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THINKING THE UNTHINKABLE: RECOGNIZING GAIN ON A 351 TRANSFER

Section 351 transfers to controlled corporations are one of the most simple transactions in the corporate repertoire. Not much can go wrong, it would seem. Indeed, in many complicated corporate structures, the Section 351 transfers (sometimes there are several) are often given short shrift. It is common in transactions which are subject to an IRS advance ruling request not to bother with rulings on the Section 351 part of the transactions. That often occurs, for example, where 351 transactions precede a Section 355 spinoff. One can get a ruling on the entire transaction, of course, but practitioners often just don't bother.

So what can go wrong with a Section 351 transaction? There are certainly a couple of possibilities, such as:

- receiving stock or securities in exchange for services (rather than property);
- having prearranged (or close in time) subsequent stock transfers, which may adversely impact the "immediately after the exchange" requirement;
- determining what constitutes stock and what constitutes securities, and receiving only securities;
- determining what constitutes 80% control, and dealing with contingent stock or escrowed stock and this 80% control requirement; and
- satisfying the judicial continuity of interest and business purpose requirements.

What I consider to be the biggest problem with Section 351, is the sometimes disastrous excess of liabilities over basis problem. Before we turn to that, though, let's look at some of the other things that can go wrong with a Section 351 transaction. One of the most fundamental issues concerns the requirement that the transferors of the property must have control of the corporation "immediately after" the exchange. Of course, a group of persons may transfer property and may collectively be in control following an exchange, even though no one person is in control.

There have been relatively few disputes over the question of whether a particular group of transferors ought to be considered in control. Still, the "immediately after" requirement has often been controversial. After all, just what does "immediately" mean? The step transaction doctrine is the most appropriate theory (I hate to admit!) for determining whether a transfer of stock actually satisfies this requirement. Broadly stated, the question is whether one or more subsequent transfers of stock ought to be integrated with the Section 351 transaction. We've recently covered the step transaction doctrine. See Wood, "More Step Transaction Authority," Vol. 11, No. 1, M&A Tax Report (Aug. 2002), p. 1; and Wood, "Step Transaction Doctrine and Mergers," Vol. 10, No. 6, M&A Tax Report (Jan. 2002), p. 6.

Another issue that comes up and that can spoil the tax-free nature of an otherwise simple Section 351 transaction relates to the stock or securities definition. To be considered in control of the corporation, the transferor must receive stock (rather than merely securities, although securities could accompany the share transfer), or must already own shares in the corporation. To be considered in control, the transferors must maintain 80% control immediately following the transfer. If one or more transferors receive only securities in exchange for the property transferred, and do not receive stock, watch out.

Fortunately, the IRS considers such a transferor part of the control group if he already owns shares in the corporation prior to the transfer. Conversely, if the transferor did not previously own stock in the corporation, and does not receive stock in exchange for the property transferred, the exchange of property for securities will be taxable.

<u>What's Stock or Securities?</u>
The question what constitutes stock or securities can itself be nettlesome. Section 351 requires that the transfer of property must be solely in exchange for stock or securities of the transferee corporation. Money or other property received will result in gain recognition. There have been more than a few questions over the years as to the meaning of the "stock or securities" phrase.

Oddly enough, neither term is defined in the Code or Regulations. Most of the cases have arisen under the reorganization sections, because the phrase "stock or securities" also has relevance there. And, the case law has indicated that these authorities in the reorganization area are relevant in interpreting Section 351. See Camp Wolters Enterprises, Inc., 230 F.2d 555 (5th Cir. 1956), cert. denied, 352 U.S. 826 (1956).

The Regulations do not provide that stock rights or stock warrants are not included within the term stock or securities, and therefore will constitute boot if they are distributed in exchange for money or property under Section 351. See Reg. §1.351-1(a)(1). Still, in a variety of contexts under Sections 368 and 354, the courts have held that warrants to purchase stock do not in themselves constitute stock. One older case held that stock rights constituted securities for purposes of a B reorganization, but this holding seems questionable in light of later cases (the old case is Raymond v. Commissioner, 37 B.T.A. 423 (1938)).

