1-1-1976

Tax Policy Implications of Contributions of Appreciated and Depreciated Property to Partnerships, Subchapter C Corporations and Subchapter S Corporations in Exchange for Ownership Interests

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SAMUEL C. THOMPSON, JR.*

Introduction

Appreciated or depreciated property may be contributed to a business enterprise in exchange for an ownership interest[1] either on the initial organization of an enterprise or at a time when new capital is being infused into an operating enterprise. The federal income tax effects of such transactions may differ, depending not only on the form of the enterprise but also on whether the enterprise is newly organized or operating. Such transactions will have an economic impact on both the investor who is contributing the appreciated or depreciated property (the contributing investor) and, more importantly, the other investors (the noncontributing investors). Consequently, whenever appreciated or depreciated property is contributed to an enterprise, consideration should be given to possible adjustments in the business bargain among the investors in order to take account of the federal income tax effects. Indeed, if adjustments are not made, either the contributing investor or the noncontributing investors may realize an economic detriment while the other realizes an economic benefit. The intensity of the detriment or benefit will be directly related to the

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1 The term "ownership interest" refers to both general and limited partnership interests and in the case of corporations to both stock and securities.

amount of the appreciation or depreciation in the value of the contributed property.

This article is an examination of the policy implications of the federal income tax effects of contributions of appreciated or depreciated property to partnerships,[2] subchapter C corporations[3] and subchapter S corporations[4] in exchange for an ownership interest.[5] An understanding of the tax policy implications of contribution transactions[6] can aid the tax advisor in counseling a client who is involved in such transactions. The client may be the contributing investor, the business enterprise or a noncontributing investor or investors.

In most cases the treatment of contributions to subchapter S corporations is governed by the rules applicable to subchapter C corporations, and in such cases no differentiation is made herein between the two types of corporations. Notwithstanding this equivalent treatment, the underlying economic relationships among the shareholders and the cor-

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[2] The taxation of partners and partnerships is governed by subchapter K of chapter 1 of sections 701–771 of the Code.

[3] The term "subchapter C corporation" as used here means a corporation which is subject to all the provisions of subchapter C of chapter 1 of the Code, sections 301–395. The Code provides special tax treatment for various other types of corporations.

[4] The term "subchapter S corporation" as used here means a corporation which has made a valid election to be taxed pursuant to the provisions of subchapter S of chapter 1 of the Code, sections 1371 through 1379. A subchapter S corporation is subject to the provisions of subchapter C except where otherwise specifically provided in subchapter S.

[5] The leading treatise on the federal income taxation of partnerships is WILLIS ON PARTNERSHIP TAXATION (1971) (herein cited as WILLIS), and the leading treatise on corporations and shareholders, including subchapter S corporations, is BITTKER & EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS (3d ed. 1971) (herein cited as BITTKER & EUSTICE). A combination casebook and treatise covering both partnership and corporate taxation is SURREY, WARREN, MCDANIEL & AULT, FEDERAL INCOME TAXATION (1972) (herein cited as SURREY); *see also* NESS & VOGEL, TAXATION OF THE CLOSELY HELD CORPORATION (1972); WOLFMAN, FEDERAL INCOME TAXATION OF BUSINESS ENTERPRISE (1971).

For a comparative analysis of the tax impact of operating the three forms, see Thompson, *The Federal Income Tax Impact of the Operating Function On The Choice of Business Form: Partnership, Subchapter C Corporation, or Subchapter S Corporation*, 4 BLACK L.J. 11 (1975) (herein cited as THOMPSON). For other works treating various areas, see Axelrad, *Choice of Form: Partnership, Corporation, or in Between*, 19 N.Y.U. INST. 361 (1961); Dixon, Barnett, Evall, Geller & Kalish, *Partnerships and Subchapter S: A Comparison of Tax Advantages, a Panel Discussion*, 25 N.Y.U. INST. 151 (1967); Grant, Alden, Kaufman & Lees, *The Relative Tax Advantages of Partnerships and Subchapter S Corporations*, 1969 S. CALIF. INST. 409; and Kalish, *Partnerships, Subchapter S, and Non-Special-Status Corporations*, 28 N.Y.U. INST. 509 (1970).

[6] The term "contribution transactions" refers to transfers of property to an enterprise in exchange for ownership interests.

poration may be different, and in such cases the results for subchapter S corporations will be discussed separately from those for the subchapter C corporation.

The contribution transactions considered here are limited to those in which property (other than services) is contributed to an enterprise[7] in exchange solely for an ownership interest. The author intends this to be the first of a series of three articles dealing with various aspects of contribution transactions. The second and third will deal respectively with contribution transactions involving boot distributions (including liabilities assumptions) and contributions of services.

This article is concerned with three separate aspects of contribution transactions:

(1) The policy implications of the control concept in the case of corporations and the absence of such a concept for partnerships.

(2) The policy implications of the potential for the assignment of tax detriment or benefit among the investors. The scope includes, but is broader than, the traditional assignment of income issues. Indeed, the problems of assignment of tax detriment or benefit is the genus which includes among its species traditional assignment of income issues.

(3) The policy implications of the potential for a double tax.

The purpose is to probe the flesh of the present provisions to see if they operate in accordance with a rational tax policy scheme. An underlying policy judgment is that in the absence of countervailing considerations similar contribution transactions involving the three forms should produce similar federal income tax effects. The goal of this article is not to address the broader question of whether any of the three forms should be eliminated; the goal is to explore the possibility of improving the functioning of the three forms with respect to contribution transactions. It should be pointed out, however, that even if there are changes in the taxing schemes of the three forms, such as the elimination of the double tax on dividends as recently proposed by Treasury Secretary Simon,[8] the problems raised here will nevertheless persist.

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[7] The three different business forms will sometimes be referred to collectively as the "enterprises" or the "forms."

[8] Statement by William E. Simon, Secretary of the Treasury, House Committee on Ways and Means, July 31, 1975, 975 CCH ¶ 6160. For a recent discussion of many of the policy issues with respect to the possibility of integrating the corporate and individual income tax, see McLure, *Integration of the Personal and Corporate Income Taxes: The Missing Element in Recent Tax Reform Proposals*, 88 HARV. L. REV. 532 (1975).

Before beginning the analysis, it is appropriate to briefly review (1) the federal income tax treatment of each form as an operating entity, and (2) the general principles of federal income taxation which are applicable to the formation of each form.

General Scheme for Taxing the Three Forms[9]

Partnerships are not subject to the federal income tax.[10] Each partner must include in his gross income his share of the partnership's taxable income whether such income is distributed or not.[11] Correlatively, each partner will deduct from his gross income his share of the partnership's losses.[12] Current property or cash distributions from partnerships do not, in general, generate income to the partners.[13] Partnerships can be either general or limited, but for the most part the tax impact of the operating function will be the same for the two.

A subchapter C corporation is a taxable entity separate and distinct from its shareholders.[14] In general, such corporations are required to pay a federal income tax on their taxable income for each taxable year, and shareholders are subjected to a tax liability on receipt of a current distribution of cash or property from the corporation.[15] Subchapter C corporations are, therefore, subjected to taxation as entities separate from the shareholders, whereas partnerships are not.

Subchapter S corporations are tax hybrids; they are in effect crosses between partnerships and corporations. With respect to the operating function of the business enterprise, the tax scheme for subchapter S corporations is for the most part analogous to the tax scheme for partnerships. The subchapter S corporation is not, in general, subject to taxation.[16] Each shareholder is required to include in his gross income his proportionate share of the corporation's taxable income whether or not distributed.[17] Correlatively, each shareholder will deduct his proportionate share of the corporation's losses.[18] The analogy to partnership taxation is not a complete one; the schemes differ to a great extent. For instance, current property distributions by subchapter S corpora-

[9] *See generally* THOMPSON.
[10] I.R.C. § 701.
[11] I.R.C. § 702(a).
[12] *Ibid.*
[13] I.R.C. § 731(a).
[14] I.R.C. § 11.
[15] I.R.C. §§ 301, 312, 316.
[16] I.R.C. § 1372(b)(1).
[17] I.R.C. § 1373(a).
[18] I.R.C. § 1374(a).

tions, with certain exceptions, will be treated similarly to such distributions by subchapter C corporations,[19] and subchapter S corporations may be subject to taxation.[20]

Federal Income Tax Consequences of Formation of an Enterprise

The starting point for determining the tax consequences on the formation of an enterprise is section 1001(a) [21] of the Code which provides that the gain or loss on a sale or other disposition of property shall be the difference between the amount realized [22] and the property's adjusted basis.[23] Generally, realized gain or loss must be recognized [24] (taken into account for tax purposes), except as otherwise provided in the income tax provisions of the Code. If there is a contribution of appreciated or depreciated property in exchange for an ownership interest on the organization of an enterprise or on the addition of new investors to an operating enterprise gain or loss will be realized by both the contributing investor and the enterprise. The partnership and corporate provisions, however, provide exceptions to the general rule of recognition for both the contributing investor and the enterprise.[25]

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[19] I.R.C. § 1373(c).

[20] I.R.C. § 1378.

[21] Section 1001(a) reads: "The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized."

[22] The amount realized on a sale or other disposition of property is defined in section 1001(b) as "the sum of any money received plus the fair market value of the property (other than money) received."

[23] The adjusted basis of property is, in general, the taxpayer's cost of such property as provided in section 1012, less depreciation (if any), plus or minus certain other adjustments as provided for in section 1016. The cost of property received in an exchange is the amount paid for such property which in any arm's length exchange is presumed to be equal to the fair market value of the property given up. *See* Reg. § 1.1012-1(a); *cf.* Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184 (Ct. Cl. 1954) (held, where the value of property received in an arm's length transaction could not be determined, the value and, therefore, the cost basis of such property was presumed to be the value of the property given up).

[24] Section 1001(c) provides that a gain or loss realized under section 1001(a) shall be recognized as provided in section 1002. Section 1002 provides that in all cases gain or loss which is realized under section 1001(a) shall be recognized except as otherwise provided in the income tax provisions of the Code.

[25] If there is an exception to the recognition of gain or loss on an exchange, in order to preserve (defer) the nonrecognized gain or loss the basis of the property received must be equal to the basis of the property given up. This requires an exception to the cost basis rule of section 1012. In describing the relationship

Section 721, the provision governing contributions to partnerships, reads: "No gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership." [26] The price to the contributing partner of nonrecognition treatment on such transfers is the requirement in section 722 that the partner take as his basis in the partnership interest received the basis he had in the property contributed.[27] This substituted basis has the effect, in general, of deferring the gain or loss which the partner would have had to recognize in the absence of the section 721 exception to the general rule of recognition. Consequently, on a later sale or exchange of the partnership interest, the partner may recognize his previously nonrecognized gain or loss.

Section 723, as a corollary to section 722, provides that a partnership's basis for property contributed to it by a partner is the partner's basis for such property at the time of the contribution.[28] Thus, the part-

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between the predecessors of (1) the nonrecognition exceptions to the current section 1002 and (2) the basis exceptions to the current section 1012, the House report to the 1924 Revenue Act said: "[T]hese provisions result not in an exemption from tax but in a postponement of tax until the gain is realized by a pure sale or by such an exchange as amounts to a pure sale." H.R. REP. No. 179, 68th Cong., 1st Sess. 16–17 (1924).

[26] Section 1.721–1 of the regulations amplifies section 721 in numerous ways. This regulation makes it clear that the general rule of nonrecognition applies both to contributions to newly organized partnerships as well as operating partnerships. Also, the regulation makes it clear that section 721 nonrecognition treatment does not apply to sales and lease transactions between a partner and partnership. Such transactions are beyond the scope of this paper. For a discussion of some of the problems in this area, see WILLIS at 151–60.

Subsection (b) of the regulation provides that section 721 will not apply to the receipt of a capital interest in a partnership as compensation for services or in satisfaction of an obligation. Contributions of services in exchange for partnership interests are beyond the scope of this article, see WILLIS at 77–98.

The rule of nonrecognition applies to the recapture of depreciation, sections 1245(b)(3) and 1250(d)(3). Also, pursuant to section 47(b) there is generally no recapture of investment credit on the contribution of section 38 property. However, section 1.47–3(f) of the regulations sets up certain requirements for nonrecognition which are designed to prevent sham transfers of investment credit property. Further, contributions of installment obligations will not give rise to recognition. *See* Reg. §§ 1.721–1(a), 1.453–9(c)(2).

[27] Pursuant to section 1223(1) the partner's holding period for his partnership interest will be determined by reference to the holding period of the capital assets and section 1231(b) assets transferred, to the extent thereof. This is known as the tacking of the holding period. It should be noted that to the extent a portion of the partnership interest is received in respect of other assets, the holding period does not tack.

[28] Pursuant to section 1223(2) the partnership's holding period for capital assets and section 1231(b) assets received shall include the transferor's holding period of such assets. This is also known as tacking.

nership carries over as its basis in the contributed property the basis of the contributing partner in such property.[29] The effect of the carryover basis is to transfer from the partner to the partnership the potential gain or loss the partner would have recognized had he disposed of the property in a transaction requiring recognition of gain or loss.

