding stock, not authorized but unissued or treasury shares.[34] Thus, the mere fact that the corporation has been authorized to issue a certain number of shares does not preclude a tax-free exchange under section 351 of the Code, even though less than eighty per cent of the authorized shares are issued. Similarly, options to acquire stock are not included in determining control.[35] However, caution must be exercised that options or other arrangements for the issuance of additional shares or the transfer of those shares which are already issued do not bring into play the "step transaction" doctrine, resulting in a portion of the shares being considered to be

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30. Reg. § 1.351-1(a)(1); Rev. Rul. 56-330, 1956-2 CUM. BULL. 204.

31. George P. Skouras, 45 B.T.A. 1024 (1941), *acq.*, 1942-2 CUM. BULL. 17; *cf.* Griswold Co., 33 B.T.A. 537, 543-44 (1935), *acq.*, XV-1 CUM. BULL. 10 (1936). The prior requirement, that the interest of the stockholders must be substantially proportionate to the property transferred, was discontinued under the 1954 Code. Reg. § 1.351-1(b).

32. The statute "does not necessarily require simultaneous exchanges by two or more persons, but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure." Reg. § 1.351-1(a)(1).

33. § 368(c). But "control" is defined differently for other purposes. See Calkins, Coughlin, Hacker, Kidder, Sugarman & Wolf, *Tax Problems of Close Corporations: A Survey*, 10 WEST. RES. L. REV. 9, 28 (1959). See also § 267(b)(9); Jacob M. Kaplan, 21 T.C. 134 (1953), *acq.*, 1954-1 CUM. BULL. 5.

34. Louangel Holding Corp. v. Anderson, 9 F. Supp. 550 (S.D.N.Y. 1934); American Bantam Car Co., 11 T.C. 397 (1948), *aff'd per curiam*, 177 F.2d 513 (3d Cir. 1949), *cert. denied*, 339 U.S. 920 (1950).

35. American Wire Fabrics Corp., 16 T.C. 607 (1951), *acq.*, 1951-2 CUM. BULL. 1; Daisy M. Ward, 29 B.T.A. 1251 (1934), *appeal dismissed*, 79 F.2d 381 (8th Cir. 1935), *nonacq.*, XIII-1 CUM. BULL. 31 (1934).

held by others than the transferors "immediately after the transaction." This problem is discussed in more detail in a subsequent paper.[36]

It should be noted that section 351 applies both to a situation in which control is acquired at the time of the exchange of property for stock and to a situation in which the shareholders were previously in control and continued in control after the exchange.[37] In the first situation, the time of acquisition of control may be critical. A recent case involved that problem. *A* and *B* were equal partners. On January 1, 1953, *B*, desiring to retire from the business, sold his interest in the partnership to *C*. On May 23, 1953 a corporation was formed and within five days thereafter *A* and *C* transferred their partnership enterprise to the corporation and in return each received fifty per cent of the stock of the corporation. The issue in the case turned on whether in substance the transfer to the corporation was by *A* and *B*, with the stock being issued to *A* and *C*, or whether the transfer to the corporation was by *A* and *C*. The court held that the transferors were *A* and *C*, who were in control of the corporation immediately after the exchange, even though the sale from *B* to *C* was part of one plan including the incorporation.[38] It should be noted that the Government argued in this case that the exchange was tax-free, whereas the corporation argued that it was taxable in order to establish a higher basis for depreciation of the property received on the exchange. The Government's position in this case was somewhat different from that which it had taken in other cases wherein it sought a tax at the time of the transfer on the ground that the exchange was taxable. This illustrates that the rules can cut both ways and that a taxpayer seeking a tax-free or a taxable exchange must give careful attention to the substance of the transaction and its timing.

The interdependence of the various terms of section 351 is best illustrated by focusing on the term "corporation" in the first sentence of that section. Ordinarily there is no problem in determining or defining the transferee-corporation that receives the property on the exchange and

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36. See discussion p. 198-201. However, control of the beneficial interest governs; immediate control is satisfied even though stock is held by the personal trustee; G.C.M. 2177, VI-2 CUM. BULL. 112 (1927); same rule where stock deposited in escrow without loss of attributes of ownership. Bondy v. Commissioner, 269 F.2d 463 (4th Cir. 1959); American Bantam Car Co., 11 T.C. 397 (1948), *aff'd per curiam*, 177 F.2d 513 (3d Cir. 1949), *cert. denied*, 339 U.S. 920 (1950). Surrender of right to vote as in a voting trust does not negate control. National Bellas Hess, Inc., 20 T.C. 636 (1953), *acq. in part*, 1953-2 CUM. BULL. 4; Griswold Co., 33 B.T.A. 537 (1935), *acq.*, XV-1 CUM. BULL. 10 (1936); Federal Grain Corp., 18 B.T.A. 242 (1929).