<u>Contingent Stock</u>
Related to the treatment of stock rights or warrants is the treatment of contingent interests. Contingent stock rights usually involve a corporation's issuance of warrants that may be converted into shares of stock in the event certain contingencies occur. For example, the event on which the issuance of additional shares might depend could be the imposition of certain liabilities. Contingent stock rights may be useful in situations where it is not immediately clear how many shares may be issued to one or more transferors.

Suppose, for example, that a particular asset is subject to a liability that cannot be readily determined at the time of the transfer. Contingent share rights might be used, issuing such rights to the transferor of the asset in order to take that uncertain liability into account. The IRS' position is that such contingent stock rights are neither stock nor securities, and therefore that they must be boot. See Revenue Ruling 57-586, 1957-2 249.

In contrast, several cases have treated such rights as equivalent to stock, because they cannot be converted into anything but stock. The IRS subsequently acquiesced in the result of at least one of these cases, on the theory that contingent stock rights would be considered stock or securities for purposes of Section 351 if: (a) they were not assignable and not transferable; and (b) they could give rise solely to the receipt of additional stock by one of the transferors (the acquiescence was to the result in Hamerick v. Commissioner, 43 T.C. 21 (1964), acq'd, 1966-1 C.B. 2; see also Revenue Ruling 66-112, 1966-1 C.B. 68).

Eventually, the IRS issued a Revenue Procedure describing the conditions under which it would issue rulings in connection with contingent stock issued in reorganizations. Relevant only for purposes of determining whether an advance ruling would be issued, these criteria required that:

- all contingent stock must be issued within five years of reorganization;
- there is a valid business purpose for not issuing all shares immediately;
- the contingent rights must not be assignable and must not be readily marketable;
- only additional stock of the acquiring or controlling corporation is issued;
- at least 50% of the maximum of shares of each class of stock that may be issued is issued at the time of the initial distribution;
- the maximum number of shares that may be issued must be stated;
- the stock issuance cannot be triggered by an event controlled by the shareholders;
- the issuance of the contingent stock rights must not be triggered by the results of an IRS audit; and
- the event for determining whether the contingent shares are to be issued, and the number of shares to be issued, must be objective and readily ascertainable. See Revenue Procedure 77-37, 1977-2 C.B. 568, amplified numerous times, and now embodied in Revenue Procedure 84-42, 1984-1 C.B. 21

<u>Escrowed Stock</u>

Although escrowed stock is frequently used in corporate reorganizations, it is much less important in the context of transfers under Section 351. Instead of distributing contingent stock rights that may or may not be exchanged for actual shares, stock may be escrowed and distributed only on the occurrence of certain conditions. In the case of escrowed shares, the stock would actually be issued, but its delivery would be subject to one or more subsequent conditions.

The question is whether this escrowed stock should be treated as owned by the transferors of the property for purposes of the 80% control requirement of Section 351. There should be little dispute about whether the escrowed stock constitutes "stock" for purposes of 80% control. Furthermore, it is likely that escrowed stock would be treated as owned by the transferors for purposes of meeting the 80% control requirement as long as the escrowed stock is listed on the company's books and records as owned by the transferors, and the stock is effectively so treated.

The IRS has a ruling policy with respect to escrowed stock (in the context of rulings under A, B or C reorganizations). The spirit of this list of items suggests that escrowed stock would satisfy all elements of Section 351 as long as it is beneficially owned by the shareholder. Plus, the triggering event for the escrow should not be something that might be considered abusive (or even giving rise to abuses), such as an event within the control of the shareholder.

<u>Definition of "Securities"</u>
As with the term "stock," the term "securities" has an important meaning for purposes of Section 351. The relevance of the concept is, once again, that if something does not constitute stock or securities, and it is received in exchange for a contribution of money or property pursuant to Section 351, gain may be recognized measured by the value of the property other than stock or securities received. Not surprisingly, there has been considerably more controversy over the meaning of the term "securities" than over the definition of "stock."