The general results on a contribution of appreciated or depreciated property to a partnership can be summarized:

(1) The contributing partner does not recognize his potential gain or loss because section 721 provides an exception to the general rule of recognition.

(2) Pursuant to section 722, the contributing partner substitutes as his basis in the partnership interest received the adjusted basis of the property contributed, thus deferring any potential gain or loss.

(3) Pursuant to section 721, the partnership does not recognize gain or loss on the exchange of its partnership interest for property.

(4) Pursuant to section 723, the partnership carries over as its basis in contributed property the basis in such property to the contributing partner.

Section 351(a), the provision governing contributions to both subchapter C and S corporations, reads in pertinent part:

> 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.

The price of nonrecognition treatment is the requirement in section 358(a)(1) that the shareholder or security holder substitute as his basis for the stock or securities received the adjusted basis of the property contributed.[30]

The phrase "stock or securities" is not defined in the Code. In general stock refers to common or preferred stock without regard to the particular characteristics,[31] and securities refers to long-term debt in-

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[29] The partnership will not necessarily get a carryover basis in the case of a contribution of personal use property which is depreciable property to the partnership. In such case the partnership's basis for such property is the lesser of the carryover basis or the fair market value of the property. Reg. § 1.167(g)-1; *see* Lawrence Y.S. Au, 40 T.C. 264 (1963), *aff'd per curiam*, 330 F.2d 1008 (9th Cir. 1964) (held, on transfer of personal use automobile to partnership, the basis of the automobile to the partnership was the lesser of the partner's basis or the fair market value).

[30] Pursuant to section 1223(1), the shareholder's holding period for his stock and securities may tack as is the case with partnerships.

[31] *See* BITTKER & EUSTICE at Ch. 4.

struments of the corporation.[32] If debt instruments have a short maturation term, they may be classified as other property, rather than securities, and as such will not qualify for nonrecognition treatment.

Under section 351(a), only transferors in control singly or as a group can qualify for nonrecognition treatment on the receipt of stock or securities.[33] Control is defined in section 368(c) to mean ownership of "at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation." The control must exist "immediately after" the exchange,[34] and a group of transferors are counted together for purposes of determining whether the requisite control exists, provided the group is jointly making contributions to the corporation. Furthermore, so long as one person has control of a corporation he can make a contribution of property[35] to such corporation at any time and receive nonrecognition treatment. It is not sufficient that the transferor receive securities only; to be counted in the control group the transferor must either receive stock in addition to securities or have owned stock at the time of the receipt of securities.[36] In other words, in order to be in the control group the investor must either become a stockholder or have been a stockholder.

From the corporation's side of the transaction, section 1032 provides that a corporation will receive nonrecognition treatment on the issuance of stock in exchange for property, and section 118 provides that a corporation will not have income on the receipt of a contribution to capital. Also, pursuant to section 1.61–12(c) of the regulations, a corporation will not have income upon the issuance of its securities in exchange for property. A corporation's basis for property received in a section 351(a) transaction is a carryover basis pursuant to section 362(a).[37]

The general results on a contribution of property by control persons

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[32] *Ibid.*

[33] For a discussion of the "control" element, see BITTKER & EUSTICE at 3–29, *et seq.*

[34] For a discussion of some of the problems revolving around the "immediately after" element of section 351(a), see BITTKER & EUSTICE at 3–32, *et seq.*

[35] For a discussion of the meaning of the term "property" in section 351(a), see BITTKER & EUSTICE at 3–10.

[36] Rev. Rul. 73–472, 1973–2 C.B. 115 (held, if one of the transferors in a section 351 transaction receives only securities, he is not within the control group of section 368(c), and, therefore, has recognition because he lacks a proprietary interest).

[37] Pursuant to section 1223(2), the corporation's holding period for capital assets and section 1231(b) assets will tack as is the case with partnerships. For a possible exception to the carryover basis rule, see N. 29 *supra.*

to a corporation in exchange solely for stock or securities can be summarized:

(1) The contributing shareholder does not recognize his potential gain or loss because section 351(a) provides an exception to the general rule of recognition.

(2) Pursuant to section 358(a)(1), the contributing shareholder substitutes as his basis in the stock or securities received the adjusted basis of the property contributed, thus deferring any potential gain or loss.

(3) Pursuant to section 1032 and section 1.61–12(c) of the regulations, the corporation does not recognize gain or loss on the exchange of its stock or securities for property.

(4) Pursuant to section 362(a), the corporation carries over as its basis in the contributed property the basis of the shareholders in such property.

Control Requirement

Comparative Analysis of Control Requirement

Outline of Problem

The principal distinction between the partnership and corporate provisions with respect to the availability of nonrecognition treatment on the contribution of appreciated or depreciated property is that section 721 provides for nonrecognition treatment for contributions to partnerships without regard to the amount of partnership interest received, whereas, under section 351(a) nonrecognition will obtain only if the shareholder either has control of the corporation or is a member of a control group. It may appear that another distinction is the according of nonrecognition treatment on the receipt of corporate securities under section 351(a), and the absence of such a provision in section 721. This distinction would appear to be illusory, however. If securities were distributed by a partnership in a section 721 transaction, the tax treatment of the securities would presumably be governed by section 731 which, in general, provides for nonrecognition treatment on the distribution of property by a partnership.[38]

At first blush it may seem as though the control requirement in section 351(a) operates as a major disadvantage to investors contributing

[38] Research has disclosed no cases or rulings dealing with the tax treatment of the distribution of securities by a partnership. Partnership securities would, however, appear to be property, as opposed to cash, and if this assumption is correct, then pursuant to section 731 there would be no gain to the distributee partner on receipt of the securities.

to a corporation as opposed to those contributing to a partnership. The reverse may be true, however. If depreciated property is contributed to an enterprise in exchange for an ownership interest, the investor may want to immediately recognize the loss rather than have the loss shifted to the enterprise and deferred by reason of the operation of the carryover and substituted basis rules. Moreover, even on a contribution of appreciated property, it may be desirable for the investor to recognize the gain in order to give the enterprise a higher basis. To take but one obvious example, if the property contributed is a capital asset to the investor and either depreciable property or inventory to the enterprise, immediate recognition at the time of contribution would give the investor a gain that would be taxed at the preferred capital gain rate, and the future ordinary income of the enterprise would be reduced by way of either an increased depreciation charge or a smaller gain on the disposition of the inventory.

Neither immediate loss recognition nor immediate capital gain recognition can be attained in the case of a contribution to a partnership in exchange for a partnership interest. Both can be attained, within certain limitations, on contributions to corporations in exchange for stock or securities. As long as the shareholder neither has control nor is a member of a control group he can recognize gain on the contribution of property to a corporation in exchange for stock or securities. Loss can be recognized as long as the shareholder (along with certain related parties) does not own greater than 50 percent of the stock.[39]

On the formation of a new enterprise there is no inherent difference between sections 721 and 351 with respect to the control element, because all of the contributing shareholders will be included in the control group without regard to the amount of stock received. Although a shareholder may receive only 1 percent of the stock, he will be given nonrecognition treatment as long as he is a member of the control group. Different treatment can occur, however, on the admission of new investors to an operating enterprise. The following example will illustrate the potential severity of the divergent treatment. Assume the *AB* operating enterprise is going to take in a new investor, *C*, who will be transferring to the enterprise as his capital contribution a building which has a fair market value of $100K and an adjusted basis of $10K. If the enterprise is a partnership, the transaction will *not* give rise to

[39] Section 267(a) will prevent, inter alia, the recognition of a loss on an exchange between a stockholder and a corporation in which the shareholder along with certain related parties, owns more than 50 percent in value of the outstanding stock. This has the effect of lowering the section 368(c) control test to 50 percent in the case of a contribution of loss property.

recognition to *C* regardless of the amount of partnership interest he receives in the transaction. On the other hand, if the enterprise is a corporation, the transaction would give rise to recognition to *C* unless he received at least 80 percent of the stock of the corporation. Is there a rational tax policy basis for giving *C* nonrecognition treatment in a case where he receives a 1 percent partnership interest, but recognition treatment when he receives anything less than an 80 percent stock interest in a corporation? This and other questions are considered below.

With creative tax planning the 80 percent barrier to nonrecognition treatment may be reduced to a low hurdle, but with certain risks. For instance, assume that *A* is planning to make a contribution to the *X* operating corporation in exchange for less than 80 percent of the *X* stock. In order to get nonrecognition treatment, *A* might form a separate wholly-owned corporation, *Y*, to which he would transfer his assets in a nontaxable section 351 exchange. After operating *Y* as a viable entity for a respectable period, *X* could then acquire the *Y* stock from *A* in exchange for voting stock of *X* in a section 368(a)(1)(B) nontaxable reorganization. *X* could then liquidate *Y* in a nontaxable liquidation pursuant to section 332. The end result would be the same as if *A* had been a member of a control group in making a section 351 transfer of his assets directly to *X*. The Commissioner, however, would probably apply the step transaction and business purpose doctrines to treat the transactions as a mere purchase by *X* of *A*'s assets in exchange for *X* stock.[40] Crucial to the applicability of those doctrines would be whether the formation of *Y* was a part of an interrelated scheme, and whether its formation had an independent business purpose. If *A* could establish that he had bona fide business reasons for forming *Y*, apart from the acquisition by *X*, and that *Y* was not formed for the purpose of conveying the assets to *X*, then he might prevail in having the various transactions treated as independent steps. The taxpayer in *Earl Vest v. Commissioner*[41] was successful in beating back the Commissioner's attempt to treat such a transaction as a mere purchase of assets. The taxpayer there established that he had independent business reasons for forming his corporation and that although the corporation was acquired by Standard Oil in a section 368(a)(1)(B) reorganization shortly after formation, the formation was not "part of an interrelated scheme."[42]

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[40] *See* Rev. Rul. 70–140, 1970–1 C.B. 73; *see also* BITTKER & EUSTICE at 3–8 to 3–10.

[41] 57 T.C. 128 (1971), *aff'd*, 481 F.2d 238 (5th Cir.), *cert. denied*, 414 U.S. 1092 (1973). *But cf.* Rev. Rul. 70–140, 1970–1 C.B. 73.

[42] 57 T.C. at 145.

Notwithstanding the potential application of the step transaction and business purpose doctrines to prevent end runs around the 80 percent control test, in some cases the taxpayer may be playing a zero sum game. He may have everything to gain if he wins the game (*i.e.*, nonrecognition) and nothing to lose, because the transaction would surely be taxable if the assets were simply transferred to the acquiring corporation in exchange for its stock.[43]

Genesis of the 80 Percent Control Test for Corporate Contributions

The genesis of both the section 351(a) nonrecognition rule and the section 368(c) definition of control was section 202(c)(3) of the Revenue Act of 1921.[44] The legislative purpose of section 202(c)(3) appears to have been to facilitate business readjustments, and at the same time prevent erosion of the fisc by the generation of colorable losses.[45] Congress thought it was economically unsound[46] to treat a contribution to a corporation as a taxable event where the shareholder either had control or was a member of a control group. Section

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[43] The incorporation followed by reorganization procedure outlined above points up another fallacy in the operation of the 80 percent test. Why should it be possible for General Motors to acquire the stock of the *Mom and Pop Corner Grocery Store, Inc.* in exchange for voting stock of G.M. and have the transaction treated as a nontaxable reorganization, whereas if G.M. acquired the partnership interests of the *Mom and Pop Corner Grocery Store Partnership* in exchange for voting stock, the exchange would be taxable? Of course, the 80 percent test as it applies to section 351 is not to be blamed, because it operates to insure that the second transaction is taxed in accordance with its economic substance. The problem lies with the reorganization provisions, for they operate to treat the first transaction in a manner that is truly alien to common sense. The tax impact of such transactions should not be based on the fortuitous choice of business form by Mom and Pop. Although the 80 percent test operates to produce a sound result in the second transaction, it nevertheless operates inequitably in view of the nonrecognition treatment available for the first by reason of the reorganization provisions. But for this short digression, the 80 percent control requirement of section 351 is viewed without respect to the operation of the reorganization provisions which are beyond the scope of this article. *See generally* BITTKER & EUSTICE at Ch. 14.

[44] Revenue Act of 1921, ch. 136, § 202(c)(3), 42 Stat. 227 (now section 351(a) of 1954 Code).

[45] These purposes were indicated in the following passage from the Senate report: "The . . . amendments . . . will, by removing a source of grave uncertainty and by eliminating many technical constructions which are economically unsound, not only permit business to go forward with the readjustments required by existing conditions but also will considerably increase the revenue by preventing taxpayers from taking colorable losses in wash sales and other fictitious exchanges." S. REP. No. 275, 67th Cong., 1st Sess. 11–12 (1921). The same statement also appears in the House report. H.R. REP. No. 350, 67th Cong., 1st Sess. 7 (1921).

[46] *Ibid.*

202(c)(3) also treated as nonrecognition events like kind exchanges,[47] reorganizations [48] and other exchanges in which the property received did not have a readily realizable market value. The purposes of these additional exceptions to the general rule of recognition appear to have been the same as those for contributions to controlled corporations.