37. Camp Wolters Enterprises, Inc., 22 T.C. 737 (1954), *aff'd*, 230 F.2d 555 (5th Cir.), *cert. denied*, 352 U.S. 826 (1956).

38. Edlund Co. v. United States, CCH 1960 STAND. FED. TAX REP. (60-2 U.S. Tax Cas.) ¶ 9625 (D. Utah July 20, 1960). See also Lodi Iron Works, Inc., 29 T.C. 696 (1958) (later substitute issue of stock does not disqualify); Carel Robinson, 19 B.T.A. 751 (1930), *nonacq.*, X-1 CUM. BULL. 90 (1932); Strouse, Adler Co., 3 CCH Tax Ct. Mem. 641 (1944).

issues stock therefor. However, where the transferee-corporation retains only temporary control of the property, or serves only a tax purpose, the Internal Revenue Service, with some support from the courts, has seen fit to follow the property through to its ultimate destination to determine the transferee-corporation. For example, in *Electrical Securities Corporation v. Commissioner*,[39] property was transferred to *A* Corporation solely in exchange for its stock, and *A* Corporation immediately thereafter transferred the property to *B* Corporation, which issued its stock directly to the stockholders of *A* Corporation, share for share. Thereupon the stockholders of *A* Corporation surrendered their shares in *A*, which was dissolved. The transfer to *A* Corporation in exchange for stock apparently was a step designed to provide a tax-free exchange, since the shareholders of *A* Corporation were in control of that corporation; but they would not have been and were not in control of *B* Corporation; which was the ultimate recipient of the property so transferred. The courts held that *A* Corporation was to be disregarded because it served no business purpose, and that *B* Corporation had to be considered as the transferee corporation, but that the exchange of the property for *B*'s stock did not qualify as a tax-free exchange. The same principle has been applied in other cases in which the device of a temporary corporation to comply with section 351 has been attacked by the Internal Revenue Service.[40]

These cases involving "temporary" corporations have had other ramifications in quite proper situations in which there is a "double section 351" transaction. For example, shareholders may have transferred property to a corporation in exchange for its stock and thereafter, for business reasons, the corporation may transfer all or part of the property to a wholly owned subsidiary which continues to be controlled by the parent corporation. In such a case, the transferors (shareholders) have clearly complied with section 351 in the first transaction, and the parent corporation likewise has made a transfer complying with section 351; but the question may be raised whether this "double section 351" transaction has the net effect of a transfer from the initial transferors to the subsidiary corporation, a corporation which they do not directly control. A variant of this situation may be illustrated as follows. *A* and *B* are members of a partnership. The partnership business is incorporated with all of the stock being issued to *A* and *B*. *A* and *B* then transfer their stock in *AB* Corporation to *C* Corporation as part of a group of transferors who obtain control of *C* Corporation. This again is a "double section 351" transac-

39. 92 F.2d 593 (2d Cir. 1937), *affirming* 34 B.T.A. 988 (1936).

40. Handbird Holding Corp., 32 B.T.A. 238 (1935), *appeal dismissed*, (2d Cir. 1936); *cf.* National Securities Corp. v. Commissioner, 137 F.2d 600 (3d Cir.), *cert. denied*, 320 U.S. 794 (1943); Rev. Rul. 55-36, 1955-1 CUM. BULL. 340. *But cf.* G.C.M. 7285, IX-1 CUM. BULL. 181 (1930).

tion. In this case *AB* Corporation is clearly the transferee of the partnership business (the property). The question is whether *A* and *B* (the individuals) are in "control" or whether new corporation *C* is in control of *AB* Corporation. The substance of the transaction is the same as the one previously described wherein the transferors are in reality in control of the property whether the transactions are regarded as two separate section 351 transactions or one section 351 transaction. In such situations, even though the substance and principles of the statute would appear to give a clear answer that section 351 would apply, nevertheless the taxpayer would be advised to pay attention to the details of the timing of such transfers in order to avoid this type of technical problem.[41]

Stock or Securities

There remains for further consideration the meaning of the phrase "stock or securities" under section 351. It is clear that the term includes stock *and* securities.[42] Thus, shareholders in control of a corporation may also receive securities on the exchange tax free.[43] Neither the statute nor the Regulations define the terms "stock" or "securities,"[44] and the Internal Revenue Service has refused to come forward with precise rules as to their meaning. It has held that stock rights or warrants are not "stock"[45] and that certificates of contingent interests in stock are not stock.[46]