For example, should accounts receivable be considered a security? Most people would answer no, assuming that the accounts receivable are typically paid within a short period of time. The most important case dealing with the bounds of the "security" concept in this context is Camp Wolters Enterprises, Inc. v. Commissioner, 22 T.C. 737 (1954); aff'd, 230 F.2d 555 (5th Cir. 1956); cert. denied, 352 U.S. 826. This case considered notes maturing in installments during the fifth through the ninth years after they were issued. The case holds that the notes are securities for purposes of Section 351. As a factual matter, though, the notes were actually paid within two years of issuance.

The Tax Court's formulation of the relevant factors is still significant. In particular, it is interesting that the Tax Court decries reference to the time period of the notes alone, preferring instead to give an overall evaluation of the nature of the debts, the degree of participation and continuing interest in the business, the extent of the proprietary interest compared with the similarity of the note to a cash payment, and the purpose of the advances, etc. Still, the term of the obligation is doubtless the single most important factor in determining whether an obligation should be classified as a security.

The mere existence of a long-term does not insure that there will be no dispute as to the status of the obligation. In fact, the IRS has argued that obligations should be classified as securities even when they have had relatively long terms, even up to twelve and a half years. See Dennis v. Commissioner, 57 T.C. 352 (1971); aff'd, 473 F.2d 274 (5th Cir. 1973). See also Nye v. Commissioner, 50 T.C. 203 (1968); acq'd, 1969-2 C.B. XXV (note with a ten year term held a security). Of course, the IRS is generally defeated on such extremes.

On the other hand, the Service has been successful in arguing that obligations having a term of two and a half years or less are something other than a security. See Adams v. Commissioner, 58 T.C. 41 (1972) (note having term of 27 months held not a security). In fact, a term of less than two years generally will not be treated as a security. It is often assumed that an obligation with a term of five years or less runs a risk of not being classified as a security.

Ultimately, though, a variety of factors other than the term of the obligation are relevant. In one case, an unsecured promissory note with a term of one year was held to be a security for purposes of Section 351. Mills v. U.S., 399 F.2d 944 (5th Cir. 1968). However, in this case there was evidence that the note was not expected to be repaid, and that it had been renewed several times prior to the audit. The notes matured in six months and were held not to be securities. Yet, once this case was considered on remand, the notes were considered to be an integral part of the plan for the delayed issuance of preferred stock, and therefore were treated as securities.

A variety of factors may be evaluated in determining security status. In one case, a one-year unsecured promissory note was held to be a security because of the party's intention and prevailing local business customs. See Mills v. U.S., 399 F.2d 944 (5th Cir. 1968). In another case, four-year and nine-year notes were held to be securities where the investment was at risk of a speculative business, the notes were subordinated, and the finances were shaky at the time of incorporation. See George A. Lagerquist, 53 T.C.M. 530 (1987). Even a demand note has been held to be a security. See D'Angelo Associates, Inc. v. Commissioner, 70 T.C. 121 (1978), acq'd in result, 1979-1 C.B. 1.

Taxpayers attempting to come within the bounds of Section 351 will almost always prefer any obligation to be treated as a security rather than as "other property." Obviously, the receipt of boot will result in a recognition of gain or loss, so "securities" classification is clearly desirable.

However, if only securities (and no stock) are received on the transfer, Section 351 treatment will not be available. The IRS has ruled that the receipt of debt securities in exchange for property does not qualify for Section 351 treatment if the recipient of the securities receives no stock in the exchange and has previously not held any stock of the transferee. See Revenue Ruling 73-472, 1973-2 C.B. 114. The IRS was quick to affirm that this position applies only where the receipt of debt securities is not accompanied by any stock and the recipient security holders were not previously shareholders. In a companion ruling, the Service concluded that even if only securities were received by the transferors of the property, if the transferors were in control of the corporation immediately before the transfer, Section 351's requirements will have been met. Revenue Ruling 73-473, 1973-2 C.B. 115.