The exception for exchanges involving property without a readily realizable market value would seem to have been applicable to contributions to corporations in exchange for stock amounting to less than control as long as the stock was without a readily realizable market value. Therefore, the Revenue Act of 1921 provided two exceptions to recognition treatment for contributions to corporations. The market value exception, however, was removed in the 1924 Act [49] in order to add more definiteness to the nonrecognition provisions.[50]

None of the reports to the 1921 Act explain the reason for the 80 percent control test. Possibly it was a reaction to an unsuccessful attempt to include in the Revenue Act of 1918 [51] a nonrecognition provision for contributions to corporations without regard to the amount of stock received. The Senate Committee on Finance inserted in the House bill, which became the Revenue Act of 1918, a provision which gave nonrecognition treatment to the following two types of transactions:

> [W]hen in connection with the reorganization, or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value,
>
> [W]hen a person receives in place of property stock of a corporation formed to take over such property . . . .[52]

The House receded to an amendment striking the provision relating to the organization of corporations but the reorganization, merger and consolidation provision was retained.[53] Thus, reorganizations were

[47] Section 1031 of the Code provides for nonrecognition treatment on certain like kind exchanges.

[48] The reorganization provisions of the Code are contained in sections 354 through 383.

[49] Revenue Act of 1924, ch. 234, § 203(a), 43 Stat. 253.

[50] The House report said: "It appears best to provide generally that gain or loss is recognized from all exchanges and then except specifically and in definite terms those cases of exchange in which it is not desired to tax the gain or allow the loss. This results in definiteness and accuracy and enables a taxpayer to determine prior to the consummation of a given transaction the tax liability that will result therefrom." H.R. REP. No. 179, 68th Cong., 1st Sess. 13 (1924).

[51] Revenue Act of 1918, ch. 18, 40 Stat. 1057.

[52] S. REP. No. 617, 65th Cong., 3d Sess. 5-6 (1918).

[53] H.R. REP. No. 1097, 65th Cong., 3d Sess. 44-45 (1919).

accorded nonrecognition treatment by the Congress before such treatment was accorded to contributors to corporations.

In the absence of any specific legislative statement of the purpose of the 80 percent control test, one is left to pure conjecture as to why 80 percent was chosen as the benchmark. Possibly it was a compromise between those who favored blanket nonrecognition treatment and those who favored blanket recognition treatment. At any course, the underlying theory of section 351(a) is that there is an inherent difference between (1) a transfer of property to an enterprise in exchange for an ownership interest and (2) an exchange transaction between two unrelated parties in which the transferor loses control over the asset transferred. In the words of Judge Magruder in *Portland Oil Co. v. Commissioner*,[54] a case involving the predecessor of section 351:

> It is the purpose of [section 351] to save the taxpayer from an immediate recognition of a gain, or to intermit the claim of a loss, in certain transactions where gain or loss may have accrued in a constitutional sense, but where in a popular and economic sense there has been a mere change in the form of ownership and the taxpayer has not really "cashed-in" on the theoretical gain or closed out a losing venture . . . . "The transaction described in the statute lacks a distinguishing characteristic of a sale, in that, instead of the transaction having the effect of terminating or extinguishing the beneficial interests of the transferors in the transferred property, after the consummation of the transaction the transferors continue to be beneficially interested in the transferred property and have dominion over it by virtue of their control of the new corporate owner of it." [55]

Contribution transactions may be more like "changes in form and not in substance, and consequently should not be considered as affecting a [recognition] of income at the time of the exchange." [56] In such exchanges the investor, in effect, retains a continuing interest in the property transferred equal to his percentage of the outstanding ownership interests. If the continuing interest is significant, the contribution transaction is neither "a pure sale [nor] an exchange . . . amount[ing] to a pure sale." [57]

The degree of difference between a contribution to an enterprise in exchange for an ownership interest and an exchange amounting to a pure sale varies inversely with the percentage of ownership interest received. A contribution of property in exchange for a 1 percent owner-

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[54] 109 F.2d 479 (1st Cir.), *cert. denied*, 310 U.S. 650 (1940).

[55] 109 F.2d at 488 (quoting American Compress & Warehouse Co. v. Bender, 70 F.2d 655, 657 (5th Cir. 1934)).

[56] H.R. Rep. No. 179, 68th Cong., 1st Sess. 16–17 (1924). The statement refers to the theory of the substituted basis rule which is now reflected in section 358.

[57] *Ibid.*

ship interest more nearly resembles a pure sale than does a contribution in exchange for a 90 percent ownership interest. Undoubtedly the rationale of the 80 percent control test is bottomed on a desire to give recognition treatment to those contribution transactions which are pure sales, such as contributions of property to an ongoing publicly held corporation in exchange for marketable stock amounting to only a small fraction of the corporation's outstanding stock. Certainly the 80 percent control test avoids nonrecognition treatment for some exchanges which are tantamount to pure sales, but it also gives rise to recognition treatment for some exchanges which are *not* pure sales. On the formation of a corporation a 1 percent investor will receive nonrecognition treatment because he is a member of the control group, whereas a new 79 percent investor in an operating corporation will not receive nonrecognition treatment. This is so notwithstanding the fact that the transaction involving the 1 percent shareholder clearly more nearly resembles a pure sale. Further, assume that a new shareholder will be contributing to an operating corporation a building with a fair market value of \$100K and an adjusted basis of \$50K. If he receives only 1 percent of the stock, the transaction resembles a pure sale and the 80 percent test operates in accordance with economic reality by treating it as such. On the other hand, if he receives 79 percent of the stock the transaction more nearly resembles a change in form of ownership rather than a pure sale, but the 80 percent test operates to treat the transaction as though it were a pure sale. If the property contributed had an adjusted basis in excess of its fair market value, the loss would be recognized in the case of the receipt of 1 percent of the stock, but by reason of the operation of section 267 would not be recognized in the case of the receipt of 79 percent of the stock. Section 267 disallows, inter alia, losses on otherwise taxable transactions between an individual shareholder and a "corporation more than 50 percent in value of the outstanding stock of which is owned directly or indirectly by or for such [shareholder]" and certain related parties. On the loss side, therefore, section 267 in effect lowers the 80 percent control test to more than 50 percent.[58] Although the legislative history

[58] Section 267 can operate in some cases to lower the 80 percent control requirement to a mere nominal amount of stock. This is so because of the attribution rules of section 267(c), which provide, inter alia, that a shareholder is deemed to own the stock owned by certain members of his family. Thus, if a father contributes loss property to an operating corporation in exchange for 1 percent of the stock, and his son owns the balance of the stock, the transaction would be taxable under section 351 because of the 80 percent control test, but the loss would not be recognized because of the operation of section 267. Unlike section 267 the 80 percent control test of section 368(c) does not have an attribution provision.

of section 267 does not indicate specifically why 50 percent was chosen,[59] the section is a legislative judgment that with respect to contributions of loss property in exchange for stock the breakpoint between a pure sale and a mere change in form is much lower than in the case of a contribution of gain property.

Genesis of the Partnership Contribution Provision

As is the case with the 80 percent control test for corporations, one is at a loss in attempting to ascertain a sound rationale for the total absence of any type of control requirement for contributions to partnerships. The nonrecognition rule in section 721 was first enacted in 1954. The House and Senate reports indicate, however, that section 721 was a mere codification of existing law.[60] The law as it existed at the time of the enactment of section 721 was that a contribution to a partnership in exchange for a partnership interest was not a realization event. This nonrealization concept seems to have originated in a 1920 opinion of the Solicitor of Internal Revenue.[61] In that opinion he held, inter alia, that contribution of property by a partner to a partnership in exchange for a partnership interest was not a realization event. He reasoned that to hold otherwise "would be to hold that [a] partner could make a profit by selling to himself." [62] The holding was grounded on the common-law concept that a partnership was an aggregate and not an entity.

In *Edward B. Archbald,*[63] a 1933 case, the Commissioner attempted to reverse this position that a contribution to a partnership in exchange for a partnership interest was not a realization event (at least so far as it applied to the particular facts). There the taxpayer partners had contributed appreciated property to a partnership which

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[59] H.R. Rep. No. 1546, 75th Cong., 1st Sess. 26–27 (1937).

[60] S. Rep. No. 1635, 83d Cong., 2d Sess. 388 (1954); H.R. Rep. No. 1337, 83d Cong., 2d Sess. A227 (1954). The expressed congressional intent that the purpose of section 721 was to codify the previous law is technically inconsistent with the operation of that section. Section 721 provides an exception to the general rule of recognition of section 1002 which is operative only in a case where there is a realization event under section 1001. Since, as is indicated in the immediately succeeding text, the previous law was that such transactions were not realization events there would seem to be no logical reason to provide an exception to the general rule of recognition. However, one possible explanation might be that prior to 1954 partnerships were considered aggregates, whereas under the 1954 Code they are entities for certain purposes and aggregates for others.

[61] S.O. 42, 3 C.B. 61 (1920).

[62] 3 C.B. at 64.

[63] 27 B.T.A. 837 (1933), *nonacq., aff'd,* 70 F.2d 720 (2d Cir.), *cert. denied,* 293 U.S. 594 (1934).

sold the property for amounts either equal to or greater than the value at the time of contribution. The Commissioner's primary contention was that the partnership's basis for computing gain should be a carryover basis as is presently the rule under section 723 and that the precontribution gain should be allocated ratably to the contributing partners. In the alternative the Commissioner argued that "if the partnership is so far an entity as to be a barrier to the use of the individual contributor's earlier cost basis [*i.e.*, carryover basis], then the contribution by the individual to the partnership must be . . . 'a closed transaction,' . . . and that such 'closed transaction' involves a realization to the individual of the gain."[64] The taxpayers argued for a basis equal to the fair market value at the time of contribution.

The Tax Court held for the taxpayers, reasoning, inter alia, that they would be taxed on the precontribution gain at the time the partnership was liquidated.[65] The court also reasoned that for purposes of determining the amount of a partnership's taxable income, the partnership was to be viewed as an entity. The partners would not, therefore, be deemed to have a realization of precontribution gain at the time the partnership disposed of the property. With respect to the Commissioner's closed transaction theory, the court reasoned that "[s]ince a partnership stands ambiguously before the law in other fields, it is not disturbing that it should be found so under the income tax statute,"[66] particularly in view of the 1920 Solicitor's Opinion which in effect found the partnership to be an aggregate for contribution purposes and an entity for basis purposes. The court also gave its view of the correctness of the Solicitor's Opinion:

> But if we felt entirely at liberty to consider the contention apart from its history [*i.e.*, the 1920 Solicitor's Opinion], we would find it unconvincing. That the contribution of individual property to a newly organized partnership operates to shift its title from the individual and to change the nature of his interest is clear. But it does not follow that such change is itself the realization of gain or loss. On the contrary, the investment is now more fettered than before, as it is bound with others in the joint enter-

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[64] 27 B.T.A. at 843.

[65] The court was not convinced of the merit of the Commissioner's observation that because of the stepped-up basis at death the precontribution gain would escape taxation if the partners died before the partnership was liquidated. To this argument the court responded: "The suggestion that the increment may go untaxed in the event the partner dies before such realization, is not sufficient to deflect the rule, for to a similar extent the death of an individual owner likewise defeats a tax upon increment which has not theretofore been realized. There has been no inclination thus far to enact either an obituary toll by treating death as a realization of income or to impose a preventive substitute." 27 B.T.A. at 843.

[66] *Id.* at 844.

> prise. Although a transformation in title has occurred, there has been no exchange of property for other and different property, but only a further venturing of the old investment in a new project with the hope of added income in the future.[67]

In further support of its nonrealization event rationale, the *Archbald* court distinguished partnership interests from corporate shares on the grounds that the transfer of a partnership interest would destroy the partnership, whereas a transfer of a share of stock would not destroy a corporation. Apparently the court thought that because of the inherent restrictions on the alienability of partnership interests, a contribution of property in exchange for a partnership interest would not constitute a realization event. It is questionable whether the distinction is meaningful.

Helvering v. Walbridge,[68] a 1934 case, involved facts analogous to those in *Archbald*. A partner contributed appreciated securities to a brokerage partnership. The partnership sold the securities for a price in excess of the value at the time of contribution. The partners reported only the postcontribution appreciation. The Commissioner, as he did in *Archbald*, argued in the alternative that (1) the contribution transaction was a realization event or (2) the gain on sale of the contributed securities should be calculated from a carryover basis with the difference between the carryover basis and the value at the time of contribution attributed directly to the contributing partner. Judge Learned Hand, writing for the Second Circuit, rejected the Commissioner's arguments.

On the first point the court reasoned that the contribution transaction was not a realization event because the partnership interest received did not have a fair market value: "In the case at bar Walbridge's share in this firm, engaged in marketing securities, was not 'marketable'; the assumption is wholly unfounded that it was worth the value of his contribution." [69] The court went on to say that although under the New York partnership law a sale of a partnership interest would not disrupt the firm, an assignee would only have a right to an accounting. The court said that here there were "no known buyers, nor any but imaginary demand" for such "a unique right of action." [70] The opinion would seem to have left open the possibility of certain contribution transactions being treated as realization events. For instance, if the facts showed that a partnership interest received

[67] *Ibid.* (citations omitted).
[68] 70 F.2d 683 (2d Cir.), *cert. denied*, 293 U.S. 594 (1934).
[69] 70 F.2d at 684.
[70] *Id.* at 685.

was marketable, it would not appear inconsistent with *Walbridge* to treat the transaction as a realization event under the Commissioner's closed transaction theory. But the reasoning appears faulty because the points made about the partnership interest received in *Walbridge* are equally true about stock received on the formation of a closely held corporation. The latter transactions have always been treated as realization events, and presumably the *Philadelphia Park* [71] presumption that in an arm's length transaction the value of what is received is equal to the value of the property exchanged would operate to provide a value for the ownership interest received.