With respect to "securities," the Internal Revenue Service has indicated its position by some rulings, but has announced that it will not rule on transactions where the issuance of a ruling would involve the definition of "securities."[47] The problem is not troublesome generally with respect to short-term notes, which are not considered "securities."[48] The real difficulties arise in connection with long-term notes and the

41. In connection with the last example, it should be noted that the statute (§ 351(c)) expressly permits a corporate transferor to make an immediate distribution of the stock received on the exchange but the same express provision does not apply to an individual. Hence the question arises whether an individual who transfers his stock (received on the first purported § 351 transaction) is in "control."

42. *Cf.* Reg. § 1.368-2(h).

43. Camp Wolters Enterprises, Inc., 22 T.C. 737 (1954), *aff'd*, 230 F.2d 555 (5th Cir.), *cert. denied*, 352 U.S. 826 (1956).

44. As to meaning of terms generally, see cases collected in 3 MERTENS, FEDERAL INCOME TAXATION §§ 20.47, .67 (1957).

45. Reg. § 1.351(1)(a)(i).

46. Rev. Rul. 57-586, 1957-2 CUM. BULL. 249 (certificates of contingent interests in stock, not stock).

47. See Rev. Proc. 60-6, 1960 INT. REV. BULL. No. 12, at 29 (item 15).

48. Rev. Rul. 56-303, 1956-2 CUM. BULL. 193 (notes maturing in less than 4 years held "boot").

problem of whether they constitute "securities" or "stock."[49] Upon the organization of a corporation this problem is traditionally referred to as the "thin incorporation" problem, which is discussed in a later paper in connection with the subject of the capitalization of the corporation.[50] However, the wording of the statute seems to indicate that if some shareholders among a group of transferors receive solely stock and some receive solely "securities," the transfers will be tax-free as to all. This conclusion has been confirmed by some cases,[51] but usually the arguments are reversed, with a corporation, which has issued a long-term promise to pay for property, taking the position that the property was acquired in a taxable sale rather than a tax-free exchange in order to "step up" its basis for the property for depreciation purposes. The problem of having such a transaction treated as a "sale" instead of a tax-free exchange is discussed in a subsequent paper.[52]

In connection with the issuance of *stock* in a tax-free exchange under section 351, attention must be given not only to the rules under section 351, but also to many other considerations. The stock to be issued may take a variety of forms to fit the particular financing requirements and the desired capital structure.[53]

As a basic requirement, the courts have placed a gloss on section 351, as they have in applying the reorganization provisions of the Internal Revenue Code, by requiring that there be a continuity of interest in the transferors as reflected by their form of ownership in the transferee-corporation.[54] This most often appears as a problem where a corporation is formed as a successor to an insolvent business, but recently the Internal Revenue Service applied the concept of continuity of interest to long-term securities, such as a twenty year first mortgage bond, and treated the transferor of property as a shareholder rather than as a creditor.[55] Thus, it can be said that we are in a state of flux with respect to the treatment of securities, with the Government moving in the direction of obliterating the term under section 351 and treating it as the equivalent of stock.

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49. As to what constitutes securities, see Weyher & Weithorn, *Capital Structure of New Corporations,* N.Y.U. 16TH INST. ON FED. TAX 277, 285 (1958).

50. See discussion pp. 204-09.

51. W. H. Truschel, 29 T.C. 433 (1957); Camp Wolters Enterprises, Inc., 22 T.C. 737 (1954), *aff'd,* 230 F.2d 555 (5th Cir.), *cert. denied,* 352 U.S. 826 (1956).

52. See discussion pp. 253-55.

53. See discussion pp. 215-17 as to capitalization of a new corporation. See also Weyher & Weithorn, *Capital Structure of New Corporations,* N.Y.U. 16TH INST. ON FED. TAX 277 (1958). Note that particular forms of stock may be required to satisfy other provisions of laws. See, *e.g.,* § 1244, Subchapter S, and discussion p. 216. See also Calkins, Coughlin, Hacker, Kidder, Sugarman & Wolf, *Tax Problems of Close Corporations: A Survey,* 10 WEST. RES. L. REV. 9, 27-29 (1959).

54. See LeTulle v. Scofield, 308 U.S. 415 (1940).

55. W. H. Truschel, 29 T.C. 433 (1957).