<u>Dealing With Assumed Liabilities</u>
Before this long digression into the other foibles of Section 351, we started with the premise that assumptions of liabilities represent the biggest trap in an otherwise straightforward provision. Before we get to the bad, though, let's look at the good. Section 357 treats an assumption of liability (in general) by the transferee corporation (or its acquisition of property subject to a liability) in a Section 351 exchange as not equivalent to the transferor's receipt of money or other property.

Consequently, the general rule is that the exchange will qualify under Section 351 regardless of the assumption of liability (or the taking of property subject to it). Plus, in general, the transferor does not recognize gain or loss by reason of that assumption. Now the bad.

Section 357 expressly provides for gain recognition in two circumstances:

- Where the transferee corporation's assumed or acquired liabilities exceed the transferor's adjusted basis in the properties transferred by the transferor to the corporation, in which case any excess liabilities are boot and are treated as gain from the sale or exchange of property.

- Where it appears that the principal purpose of the taxpayer with respect to the assumption or acquisition of the liability was the avoidance of federal income tax on the exchange, or (even if the purpose was not tax avoidance) that purpose was not a bona fide business purpose.

<u>Liabilities in Excess of Basis</u>
The liabilities in excess of basis trigger applies separately to each transferor. Therefore, the total of each transferor's liabilities assumed by (or taken subject to) the corporation is compared with his basis in the entire property transferred by him to the corporation.

It is relatively easy to see how this rule applies once it is determined whether liabilities have been assumed or taken subject to. A troubling question, though, is the scope of the term "liabilities," inasmuch as many obligations that are assumed may not rise to the level of a "liability" for purposes of Section 357. For example, are ordinary trade accounts payable included? The answer surely should be no.

Yet, over the years there was a considerable flap over this seemingly simple point. After a court battle, Section 357(c) was eventually amended to state that liabilities assumed by the transferee will not include accounts payable, if these accounts would be deductible by the transferor if paid by it, and assuming that the incurrence of the liability does not result in any decrease in the basis of any property.

Shareholders, of course, can always eliminate the excess liabilities problem by contributing more cash, which will increase their aggregate bases. By doing so, they can effectively calibrate the bases and liabilities. Nevertheless, this isn't an attractive solution. It simply doesn't appeal to many shareholders since it requires a cash outlay.

Shareholders have attempted to reach the same result without paying cash by issuing a personal note to the corporation equal to the excess of liabilities over bases in the contributed property. For many years, this strategy failed. The IRS and the Tax Court virtually always assigned a zero basis to the shareholder's notes. See Alderman v. Commissioner, 55 T.C. 662 (1971). So no matter what value the shareholder assigned to the face of the note, the note could not increase the aggregate bases of the contributed property.

<u>I Love Lessinger</u>
All of that changed as a result of the now famous case of Lessinger v. Commissioner, 872 F.2d 519 (2d Cir. 1989), in which the Second Circuit confronted open account indebtedness between a shareholder and the corporation. The taxpayer argued that ordinary accounts payable should not be included in the category of liabilities assumed. More significantly, the taxpayer argued that his own debt to the corporation, a journal entry showing a loan receivable from him to the corporation of $255,000, had to be considered. The Second Circuit analyzed whether this open account indebtedness was true debt, concluding that the debt was real rather than artificial. Thus, the court treated the face amount of the debt to the corporation as property on the transfer, thus offsetting an equivalent amount of gain.

But how did the court resolve the question of the shareholder's basis in his own note? Interestingly, the court did not assign any shareholder basis to the loan. Rather, it looked to the corporation's basis in the note, which it found to be the face value of the note, even though the approach did not fit with the statutory language.

The Ninth Circuit reached a similar result in Peracchi v. Commissioner, 143 F.3d 487 (9th Cir. 1998). In that case, a shareholder transferred an unsecured promissory note to his corporation with a face value equal to the excess of the aggregate liabilities over the aggregate bases. Not surprisingly, the shareholder argued the basis of the note was its face value. The IRS contended the note's basis was zero. The Tax Court ruled for the IRS, finding that the note was a sham. T.C. Memo 1996-191.