The 1920 Solicitor's Opinion and the rejection of the Commissioner's closed transaction theory in *Archbald* and *Walbridge* appear to be grounded on the absence of a pure exchange transaction. Since the partner retains an interest in the property contributed by reason of his partnership interest, no exchange amounting to a pure sale has taken place.[72] There is no realization event. Since the transaction is not a realization event there is no need to search for an exception to the general rule that all realized gain shall be recognized. This conceptual treatment of contributions to partnerships is inherently different from the treatment for contributions to corporations. As indicated above, not until the Revenue Act of 1921 were some corporate contributions statutorily excepted from the general rule of recognition.

Without regard to whether a contribution transaction is treated as a nonrealization event or a statutory exception to the recognition rule, it is indeed logical to provide nonrecognition treatment in cases where the contributing partner receives a substantial partnership interest. Such were the facts in each of the Solicitor's Opinion, *Archbald* and *Walbridge*. But the important question is: How far can nonrecognition treatment be logically extended? Should it also apply to a transfer of property to a publicly held limited partnership which is listed on the New York Stock Exchange in exchange for a 1 percent limited partnership interest? If the Solicitor's Opinion, *Archbald* or *Walbridge* had dealt with such a situation, it is likely that the exchange would have been found to be a realization event under the Commissioner's closed transaction theory. In all probability an unarticulated aspect of each of these decisions is the requirement of a substantial continuing proprietary interest in the partnership. Not facing a close case, neither the courts in *Archbald* and *Walbridge*, nor the Solicitor of Internal Revenue in his 1920 Opinion considered the breakpoint be-

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[71] Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184 (Ct. Cl. 1954).

[72] H.R. REP. No. 179, 68th Cong., 1st Sess. 16–17 (1924).

tween a substantial proprietary interest and a mere nominal proprietary interest. They did not come to grips with the question of when a contribution to a partnership in exchange for a partnership interest more nearly resembles a pure sale than a mere change in form of ownership.

There is no sound rationale for distinguishing partnership interests from shares of stock with respect to the question of whether a realization event has occurred. In the case of small closely held enterprises it is likely that the ownership interests will be unmarketable without regard to whether the enterprise is a partnership or corporation. The ownership interests of both closely held corporations and closely held partnerships are likely to be subject to restrictions set out in a buy-sell agreement. Under the Uniform Partnership Act the transfer of a partnership interest will not itself dissolve the partnership,[73] although the transferee's rights are in essence limited to sharing the profits attributable to the partnership interest acquired.[74] A corporate buy-sell agreement may have the same effect. Under the Uniform Limited Partnership Act, a limited partner's interest is assignable,[75] and if the other partners agree, the assignee can become a substituted limited partner with all the rights of the assignor limited partner.[76] Consequently, without regard to the previous state of the law of partnerships, presently an assignment of a partnership interest will not dissolve the partnership.

At the time of each of the decisions in the Solicitor's Opinion, *Archbald* and *Walbridge,* there were probably no publicly held partnerships as there are today. At the time of the codification of the nonrecognition rule in 1954 with the enactment of section 721, there were probably few, if any, publicly held limited partnerships. The publicly held limited partnership did not become common until after the enactment of the 1954 Code.[77] Even today, however, the overwhelming number of partnerships have only a handful of partners.[78] Consequently, there

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[73] UNIFORM PARTNERSHIP ACT § 27.

[74] *Ibid.*

[75] UNIFORM LIMITED PARTNERSHIP ACT § 19.

[76] *Ibid.*

[77] *See* WILLIS at 21.

[78] *The Business Income Statistics of the Internal Revenue Service for 1968* indicates that in 1968 the average number of partners per partnership was just over three. U.S. TREASURY DEP'T, INTERNAL REVENUE SERVICE PRELIMINARY; STATISTICS OF INCOME 1968; BUSINESS INCOME TAX RETURNS 24 (1970). Also, Schedule M of the Partnership Return Form 1065 has space for a maximum of four partners, an indication of the usual small number of partners in a partnership. Of course, if there are more than four partners a supplement to Schedule M must be attached.

will probably be few instances in which contributions of property to a partnership in exchange for a partnership interest will resemble a pure sale. In the normal case, therefore, the operation of section 721 is in accordance with economic reality, nevertheless, in certain cases it may operate inconsistently with a rational tax policy.

Search for a Rational Policy—
Policy Implications of Control Requirement

It is unsound from a tax policy standpoint for all contributions to partnerships in exchange for partnership interests to be given nonrecognition treatment while only a limited number of contributions to corporations in exchange for stock or securities are given nonrecognition treatment.[79] There is no economic difference between contributions to the two types of enterprises, therefore, contribution transactions should be treated the same without respect to the nature of the enterprise. Since the investor group on an initial organization exchange ends up with 100 percent of the ownership interests, there is no difference in the treatment with respect to an initial organization exchange, because section 351 with its 80 percent control group test is analogous to the treatment under section 721. Different treatment can occur, however, in the case of contributions to operating enterprises. A transfer to an operating partnership in exchange for a partnership interest will not give rise to recognition, whereas a transfer to an operating corporation in exchange for stock or securities may give rise to recognition.

The strongest policy reason for giving either transaction nonrecognition treatment would seem to be the facilitation of business development through the attraction of additional capital.[80] A second reason is that, in general, there could be no sound policy justification for taxing exchanges which are mere changes in form of ownership. Set off against these rationales is the desirability of treating exchanges which resemble pure sales as taxable. In the partnership area, the legislative judgment appears to have been that no contribution of property in exchange for a partnership interest resembles a pure sale. In the cor-

[79] Prior to the Revenue Act of 1921 all transfers of property to corporations were treated as both realization and recognition events. Section 203(c) of the 1921 Act gave nonrecognition treatment to such transfers where the transferors had 80 percent control. Notwithstanding this nonrecognition treatment, such transfers are still realization events.

[80] The *Archbald* court gave this as a reason for nonrealization treatment for contributions to partnerships (27 B.T.A. at 844); and the Senate and House reports to the 1921 Act gave this as one of the reasons for the enactment of the predecessor of section 351.

porate area, the tension between the two policies is resolved by the legislative judgment that contributions in which less than 80 percent control is received more nearly resemble pure sales than mere changes in form of ownership. Such transactions will, therefore, be treated as taxable.[81] The 80 percent control test for corporations and the complete absence of a control test for partnerships can produce illogical results. A contribution of property to an operating partnership in exchange for a 1 percent partnership interest will not produce recognition, but a contribution of property to an operating corporation in exchange for 79 percent of the stock in the case of gain property or 50 percent of the stock in the case of loss property[82] will produce recognition. A contribution to a partnership in exchange for a 1 percent partnership interest obviously resembles a pure sale, and, more importantly, a contribution to a corporation in exchange for 79 percent of the stock is clearly the type of transaction which both (1) will facilitate business development and (2) resembles an exchange which is a mere change in form of ownership.

Since the 80 percent control requirement can lead to absurd results but at the same time may be easily circumvented with creative tax planning, what meaningful purpose does it serve? Is it not just a trap for the uninformed? On the other hand, cannot the blanket nonrecognition treatment for any and all contributions to partnerships operate to treat transactions which are in economic substance sales as nonrecognition events? There is, however, logic and illogic in both rules. The problem from a tax policy standpoint is to attempt to eliminate the absurdities which are alien to both common sense and economic reality and to design a simple and logical scheme that would be equally applicable to partnerships and corporations. This can be done by distinguishing those contributions of property to an enterprise which more nearly resemble pure sales from those which more nearly resemble mere changes in form of ownership. One of the bases for the distinction should be whether the transaction is likely to have such a significant impact on business development so as to be facilitated by exemp-

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[81] Section 267 is an exception to this judgment in the case of a contribution of loss property.

[82] Transactions in which a shareholder receives less than control are not protected by section 351 and, therefore, recognition would prevail. In cases where the stock ownership is greater than 50 percent but less than 80 percent, section 267 would operate to treat a contribution of loss property as a nonrecognition event. Consequently, on a contribution of loss property for stock amounting to more than 50 percent but less than 80 percent, the transaction is treated as a sale for purposes of section 351, but is treated as a nonrecognition event by section 267. Section 267 is designed to prevent the creation of artificial loss deductions.

tion from the general rule of recognition. In making the distinction it is desirable to treat separately three types of transactions:

(1) The organization of a new enterprise.

(2) A contribution by a group of investors to an operating enterprise of a massive amount of capital as measured by the value of the outstanding stock received for the property contributed.

(3) A contribution by a single investor to an operating enterprise of a substantial amount of capital as measured by the value of the outstanding stock received for the property contributed.

These three transactions should be considered separately because each presents different factors which should be considered in determining whether nonrecognition treatment should be accorded to a contribution.

Organization of a New Enterprise

The coming together of a diverse group of investors to organize a single business venture is important to the development of business enterprises. Also, such transactions do not, in general, resemble pure exchanges. Although in the case of the 1 percent investor the organization transaction may not resemble a mere change in form of ownership, because the organization of new business enterprises is of such importance, it would not be wise to treat such transactions as recognition events for any of the members of the initial investment group. A denial of nonrecognition treatment to some (or possibly all) members of the organization group could certainly deter the organization of new business enterprises. Consequently, on the organization of a new enterprise all of the initial investors should be given nonrecognition treatment for their contributions of property in exchange for ownership interests. Under the current state of the law with respect to the formation of partnerships and corporations, all of the investors in an organization group receive nonrecognition treatment and this treatment should be continued.

Contribution of a Masssive Amount of Capital by a Group of Investors to an Operating Enterprise

A contribution of a massive amount of new capital to an operating enterprise by a group of investors should be given nonrecognition treatment for the same reasons which support nonrecognition on an initial organization. Such contributions are an indicia of a revitalization of an ongoing venture and do not resemble pure exchange transactions. Consequently, they should be given nonrecognition treatment.

The test of whether a contribution is massive should be determined by reference to the value of the ownership interest received in exchange for the property contributed relative to the value of the outstanding ownership interests immediately after the contribution. In order to consider the contributions of all members of the new investor group the basic control group concept for contributions to corporations would have to be used, but control would be measured solely by reference to the percentage of ownership interests received as a result of the contribution of the property. To include previously owned ownership interests in determining whether control existed would permit nonrecognition to be accorded for a small investment by a group in a case where the group or certain members thereof owned substantial ownership interests prior to the contribution.

The measurement of control by reference to the ownership interests received by the group in respect of the property contributed would be a clear departure from the current rule for both corporations and partnerships. With respect to corporations, if a group of shareholders owns in the aggregate 80 percent of the stock of a corporation after a contribution of property (without respect to the amount owned before the contribution) nonrecognition treatment is accorded to all members of the group. This means, for instance, that if a group of shareholders owned 100 percent of the stock of a corporation the group would receive nonrecognition treatment on the contribution of any additional property without respect to the value of such property. The normal situation in which a group of present shareholders will be making additional contributions will involve proportionate contributions by all shareholders. It may appear at first glance that such contributions should be given nonrecognition treatment. A blanket rule of nonrecognition would not be wise, however, because it would permit certain transactions which were pure exchanges to be given nonrecognition treatment. For instance, suppose a group of three equal shareholders owned a corporation with a value of $10 million and that each will be making additional contributions of a small amount of capital, say $5K. There is no sound policy reason for permitting these shareholders nonrecognition treatment for such minor contributions. Such contributions would resemble pure exchange transactions, and it is unlikely that the application of the general rule of recognition would act as a deterrent to such contributions if, indeed, the additional capital was needed by the enterprise. On the other hand, if the contributions were massive (say, for instance, each shareholder would be contributing $5 million of additional capital), then nonrecognition treatment should be accorded to the contributions because such contributions, in general, are essential to the business development and do not resemble pure exchanges. Although under the rule proposed here only group contributions of massive amounts of capital would be given nonrecognition treatment, the single investor can also rely on the substantial contribution provision described below.

The recognition rule for nonmassive group contributions would apply even in cases where because of the pro rata nature of the contributions the shareholders in the group do not take back additional ownership interests. If additional ownership interests were not distributed, the transaction should be considered as a constructive receipt of ownership interests in exchange for the property contributed.[83]

In determining the amount of ownership interest which would be representative of a massive infusion of capital, the starting point should be the 80 percent control test of section 368(c) which is made applicable to the formation of corporations by section 351(a). The 80 percent rule is a clear legislative judgment that a contribution of property in exchange for 80 percent of the stock of a corporation represents a massive infusion of capital. But, is 80 percent necessarily a logical breakpoint? It would appear that the breakpoint could be much lower, possibly 50 percent. The adoption of a 50 percent test would mean that nonrecognition treatment would result any time a group of investors contributed property to a corporation or partnership in exchange for ownership interests representing at least 50 percent control of the enterprise as determined by reference to the ownership interests received in respect of the contributed property. This rule would both broaden and narrow the nonrecognition treatment presently accorded to operating corporations and narrow the availability of nonrecognition treatment for contributions to operating partnerships. A group of new investors who contribute property to an operating corporation in exchange for less than 80 percent of the stock currently receive recognition treatment. Under the proposed rule such transactions would be given nonrecognition treatment as long as the group received at least 50 percent of the stock, thus broadening the corporate nonrecognition treatment. But, since the control test would be determined by reference to the stock received in respect of the property contributed, as opposed to the present rule of considering all stock without respect to the amount of stock received, the corporate

[83] *See, e.g.*, section 367 and Revenue Procedure 68-23, 1968-1 C.B. 821, issued under section 367. These provisions treat certain transfers of appreciated property to controlled foreign corporations as recognition events without respect to whether additional stock is issued by the controlled foreign corporation. This same principle could be applied to the transaction discussed in the text.

nonrecognition provisions would be narrowed. This narrowing, however, is constrained by the rule for contributions of substantial capital by the single investor which is discussed immediately below.

Contribution of Substantial Capital by a Single Investor to an Operating Enterprise

In considering contributions by a single investor, the 50 percent rule for massive infusions of capital seems to be too high a barrier to nonrecognition treatment. When a single investor contributes a substantial amount of new capital, as measured by the value of the outstanding stock received in exchange for the property contributed, nonrecognition treatment should be accorded, because such transactions do not resemble pure exchanges. Also the tax laws should not deter substantial investments by single investors in operating ventures. It is important to note the relationship between this substantial investment rule and the massive infusion of capital rule. The latter rule would apply to groups of investors and the group may contain investors who individually would be making insubstantial contributions of property. However, as long as the contributions of the group as an aggregate represent a massive infusion of capital, which is designated to be capital equal to 50 percent of the value of the outstanding ownership interests of the enterprise, nonrecognition treatment results. The investor who makes an insubstantial contribution will be given recognition treatment unless he is a member of an initial organization group or a group which is making a massive infusion of capital.

In determining whether a contribution by a single investor is substantial, only the stock received in respect of the property contributed should be considered. This provision would change the present rule for both partnerships and corporations. Under the present corporate provisions a more than 80 percent shareholder is given nonrecognition treatment for all contributions, whether substantial or insubstantial. For instance, under the present rules a shareholder who is the sole owner of a corporation with a value of $10 million can contribute an asset with a fair market value of $5K and an adjusted basis of $1K and receive nonrecognition treatment on the contribution. Clearly the transaction resembles a pure exchange, and further it is unlikely that the general rule of recognition would act as a deterrent to such a contribution if, indeed, the $5K asset would have a substantial impact on the viability of the enterprise. There is an absence of a sound policy rationale for granting nonrecognition to such transactions whether the enterprise is a partnership or a corporation. This is so even if the investor does not take back additional ownership interests to represent his additional contribution. As in the case of contributions by groups, if the investor does not take back additional ownership interests, the transaction should be viewed as a constructive distribution of ownership interests in exchange for the property.[84]

The next question is what is a logical breakpoint between a substantial and insubstantial investment. Obviously the breakpoint should be lower than the 50 percent which is suggested for massive infusions of capital. Indeed, the denial under section 267 of loss deductions for sales between a corporation and a greater than 50 percent shareholder is an implicit recognition by Congress that such transactions more readily resemble mere changes in form of ownership than pure exchange transactions.

Possibly some insight into the question of a logical breakpoint between a substantial and insubstantial contribution can be gotten from a look at the collapsible corporation area. The courts and the Commissioner have wrestled with the problem of determining what is or is not a substantial part of a whole as the term is used in the definition of a collapsible corporation.[85] The two leading cases are *Commissioner v. Kelley*[86] and *Heft v. Commissioner*,[87] both of which were decided by the Fifth Circuit Court of Appeals. *Kelley* held that a 33⅓ percent realization was a substantial part. The corporation was, therefore, not collapsible and the taxpayer had capital gains rather than ordinary income on the sale of his stock. *Heft* held that 17 percent realization was not a substantial part. The corporation was, therefore, collapsible and the taxpayer had ordinary income rather than capital gains on liquidation. The Commissioner has said he will follow the *Kelley* decision, thus agreeing that 33⅓ percent is a substantial part.

Although it can be misleading to analogize principles in two different areas of the law, it would not be illogical to conclude that since 33⅓ percent is a substantial part of a whole, a contribution to a firm in exchange for a 33⅓ percent ownership interest is a substantial contribution. The use of a substantial part in the collapsible corporation

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[84] *Ibid.*

[85] The problem of determining what is a substantial part of a whole arises in the collapsible corporation area under section 341. Section 341(b)(1) defines a collapsible corporation as, inter alia, a corporation with respect to which the shareholders intend to either liquidate or sell before the corporation has realized a substantial part of the taxable income to be derived from certain property. If a substantial part has not been realized, a sale of the stock or liquidation may give rise to ordinary income as opposed to capital gains.

[86] 32 T.C. 135 (1959), *acq., prior nonacq. withdrawn*, Rev. Rul. 72–48, 1972–1 C.B. 102, *aff'd*, 293 F.2d 904 (5th Cir. 1961).

[87] 294 F.2d 795 (5th Cir. 1961), *affirming* 34 T.C. 86 (1960).

area is, however, designed as part of a prophylactic device for preventing the conversion of ordinary income into capital gains, whereas the nonrecognition provisions are designed to facilitate business adjustments. It would not, therefore, be illogical to consider something less than a 33⅓ percent contribution as substantial. Possibly the breakpoint should be 25 percent, a clean split between *Kelley*'s 33⅓ percent and *Heft*'s 17 percent.

The effect of a 25 percent test for substantial contributions by a single investor would be to measurably broaden the availability of nonrecognition treatment for contributions to operating corporations, except with respect to contributions by 80 percent or more stockholders who are currently given nonrecognition treatment without respect to the amount of their contributions. The overall effect would be to further facilitate corporate business adjustments while at the same time putting a tighter control on the deductibility of colorable losses.[88] The rule would narrow the availability of nonrecognition treatment for contributions to operating partnerships. This would be a possible detriment to taxpayers in the case of a contribution of gain property in exchange for less than a 25 percent partnership interest, but a benefit on the contribution of loss property for less than a 25 percent partnership interest. Although it might seem harsh to give a less than 25 percent partner recognition treatment on the contribution of gain property to an operating partnership, there would also be a benefit to the partnership (and derivatively to the partners, including the contributing partner) of a higher basis for the asset contributed.[89] Moreover, under the present law such a transaction would be a recognition event if the firm (with the same assets and liabilities) happened to be a corporation rather than a partnership.

In summary the following rules of nonrecognition for contributors to enterprises are proposed:

(1) Nonrecognition treatment should continue to apply to contributions to newly organized enterprises.

(2) Nonrecognition should apply to contributions of property to operating enterprises by a group of investors in exchange for at least

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[88] A lowering of the 80 percent test to 25 percent would automatically lower the section 267 control test for nonrecognition of losses from more than 50 percent to 25 percent when property is contributed in exchange for stock.

[89] This would permit the conversion of capital gains into ordinary income in a case where the asset contributed by the less than 25 percent partner would produce capital gains to the partner and would give the partnership a higher basis for either depreciation or inventory. This is, however, the present result for contributions to operating corporations for less than 80 percent of the stock.

50 percent of the value of the outstanding ownership interests determined as of immediately after the contribution, and only the ownership interests received for the property contributed should be considered in determining whether the 50 percent test is met.

(3) Nonrecognition treatment should be accorded to contributions of property to an operating enterprise by a single investor in exchange for at least 25 percent of the value of the outstanding ownership interests determined as of immediately after the contribution, and only the ownership interests received for the property contributed should be considered in determining whether the 25 percent test is met.

These three rules of nonrecognition treatment would substantially mitigate the illogical results under the present scheme which were pointed out above. No longer would the 79 percent investor in an operating corporation receive recognition treatment while a 1 percent investor who is a member of a corporate organizing group is given nonrecognition treatment. Although the 1 percent group investor would still receive nonrecognition, the single investor contributing to an operating corporation in exchange for a 25 percent or greater ownership interest would be given nonrecognition treatment. No longer would the 1 percent investor in an operating partnership be given nonrecognition treatment, while (1) a 79 percent investor in an operating corporation is given recognition treatment in the case of a contribution of gain property or (2) a 50 percent or less shareholder in an operating corporation is given recognition treatment in the case of a contribution of loss property. The rules would reverse the results. The 1 percent investor in an operating partnership would receive recognition treatment. The 79 percent and 50 percent investors in an operating corporation would receive nonrecognition treatment. The rules will not eliminate attempts to obtain nonrecognition treatment through creative tax planning, but they will substantially reduce the necessity for the use of tax schemes to obtain nonrecognition treatment in the case of contributions to operating corporations. Creative planning may permit the circumvention of the 25 percent and 50 percent tests in order to obtain nonrecognition treatment on contributions to either a partnership or corporation just as it permits the circumvention of the present 80 percent test for contributions to corporations. The creative planning schemes would be equally applicable to both partnerships and corporations, and, therefore, any prophylactic devices which might become necessary could apply equally to partnerships and corporations.

There is nothing sacrosanct about the suggested 25 percent and 50 percent tests for nonrecognition treatment. Indeed it might even be wise to lower the 25 percent test to 10 percent or 5 percent and the 50 percent test to 25 percent. Possibly the Treasury should undertake to ascertain the optimum breakpoint between those contribution exchanges which are in effect mere changes in form and those which more nearly resemble pure sales.

Assignment of Tax Detriment or Benefit

Comparative Analysis of Assignment of Tax Detriment or Benefit

Outline of Problem

Introduction. This discussion is detailed and may be found rough going, but the issues are significant and to the author's knowledge have not been fully discussed before. A full development of the issues is necessary for an understanding of the policy proposal.[90]

If the ownership interests received by investors are based on the relative fair market values of the property contributed to the enterprise and the adjusted basis of some such property is different from its fair market value, there will be a shifting or assignment of (1) tax detriment in cases where the fair market value exceeds the adjusted basis or (2) tax benefit in cases where the adjusted basis exceeds the fair market value.

An investor who contributes property with a fair market value in excess of the adjusted basis will be shifting (assigning) to the other investors part of the tax liability in respect of the gain when the asset is disposed of. Also, if the asset is depreciable, the depreciation deduction will be lower than it otherwise would be. Both the potential tax liability and the reduced depreciation are referred to here as tax detriments to the other investors. On the other hand, an investor who contributes property with an adjusted basis in excess of fair market value will be shifting (assigning) to the other investors part of the benefit of the loss deduction to be realized on the disposition of the property. Further, if the asset is depreciable, the depreciation will be higher than it otherwise would be. Both the potential loss deduction and the higher depreciation charge are tax benefits to the other investors. The discussion here relates only to cases involving the assignment of tax

[90] *See generally* NESS & VOGEL, TAXATION OF THE CLOSELY HELD CORPORATION 2–64 *et seq.* (1972); Herwitz, *Allocation of Stock Between Services and Capital in the Organization of a Close Corporation,* 75 HARV. L. REV. 1098 (1962); and Baldwin, *§ 351 of the Internal Revenue Code and "Mid-Stream" Incorporations,* 38 U. CIN. L. REV. 96 (1969).

detriment; that is, cases where the fair market value of the property contributed is higher than the adjusted basis. In general, the results in the case of the assignment of tax benefit are the converse of those which obtain in case of the assignment of tax detriment.

Traditional assignments of income similar to those in *Lucas v. Earl*[91] and *Helvering v. Horst*[92] may occur on the formation of an enterprise. However, in all cases where the fair market value of the property contributed exceeds the adjusted basis there is a potential for an assignment of tax detriment without respect to whether the contribution is within the traditional assignment of income doctrine.

The problem with assignments of tax detriment can be particularly acute where there is a "midstream" contribution of assets of a going concern, such as a sole proprietorship. This could happen if, for instance, *A* and *B* formed the *AB* equal enterprise, and *A* contributed \$50K in cash and *B* contributed accounts receivable earned by him as a sole proprietor with a \$50K fair market value and a zero adjusted basis. This is an example of a traditional assignment of income scheme. Alternatively, an investor may contribute property in respect of which he has taken a business deduction which causes the property to have a higher fair market value than adjusted basis at the time of contribution. This could occur where, for instance,

(1) an investor takes a depreciation deduction before contributing property to an enterprise,

(2) an investor has immediately expensed the cost of certain assets, which are subsequently contributed to an enterprise,[93] or

(3) an investor has taken a deduction for an addition to a reserve for bad debts in respect of receivables which he subsequently contributes to an enterprise.[94]

Following are hypothetical fact situations which are used here

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[91] 281 U.S. 111 (1930).

[92] 311 U.S. 112 (1940).