Sometimes the Ninth Circuit lives up to it's "taxpayer's circuit" pseudonym. Here, the Ninth Circuit reversed the Tax Court. However, this Left Coast Court refused to use the basis analysis used by the Second Circuit in Lessinger. Instead, the Ninth Circuit found that the shareholder's note had a basis equal to its face value. The court reasoned that the note put the shareholder on the hook for the corporate debts. After all, creditors could reach the shareholder's assets by enforcing the note as an unliquidated asset of the corporation.

Don't Try This at Home

A good example of the reach of Section 357 is presented by the recent Seventh Circuit case, Seggerman Farms, Inc., et al. v. Commissioner, 308 F.3d 803 Tax Analysts Doc. No. 2002-24075, 2002 TNT 207-5 (7th Cir., October 24, 2002). This case involved the shareholders of a family farm, who were required to recognize gain on the transfer of assets to their controlled corporation when the assumed liabilities exceeded the adjusted basis of the property transferred. What is perhaps most startling about the case is that all the family members remained liable on the debt, so there was no real relief of indebtedness.

Isn't it clear there should be no gain triggered here? Well, you might think so, but the courts were unsympathetic. They zapped the taxpayers, family farmers!

Ronald Seggerman and his sons operated a farm as a joint venture. In 1993 Ronald incorporated Seggerman Farms (the farm) and distributed the stock to himself and his family (the family). Ronald and his sons transferred assets subject to liabilities in excess of their adjusted basis to the farm. After incorporation, Seggerman Farms refinanced the debt, the family remained personally liable for the assumed debt, and none of the loan proceeds were disbursed directly to the family members.

Predictably, the family members argued that because they weren't personally relieved from liability for the assumed debt, they shouldn't recognize gain on the liabilities that exceeded the basis of the transferred assets. The Tax Court held that even if the family members remained liable on the debt, they had to recognize gain under Section 357(c) to the extent that the liabilities to which the transferred property was subject exceeded the family's adjusted basis in the assets. The Tax Court determined that the family didn't contribute loan receivables or personal notes to the farm that covered the difference between the transferred liabilities and the adjusted basis of the properties.

Aren't personal guarantees the same as a primary liability? Not really, and there are numerous examples in the S corporation arena. The Tax Court concluded that the family's personal guaranties weren't the same as incurring a primary indebtedness to the corporation. A guaranty is only a secondary liability, a promise to pay in the future only if certain events occur. The Tax Court held that the guaranties were not economic outlays, which are required to convert a loan guaranty into an investment. The family appealed to the Seventh Circuit.

There, the court rejected the family's argument that the Tax Court's reliance on the Rosen and Testor cases was misplaced. See Rosen v. Commissioner, 62 T.C. 11 (1974), and Testor v. Commissioner, 337 F.2d 788 (7th Cir. 1964). The court, concluding that the cases weren't outdated, agreed that Section 357(c) is meant to apply whenever liabilities are assumed or property is transferred subject to a liability. The court rejected the argument that these cases were not binding, noting that the family provided no controlling law that overrules Rosen and Testor.

Do Equity Unto Others?

The Seventh Circuit also rejected the argument that the court should depart from Seventh Circuit law in favor of an emerging equitable interpretation of Section 357(c). Distinguishing Lessinger v. Commissioner, 872 F.2d 519 (2nd Cir. 1989), and Peracchi v. Commissioner, 143 F.3d 487 (9th Cir. 1998), the court found that the family's personal guaranties of the debt were simply not the same as incurring indebtedness to the corporation. Echoing the Tax Court, the Seventh Circuit found that no economic outlay was made, and that the loan guaranties were not converted into investments.

The appellate court concluded that if a taxpayer retains a liability as a guarantor on debts transferred, Section 357(c) requires the amount in excess of the basis in the assets to be recognized as taxable gain. Finally, the court rejected the suggestion that it exercise its general equitable power to fashion a case-specific exception to Section 357(c). Noting the clarity of the statute, the court concluded that fashioning that exception would exceed the scope of the court’s function.

Thinking The Unthinkable: Recognizing Gain on 351 Transfers, Vol. 11, No. 5, M&A Tax Report (December 2002), p. 1.

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