[93] This would arise if, for instance, a sole proprietor in a laundry service business contributed to a firm laundry items which were expensed on purchase but had a fair market value at the time of contribution. *Cf.* Anders v. Comm'r, 414 F.2d 1283 (10th Cir.), *cert. denied,* 396 U.S. 958 (1969) (holding on tax benefit grounds that the sale of such expensed items generated taxable income unprotected by the nonrecognition provisions of section 337).

[94] In Nash v. United States, 398 U.S. 1 (1970), the Supreme Court held that a contribution of receivables to a corporation in a section 351 transaction will not give rise to income at the investor level in the amount of the deductions for the bad debt reserves where the stock received equalled the value of the receivables minus the reserve. The Court rejected the government's argument that the reserve for bad debts had to be recovered on tax benefit principles.

to illustrate the operation of various aspects of the assignment of tax detriment. Certain operating assumptions are made in order to isolate the tax detriment element. In the discussion there are two investors: the contributing investor and the noncontributing investor. The contributing investor contributes property with a fair market value in excess of its adjusted basis. He is thus contributing property in respect of which there is a potential assignment of tax detriment. The noncontributing investor contributes property with a fair market value equal to its adjusted basis. The tax detriment has one element in all cases and a second element in the case of depreciable assets. The first element is the tax liability which the noncontributing investor will suffer (either directly or derivatively) when the asset produces taxable income for the enterprise. This could occur either on the disposition of the asset in a taxable transaction, or, in the case of assets such as accounts receivables with a zero adjusted basis, on the collection of the income by the enterprise. The second element is that the benefit to the noncontributing investor from the enterprise's depreciation deduction in respect of a contributing investor's property will be less than it otherwise would have been if the adjusted basis of such property had been equal to its fair market value. Although economic reality is likely to diverge from the operating assumptions, the tax detriment element will be present regardless of the economic circumstances. In all cases the noncontributing investor would have been better off in the amount of the tax detriment if the adjusted basis of a contributing investor's property had been equal to its fair market value.

Example of Assignment of Tax Detriment With Respect to Property Not Subject to an Allowance for Depreciation. Assume that *A* and *B* form the *AB* equal enterprise, and *A* contributes $50K in cash and *B* contributes nondepreciable property with a fair market value of $50K and an adjusted basis of $25K. In the absence of an adjustment in the bargain to take account of the disparity between the fair market value and adjusted basis of *B*'s property, *B* will be assigning to *A* one half of the potential tax detriment in respect of the nonrecognized gain in his property. In the case of either a partnership or a subchapter S corporation, the assignment would be directly to *A* since both *A* and *B* would be directly liable for the tax on the enterprise's gain. In the case of a subchapter C corporation, the assignment would be directly to the corporation since it is a taxable entity and derivatively to *A* since the value of both *A*'s and *B*'s stock in the corporation would be diminished by any corporate tax paid in respect of such gain.[95]

[95] If *B* were the sole shareholder of the corporation to which the asset was contributed he would ultimately bear the burden of the tax in respect of the property.

Assuming the fair market value of the property remained constant, the enterprise would have a gain recognized of $25K when it sold the property. If the enterprise otherwise broke even, it would have $25K of taxable income. In the case of a partnership or subchapter S corporation each of *A*'s and *B*'s share of the taxable income would be $12.5K.[96] The tax detriment in respect of one half the gain is shifted directly to *A*. In the case of a subchapter C corporation the $25K gain would be subjected to a corporate tax, and the gain proceeds after payment of the tax would increase the corporation's earnings and profits.[97] Assuming that the corporate tax rate on the gain would be 30 percent,[98] the tax would be $7.5K, and the after-tax gain proceeds of $17.5K would increase the corporation's earnings and profits in such amount.[99] By contributing the property to the corporation *B* has shifted one half of the tax detriment in respect of such property to *A*. *A*'s stock, which initially had an intrinsic value of $50K [100] at the time of contribution, will have an intrinsic value of $46.25K after the sale (*i.e.*, $50K minus one half the tax, $3.75K).[101] Although the gain at the corporate level might be capital, any dividend distribution to the extent of the earnings and profits generated by the after-tax proceeds would be ordinary income.

The above results should be contrasted with the result which would have obtained if *B* had sold the asset in his individual capacity to a

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In the case of a subchapter C corporation the corporate tax would theoretically lower the value of *B*'s shares, and in the case of a subchapter S corporation, the tax in respect of the gain would be borne directly by *B*.

[96] This assumes no section 704(c) special partnership allocation. In the case of a partnership the character of the gain would be determined at the partnership level. I.R.C. § 702(b). In the case of a subchapter S corporation the character of the gain would be either ordinary income or long-term capital gains. I.R.C. §§ 1373(a), 1375(a).

[97] This built in earnings and profits at the time of contribution is referred to as donated earnings and profits. *See* SURREY at 282. Section 1.312-6(b) of the regulations requires that all items includable in gross income be included in the computation of earnings and profits. Thus, the precontribution gain which is realized and recognized by a corporation is required to be taken into account in computing earnings and profits. The surplus of the corporation for state law purposes, however, would not be increased by such gain. The surplus would be negative as a result of the tax.

[98] The corporate rate on all long-term capital gains realized for tax years beginning after December 31, 1974 is 30 percent. I.R.C. § 1201(a).

[99] *See* N. 97 *supra*.

[100] *A* put in $50K in cash for a one half interest in a corporation with assets with a fair market value of $100K. The intrinsic value of his stock was $50K.

[101] After the sale the corporation will have assets with a fair market value of only $92.5K ($100K minus the $7.5K tax on the gain), one half of which is attributable to *A*'s stock.

third party and had contributed the entire proceeds from the sale to the enterprise. In such case, *B* would have been taxed on the full gain of $25K. The character of the gain would have been determined solely by reference to the asset in *B*'s hands, and there would not have been an assignment of a portion of his tax detriment.[102]

Mitigation of Effects of Assignment of Tax Detriment on Taxable Dispositions of Ownership Interest. In the case of both a partnership and a subchapter S corporation the tax detriment shifted to the noncontributing investor will be theoretically mitigated on the taxable liquidation of the enterprise [103] or on the sale of the ownership interests. This would occur because the investors in partnerships and subchapter S corporations would increase the adjusted basis of their ownership interests in an amount equal to their share of the gain realized by the enterprise on the disposition of the asset.[104] In the case of the contributing investor such increase would be less than the fair market value of his share of the enterprise's assets. Conversely, such increase to the noncontributing investor would raise the adjusted basis of his ownership interest above the fair market value of his share of the enterprise's assets. Thus, other things being equal,[105] on taxable liquidation or sale of their ownership interests, the contributing investor would have a gain equal to the amount of the enterprise's gain previously shifted to the noncontributing investor, and the noncontributing investor would have a loss in the amount of such previously shifted gain. For example, assume that *A* contributes $50K in cash to an enterprise and *B* contributes property with a fair market value of $50K and an adjusted basis of $25K. If the enterprise is either a partnership

[102] Not only would there be no built in gain at the corporate level, there would also be no built in earnings and profits in the case of a subchapter C corporation.

[103] Pursuant to section 731, the liquidation of a partnership will, in general, be treated as a taxable event only if cash (and no other property) is distributed. If property is distributed the liquidation will, in general, be treated as a nonrecognition exchange. Pursuant to section 331, the liquidation of a corporation (both subchapters C and S) is a taxable event; however, some liquidations may be given nonrecognition treatment pursuant to section 333, an elective provision. If the liquidation is nontaxable there will not be an immediate mitigation of the assignment of the tax detriment, but such mitigation will be deferred by way of a modified substituted basis in the property distributed. I.R.C. §§ 732(a), 334(c).

[104] I.R.C. §§ 705(a)(1), 1376(a). This assumes that the enterprise otherwise broke even.

[105] "Other things being equal" here means the enterprise's assets at the time of sale or liquidation are equal in fair market value to the assets at the time of organization. This will be the case where (1) the enterprise breaks even for all periods between organization and liquidation or sale, (2) the economic depreciation on all depreciable assets exactly equals the tax depreciation, (3) there is no economic appreciation or depreciation in any of the nondepreciable assets and (4) the enterprise has made no distributions.

or a subchapter S corporation, on sale of the asset contributed by *B*, each of *A*'s and *B*'s adjusted basis for his ownership interest would be increased by $12.5K, one half of the enterprise's gain. *A*'s initial substituted basis of $50K would be increased to $62.5K, and *B*'s initial substituted basis of $25K would be increased to $37.5K. If the enterprise were liquidated in a taxable liquidation,[106] there would be $100K [107] of assets available for distribution, and *A* and *B* would each receive $50K. *A* would have a $12.5K loss on the liquidation which would compensate him for the prior incurrence of the tax detriment in respect of the shifted gain.[108] Conversely, *B* would have a $12.5K gain which is the price he would pay for shifting to *A* the tax detriment in respect of one half the gain.[109] These same results would attach if *A* or *B* sold his ownership interest.

A's $12.5K loss would theoretically offset the $12.5K of income he received from the enterprise's sale of *B*'s asset and, correlatively, *B*'s $12.5K gain on liquidation would theoretically put him in the same position he would have been in had he sold the asset himself initially. The loss or gain offset is theoretical in at least three respects. First, the offset will more than likely be capital gains or losses whereas the gain initially shifted may be ordinary income.[110] *A* may be receiving the benefit of a capital loss as an offset to ordinary income and *B* may have the detriment of a capital gain as the price for shifting ordinary income to *A*. Second, if either *A* or *B* dies while holding the ownership interest the potential offset will vanish because the basis of the property to the decedent's beneficiary would be the fair market value of the property.[111] Third, *A* is suffering the interest cost associated with the time value of money. He pays a tax in the year the enterprise sells the asset but does not get a loss deduction until he sells his owner-

[106] *See* N. 103 *supra*.

[107] *See* N. 105 *supra*.

[108] *A*'s adjusted basis for his ownership interest would be $62.5K and his amount realized $50K, giving him a loss realized and recognized of $12.5K. I.R.C. §§ 331, 731.

[109] *B*'s adjusted basis for his ownership interest would be $37.5K and his amount realized $50K, giving him a gain realized and recognized of $12.5K. I.R.C. §§ 331, 731.

[110] The liquidation or sale will give rise to capital gains or losses, in general. If the contributed asset is an ordinary income item to the firm (*e.g.*, section 1245 asset), the gain (or at least part of it) will be ordinary income. The capital gains or losses will not offset shifted ordinary income.

[111] Section 1014 requires, in general, that the basis of property acquired from a decedent be the fair market value of such property at the time of the decedent's death. On death *A*'s basis in the ownership interest would be lowered from $62.5K to $50K, and *B*'s basis would be increased from $37.5K to $50K, thereby forever eliminating the offset.

ship interest or the enterprise is liquidated. Thus, on liquidation or sale of the ownership interests of a partnership or subchapter S corporation there may be a theoretical equalizing effect, although the character of the gain or loss might differ from that of the initially shifted income.

The results in the partnership and subchapter S area do not obtain with subchapter C corporations. There will not be a theoretical equalizing effect at the time of taxable liquidation or sale of the shareholder's stock. The tax detriment shifted to the noncontributing shareholder will not be compensated for because there is no basis increase in his stock as is the case with partnerships and subchapter S corporations. Although, other things being equal,[112] the noncontributing investor will receive the benefit of a loss deduction on taxable liquidation or sale, the deduction will not fully compensate him for the incurrence of the tax detriment. The contributing shareholder will experience a double tax on his share of the gain. First, he indirectly experiences his share of the corporate tax. Second, because the adjusted basis of his stock is not increased, he will experience a tax on the gain on taxable liquidation or sale.[113]

The above principles can be illustrated by the following example. Assume that *A* contributes $50K of cash and *B* contributes $50K of property with an adjusted basis of $25K. After the subchapter C corporation sells the asset contributed by *B* and pays the corporate tax in respect of the gain, it would have $92.5K of assets. On taxable liquidation *A* and *B* would each receive $46.25K. *B* would be taxed on a gain of $21.25K, the difference between the amount realized ($46.25K) and the initial substituted basis of his stock ($25K). If he had borne the burden of all the $7.5K corporate tax, he would have received only $42.5K on liquidation, and he would have been taxed on a gain of $17.5K. In any event *B* would bear the burden of a double tax. One half of the corporate tax detriment, however, was shifted to *A*. Whereas *B*'s benefit from the shifting of the tax detriment is an additional $3.75K on liquidation minus the tax liability in respect thereof, *A*'s detriment from such shifting is the receipt of $3.75K less than he would have received had there been no shifting of the tax detriment. That is, without any shifting, *A* would have re-

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[112] *See* N. 105 *supra.*

[113] The taxable gain, other things being equal, will be one half the amount of the taxable gain to the corporation less one half of the corporate taxes attributable to such gain. If the firm were liquidated he would receive one half the assets, which would have a fair market value equal to the initial fair market value minus the corporate tax.

ceived \$50K on liquidation which is the amount of capital he contributed. The cost to *A* of the tax detriment would be somewhat mitigated, however, by the loss deduction which he would receive on liquidation. Since *A*'s adjusted basis in his stock is \$50K and he would receive \$46.25K on liquidation (the \$50K he contributed minus the \$3.75K corporate tax in respect of *B*'s property), he would get a \$3.75K loss deduction which would partially compensate him for incurring the detriment of one half the corporate tax.[114] The same results would obtain on sale of their ownership interests.

Assignment of Tax Detriment and Mitigation Thereof With Respect to Depreciable Property. A second element of the tax detriment will occur in the case where the property contributed is subject to an allowance for depreciation. Returning to the facts involving the *AB* equal enterprise, assume that the property *B* contributed had been an apartment building which he had purchased ten years ago for \$50K and that he had taken straight line depreciation of \$2.5K per year for each of the ten years he had held the building before contributing it to the enterprise. Also, assume that due to price level changes the building had retained its original fair market value of \$50K. Further, assume that the building was a depreciable asset to the enterprise, and the enterprise deducted \$2.5K of straight line depreciation each year. If the enterprise broke even before taking account of depreciation on *B*'s property, the \$2.5K depreciation deduction would generate a \$2.5K net operating loss. In the case of both a partnership and a subchapter S corporation each investor's share of such loss would be \$1.25K.

When considered in isolation the depreciation deduction looks like a clear tax benefit to both investors. In the case of *A*, however, there is a tax detriment, because if *B*'s property had had an adjusted basis equal to the \$50K fair market value, the depreciation would have been \$5K and *A*'s share of such depreciation would have been \$2.5K. *A*, therefore, has suffered a tax detriment in the amount of \$1.25K of depreciation which he should have received. It may seem as though *B* is also suffering a tax detriment since he too would have received the benefit of the extra depreciation after the contribution. However, *B* had already received the benefit of a total of \$25K depreciation at the time of contribution, and in order to treat both investors equally with respect to *B*'s contributed property, *A* would also

[114] This may look as if *A* is in his original position, but he is not. If *B*'s property had had an adjusted basis of \$50K, *A* would have received \$50K on liquidation or sale because no tax would have been payable on the sale of *B*'s assets. Consequently, *A* is only partially compensated for bearing the detriment of one half the tax attributable to *B*'s property. Such compensation is equal to the tax savings generated by the loss deduction.

have to receive the full benefit of $25K of the depreciation over the remaining life of the asset. Since the investors share equally in all respects *B* would get the advantage of one half of the depreciation after contribution in addition to the $25K of depreciation he received before contribution. The $1.25K yearly extra depreciation deduction which *A* should be receiving is taken by *B*. At the end of the 20 year useful life period, *A* would have had the benefit of $12.5K in depreciation deductions and *B* would have $37.5K.

In the case of a partnership or a subchapter S corporation, if there is either a taxable liquidation or sale of the ownership interests after depreciation is taken by the enterprise, there would be a theoretical mitigation of the effects of the assignment of tax detriment. *A* and *B* would be theoretically returned to the positions they would have occupied had the depreciation on *B*'s property been from an adjusted basis of $50K. In order to illustrate the mitigation effect, assume that (1) the rate of economic depreciation of the property contributed by *B* equaled the rate of tax depreciation for such property, (2) there was no economic appreciation or depreciation in any of the other assets and (3) the enterprise operated at a tax loss equal to the tax depreciation on *B*'s property. In such case *A* would get a loss recognized on the taxable liquidation or sale equal to the amount of the extra depreciation he should have gotten ($1.25K),[115] and *B* would have an added gain recognized equal to the depreciation which was diverted from *A* ($1.25K).

Since under the assumptions the rate of economic depreciation on *B*'s property equaled the rate of tax depreciation (10 percent), at the end of the year the fair market value of such property would be $45K, a decrease of $5K. On the other hand, the tax depreciation in respect of such property would have only been $2.5K (10 percent of the enterprise's initial carryover basis).[116] Consequently, although *B*'s prop-

[115] This assumes that the going concern value of the enterprise is equal to the fair market value of the enterprise's underlying assets.

[116] This assumption is based on the theory that the economic depreciation in the property will equal tax depreciation. Indeed, tax depreciation, here 10 percent of the adjusted basis, is premised on an assumption about the economic depreciation. Since the building has an estimated useful life of ten years, a zero salvage value and straight line depreciation is taken, the 10 percent yearly tax depreciation assumes that the building will also economically depreciate 10 percent per year. The economic depreciation is taken from the fair market value of the property, which in this case is $50K, whereas, the tax depreciation is taken from the adjusted basis of the property pursuant to section 167, which in this case is the carryover basis of $25K. Consequently, assuming that the percentage of economic depreciation on *B*'s property during the first year was equal to the percentage of tax depreciation during such year, the building would have a fair market value of $45K at the end of the year and an adjusted basis of $22.5K.

erty has economically depreciated in value by $5K, the tax depreciation deduction has only allowed for a $2.5K recovery of capital.[117] The capital recovery is reflected by the $2.5K net operating loss, $1.25K of which would be deducted by each of *A* and *B*. The fair market value of the enterprise's capital at the end of the year would be $95K—the original fair market value ($100K) minus the economic depreciation on *B*'s asset ($5K).[118] On sale of their ownership interests, *A* and *B* would each receive $47.5K. Since *A* would have gotten a loss deduction of $1.25K for the taxable year by reason of the depreciation deduction, the adjusted basis of his ownership interest would have dropped from $50K to $48.75K. On sale he would, therefore, have a loss recognized of $1.25K. This $1.25K loss deduction plus the $1.25K depreciation deduction would give *A* a full capital recovery of $2.5K (the $50K capital invested minus the $47.5K amount realized on sale). The offset is theoretical, however.[119]

B's situation is the converse of *A*'s. *B*'s adjusted basis for his ownership interest would be reduced by $1.25K from $25K to $23.75K by reason of the operating loss. He would receive $47.5K on sale. He would have a gain of $23.75K, $1.25K of which would result from the extra depreciation allowable to him. The cost to him of the additional depreciation is an increased gain on sale, because if *A*'s share of the depreciation had not been allocated to him, his basis in the building would have been $1.25K higher, but he would still have received $47.5K on sale.

Similar (but not in all respects analogous) results obtain in a case of a subchapter C corporation. A $2.5K depreciation deduction will be taken by the corporation each year, thereby reducing its tax liability (assuming a profitable corporation) in such amount. The reduction in the tax liability will derivatively inure equally to the benefit of *A* and *B*. Had the adjusted basis of *B*'s property been equal to the fair market value, however, the depreciation charge would have been $2.5K higher; the taxable income would have been $2.5K lower; and the tax liability (assuming a 50 percent rate) would have been $1.25K

[117] The depreciation deduction is theoretically designed to prevent an erosion of capital. It shields part of the enterprise's income from tax. If *B*'s asset had had a $50K adjusted basis, the $5K depreciation deduction would have shielded $5K of income from tax, thus preserving the original capital.

[118] This is so because the enterprise is assumed to have broken even except for the depreciation in respect of *B's* property. Consequently, there is a loss to the extent of the depreciation in respect of *B*'s property. The economic loss is greater than the tax loss, however, because the economic depreciation ($5K) is 10 percent of the fair market value ($50K) whereas the tax depreciation ($2.5K) is 10 percent of the adjusted basis ($25K).

[119] *See* discussion in text accompanying Ns. 110–11 *supra*.

lower. The reduced depreciation causes *A* to suffer a tax detriment, because he only gets one half the benefit from the depreciation deduction he would have otherwise received had the adjusted basis of *B*'s property been equal to its fair market value. This is similar to the tax detriment *A* suffers in the partnership and subchapter S forms. Unlike the partnership and subchapter S cases, *A* will not receive a total offsetting deduction to compensate him for the loss of the benefit of the depreciation which the corporation would have had if the adjusted basis of *B*'s property had equaled the property's fair market value.

This aspect is hard to demonstrate, but a good starting point is to assume that the subchapter C corporation's income was equal to all its deductions with the depreciation deduction in respect of *B*'s property calculated on the fair market value rather than the adjusted basis.[120] This will be referred to as the economic break even point, that is, the point where the enterprise's income is sufficient to keep the enterprise's capital constant.[121] In this case the enterprise's income before taking account of the depreciation charge would be \$5K and, if the depreciation deduction was equal to the assumed economic depreciation of \$5K,[122] there would be no taxable income, because the enterprise would break even. The depreciation deduction is only \$2.5K, however, and the enterprise would have \$2.5K of taxable income. Assuming a 50 percent tax rate, the enterprise's tax liability would be \$1.25K. This \$1.25K tax liability would cause an erosion of capital in such amount (assuming an economic depreciation equal to \$5K), because at the end of the year the enterprise would have assets with a fair market value of \$98.75K. Although the enterprise has operated at the economic break even point, the lower tax depreciation caused an erosion of capital. The amount of the erosion is equal to the tax liability in respect of the taxable income. The taxable income is an amount equal to the difference between the economic depreciation and the tax depreciation. Since *A* owns one half of the ownership interests

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[120] This means that the depreciation charge is equal to the assumed economic depreciation of \$5K (10 percent of the \$50K fair market value) instead of \$2.5K (10 percent of the \$25K adjusted basis).

[121] If the tax depreciation charge were based on the economic depreciation and the firm broke even, the income would equal all the deductions, and the capital would remain constant in the absence of other price level changes. The income shielded from tax by the depreciation deduction would exactly compensate for the economic depreciation of the depreciable assets. If, however, the tax depreciation charge is less than the economic depreciation and the firm breaks even from a tax standpoint, there will be an erosion of capital equal to the difference between the economic depreciation (\$5K in this case) and the tax depreciation (\$2.5K in this case).

[122] This is 10 percent of the fair market value of *B*'s property.

of the corporation, he ultimately bears the burden of one half of the corporate tax ($.625K). If *A* were to sell his stock at the end of the first year, and the stock were valued at the fair market value of the underlying assets he would receive $49.375K, which is exactly $.625K less than he would have received if the depreciation deduction had equaled the economic depreciation.[123]

Since *A*'s adjusted basis for his stock is $50K, he would get a loss deduction of $.625K on sale to compensate him for the erosion of capital. Assuming that the deduction lowers his tax liability by 30 percent[124] of such amount, his ultimate loss from the transaction would be $.4375K. Although the corporation has operated at the economic break even point, *A* has suffered a capital erosion which he would not have suffered had the tax depreciation on *B*'s property been based on an adjusted basis equal to its fair market value.

On the other hand, *B* benefits from the transaction. This can be seen from the fact that he receives $49.375K on liquidation, whereas if he had borne the full cost of the tax liability ($1.25K) incurred by the corporation due to the disparity between economic depreciation ($5K) and tax depreciation ($2.5K), he would only have received $48.75K on liquidation. This is so because *B* has gotten the advantage of one half of the depreciation in respect of his property when all such depreciation should have inured to the benefit of *A*.

Summary of Concept of Assignment of Tax Detriment. Again it must be emphasized that the operating assumptions in each of the above hypotheticals are designed to isolate the tax detriment element. It is important to note, however, that without regard to the operating assumptions the noncontributing investor will suffer a tax detriment he would not have suffered if the adjusted basis of the contributing investor's property had been equal to its fair market value. The tax detriment will operate in one of the following ways in every case:

(1) The noncontributing investor will always suffer the tax detriment of either a greater taxable gain or a reduced taxable loss on the disposition of the contributing investor's property. In other words, if the adjusted basis of the contributing partner's property had been equal to its fair market value, the noncontributing partner's share of

[123] If the tax depreciation had equaled the economic depreciation the enterprise's capital would have been $100K and *A* would have received $50K on sale or liquidation.

[124] On sale or liquidation *A* would normally have a capital loss. Assuming *A* has capital gains equal to or greater than such losses and he is in a 30 percent capital gain bracket, the loss deduction would save him taxes in an amount of 30 percent of the deduction.

the gain would automatically be less and his share of loss automatically greater, than in the case where the fair market value is higher than the adjusted basis at the time of contribution. This is so because the amount realized from the disposition of the property is a constant figure and the gain or loss will, therefore, vary depending on the adjusted basis at the time of contribution. Only when the adjusted basis is equal to the fair market value will the taxable gain or loss with respect to such property be attributable solely to postcontribution factors.

(2) The noncontributing investor will suffer the detriment of receiving less of the benefit from the deduction in respect of a contributing investor's property than he would have received had the adjusted basis been equal to the fair market value at the time of contribution. This will happen, for instance, when the contributed property is depreciable and, therefore, the depreciation deduction is less than it otherwise would have been.

The two elements of tax detriment (assignment of gain and a reduced depreciation deduction) can operate in tandem where the enterprise holds a depreciable asset for a period and then disposes of it. In such case the noncontributing investor suffers a double tax detriment: (1) He receives less benefit from the depreciation during the period the property is held by the enterprise and (2) he bears the burden of taxable gain on disposition.

Prevention of Assignment of Tax Detriment and Benefit

Partnership Provisions. The partnership provisions, unlike the subchapter C and S corporate provisions, provide a mechanism for eliminating the assignment of tax detriment or benefit. The partners can elect to have the partnership agreement provide that the full amount of the detriment or benefit in respect of contributed property with a disparate fair market value and adjusted basis shall be allocated to the contributing partner. This is provided for in section 704(c)(2):

> If the partnership agreement so provides, depreciation, depletion, or gain or loss with respect to property contributed to the partnership by a partner shall, under regulations prescribed by the Secretary or his delegate, be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution.

Section 704(c)(1) provides that if the partnership agreement is silent with regard to such allocations, then the gain, loss, depreciation, et cetera, will be shared as if the partnership had purchased the asset.

Section 704(c)(1), therefore, adopts an entity approach as a general rule, and 704(c)(2) permits the partners to elect aggregate treatment for the income items in respect of contributed property with a disparate fair market value and adjusted basis. The theory of the aggregate approach of section 704(c)(2) is that any precontribution gain or loss which the partnership subsequently recognizes will be allocated to the contributing partner. Also, the depreciation or depletion deduction in respect of such property, to the extent thereof, will be allocated first to the noncontributing partners in an amount equal to the deduction they would have received if the adjusted basis of the contributing partner's property had equaled its fair market value, and any excess will be allocated to the contributing partner.[125] The effect of these allocations is to put the partners in the position they would have been if the adjusted basis of the property contributed had equaled the fair market value of such property. The section 704(c)(2) allocation can be made at any time on or before the "date . . . prescribed by law for the filing of the partnership return" for the year.[126]

Section 704(c)(2) was added to the partnership provisions by the Senate Committee on Finance in its consideration of the 1954 Code.[127] In discussing the entity approach of section 704(c)(1), the committee said that such "treatment was adopted as the general rule in the interest of simplification,"[128] notwithstanding the possible inequity which could accrue to the noncontributing partner. The committee then went on to point out

> While the [general rule of section 704(c)(1)] may result in possible detriment (or gain) to noncontributing partners, it should be noted that there will, in general, be a corresponding loss (or gain) to such partners upon sale or disposition of their interest in the partnership.[129]

In implementing section 704(c)(2), the regulations first provide that the amount of gain, loss, depreciation or depletion specially allocated can in no event exceed the amount of such items to the partnership. This is the obvious ceiling on the allocations.

In determining the amount of gain or loss to be specially allocated in the case of nondepreciable property, the postcontribution economic appreciation or diminution in value must be taken into account. Both

[125] If, however, the adjusted basis exceeds the fair market value, then the portion of the depreciation attributable to such excess is allocated fully to the partner who contributed the property.

[126] Reg. § 1.761-1(c).

[127] S. Rep. No. 1622, 83d Cong., 2d Sess. 379-80 (1954).

[128] *Id.* at 380.

[129] *Ibid.*

the postcontribution economic appreciation or diminution in value and the amount of tax depreciation must be taken into account in determining the amount of gain or loss to be specially allocated in the case of depreciable property.

In the case of nondepreciable property, the amount of nonrecognized gain or loss at the time of contribution (precontribution gain or loss) is the maximum amount of such gain or loss which can be specially allocated to the contributing partner at the time the partnership disposes of the property. In the case of gain assets, any postcontribution appreciation above the fair market value at the time of contribution will be allocated in accordance with the normal manner for sharing such gains. Any postcontribution diminution in the value of the assets will reduce the precontribution gain allocated to the contributing partner, and if the diminution drops below the adjusted basis, the loss would be allocated in accordance with the normal manner of sharing such losses. These rules can be illustrated graphically as follows:

CONTRIBUTION OF GAIN ASSETS

Postcontribution Appreciation in Value		Postcontribution appreciation in value will be allocated among the partners in the normal manner for sharing such gain.
	$100K FMV	
Fair Market Value = $100K at Time of Contribution Adjusted Basis = $50K at Time of Contribution		Precontribution gain will be allocated to the contributing partner. The "ceiling" on such allocated gain is $50K.
	$50K Adjusted Basis	
Postcontribution Diminution in Value Below the Adjusted Basis		Any loss attributable to postcontribution diminution in value will be allocated among the partners in the normal manner for sharing such losses.

In the case of a contribution of loss assets, any postcontribution appreciation will reduce the amount of precontribution loss allocated to the contributing partner. Any such appreciation in excess of the adjusted basis will generate gain, and such gain will be shared in accordance with the normal manner for sharing such gains. Any postcontribution diminution in value will generate additional loss which will be shared in accordance with the loss sharing ratio. These rules can be illustrated graphically as follows:

CONTRIBUTION OF LOSS ASSETS

Postcontribution Appreciation in Value in Excess of Adjusted Basis		Postcontribution gain allocated among the partners in the normal manner for sharing such gains.
Adjusted Basis = $100K at Time of Contribution Fair Market Value = $50K at Time of Contribution	$100K Adjusted Basis	Precontribution loss allowable to the contributing partner. The "ceiling" of such allocation is $50K.
Postcontribution Diminution in Value	$50K FMV	Any additional loss attributable to postcontribution diminution in value will be allocated among the partners in the normal manner for sharing such losses.

The above principles apply, in general, on the sale of the depreciable property by the partnership; however, the special allocation of the tax depreciation must also be taken into account before determining the allocation of such gain or loss. The following discussion is limited to the case of a contribution of appreciated depreciable property.

A noncontributing partner "has, in effect, purchased an undivided . . . interest" [130] in the property contributed which has a disparate fair market value and adjusted basis. Such undivided interest is measured by the noncontributing partner's relative share of the partnership interests. If *A* contributes $50K in cash to the *AB* equal partnership and *B* contributes depreciable property with a fair market value of $50K and adjusted basis of $25K, then *A* has in effect purchased a one half interest in *B*'s property.[131] The adjusted basis of *A*'s one half interest is only $12.5K, whereas the fair market value of such interest is $25K. Consequently, *A* will not get the full benefit of his depreciation on his one half interest. Under the special allocation provision of section 704(c)(2), the partners can agree in the partnership agreement to allocate *B*'s one half share of the adjusted basis to *A*. Over the remaining depreciable period of the asset *A* would, therefore, get the full amount of depreciation he would have been entitled to had *B*

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[130] *Id.* at 381; Reg. § 1.704–1(c)(2) Ex. 1.

[131] Likewise *B* has purchased an undivided one half interest in *A*'s cash.

contributed property with an adjusted basis of \$50K.[132] It can be seen that if the adjusted basis of *B*'s property had been less than \$25K, *A* would not be able to get all the depreciation he would have otherwise been entitled to because of the ceiling on such allocation. If, however, *B*'s adjusted basis was in excess of \$25K, *B* would get the benefit of the depreciation attributable to the portion of the basis in excess of \$25K. If *B*'s basis was \$37.5K and the asset had a useful life of ten years, a zero salvage value and the straight line method of depreciation was elected, there would be \$3.75K of depreciation taken each year. *A* would be allocated \$2.5K and *B*, \$1.25K.

Having seen how the depreciation can be allocated pursuant to section 704(c)(2), it is now possible to consider what happens with the special allocation of the gain or loss on the disposition of such depreciable property. The gain situation will be considered first. This calls for the introduction of a new concept—an imaginary depreciation account on the fair market value of such property.[133] The purpose of the imaginary depreciation account is to reflect what would have been the depreciation had the adjusted basis of the contributed property equaled the fair market value. The amount of gain which would be allocated to the contributing partner is an amount equal to the difference between (1) the fair market value of the contributed property, minus the accumulated imaginary depreciation, and (2) the initial carryover basis of such property, minus the partnership's accumulated tax depreciation. This difference will gradually decrease during the depreciation period, converging to zero at the end of such period. The ceiling on the amount of gain allocable to the contributing partner on sale by the partnership will be a floating amount, whereas in the case of a nondepreciable gain asset the ceiling on allocable gain is static. If the amount realized from the sale of depreciable property exceeds the original fair market value minus the accumulated imaginary depreciation in respect of such property, such excess is deemed to be attributable to postcontribution appreciation and will be shared by the partners in accordance with the normal manner for sharing gains. If the amount realized from sale is less than the initial carryover basis, minus accumulated tax depreciation, such loss will be shared by the partners in accordance with the normal manner for sharing losses.

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[132] In such case *A* would receive the benefit of \$25K depreciation over the remaining useful life of the asset, and *B* would not receive any depreciation.

[133] The imaginary depreciation each year is the normal straight line rate, which in this case is 10 percent, applied against the fair market value at the time of contribution (\$50K).

The following hypothetical illustrates these principles. *A* contributes cash of \$50K to the *AB* equal partnership, and *B* contributes depreciable property with a fair market value of \$50K and adjusted basis of \$25K. The partners adopt the section 704(c)(2) method for allocating depreciation and gain. *B*'s property has a useful life of ten years, a zero salvage value, and the straight line method of depreciation is elected. In such case the depreciation each year will be \$2.5K, all of which will be allocated to *A*. If the property is disposed of after the first year, the maximum amount of gain specially allocable to *B* will be an amount equal to the difference between (1) the fair market value at the date of contribution (\$50K), minus the imaginary depreciation (\$5K); and (2) the adjusted basis at the date of contribution (\$25K), minus the accumulated tax depreciation (\$2.5K). The maximum gain allocable to *B*, therefore, would be \$22.5K. If the asset were sold for \$45K, there would be a gain of \$22.5K (\$45K amount realized minus \$22.5K adjusted basis). The full \$22.5K gain would be allocated to *B*. If sold for a price in excess of \$45K, \$22.5K of the gain would be allocated to *B*, and the excess over \$45K would be allocated equally between *A* and *B*. If sold for less than \$22.5K, the loss would be allocated equally between *A* and *B*.

These results should be compared with those which would obtain if the asset were sold after it had been held for nine years. In such case the maximum gain specially allocable to *B* would be an amount equal to the difference between (1) the fair market value of the asset at the time of contribution (\$50K), minus the accumulated imaginary depreciation (\$45K), and (2) the basis at the date of contribution (\$25K), minus the accumulated tax depreciation (\$22.5K). The maximum gain allocable to *B*, therefore, would be \$2.5K. If the asset were sold for \$45K the gain would be \$42.5K, \$2.5K of which would be specially allocated to *B* and \$40K divided equally. If the asset were sold after the full ten year period, there would be no specially allocated gain because the difference between (1) the fair market value at the date of contribution (\$50K), minus the accumulated imaginary depreciation (\$50K), and (2) the basis at the date of contribution (\$25K), minus the accumulated tax depreciation (\$25K), would be zero.

The section 704(c)(2) allocation provision eliminates tax distortions which would otherwise occur under the general rule of section 704(c)(1). Apparently, the only justification for the general rule is its simplicity.[134] Notwithstanding the purported simplicity, the general

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[134] S. REP. No. 1622, 83d Cong., 2d Sess. 380 (1954).

rule provides a statutory license for assignment of income schemes.[135] One text writer flatly states that the nonrecognition treatment of section 721 "obviate[s]" the assignment of income doctrine of *Lucas v. Earl* and that, consequently, a cash basis taxpayer can contribute unrealized receivables to a partnership in exchange for a partnership interest without recognition treatment.[136] In the absence of a section 704(c)(2) allocation, the transferor would then be taxed only on his distributive share of such receivables when collected. Further, the general rule of section 704(c)(1) can operate to the disadvantage of unsophisticated taxpayers.[137] Indeed, the simplicity is likely to inure to the benefit of the sophisticated and penalize the unsophisticated.

In the case of a contribution by partners of property with respect to which they own undivided interests, section 704(c)(3) provides that unless the partnership agreement provides otherwise, the depreciation, depletion, gain or loss with respect to such property shall be determined as though the property had not been contributed to the partnership, provided the capital and profit interest correspond with the undivided interests. This provision operates to prevent the assignment of tax detriment or benefit with respect to such property unless the partners provide for such assignments in the partnership agreement. Section 704(c)(3) adopts as the general rule the aggregate approach and gives the partners the option of electing the entity approach; its scheme is, therefore, the reverse of the scheme of sections 704(c)(1) and (2).[138]

Subchapter C and S Corporate Provisions. The special allocation provision for partnerships is not available for subchapter C and S corporations. Section 351 in providing for nonrecognition and sections 358 and 362 in providing for a substituted and carryover basis, statutorily mandate assignments of tax detriment and benefit. There is no analogue to the special allocation provision of section 704(c)(2) which would enable the shareholders to eliminate the assignment. Thus, subchapter C and S corporations may be used to effect an assign-

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[135] If a father and son were to form an equal partnership with the father contributing appreciated property and the son contributing cash and the partnership later disposed of the appreciated asset, the father would have assigned one half of the gain to the son. The problem would be even more acute if the property contributed by the father was accounts receivable which had an adjusted basis of zero.

[136] WILLIS at 80.

[137] If the partners in the example in N. 135 *supra* were unrelated, the partner who contributed the cash would be severely penalized unless he were compensated in some other manner for the tax detriment which he realizes.

[138] A thorough discussion of section 704(c)(3) is beyond the scope of this article. *See generally* WILLIS at 131–36.

ment of unripe income of the type in *Lucas v. Earl* or *Helvering v. Horst,* but the Commissioner may respond with an attempt to use other statutory provisions or judicial doctrines to nullify the statutory license for the assignment of income. In the case of the subchapter C corporation the cost of the potential double tax may be minimal compared with the tax savings possibilities of shifting income from a shareholder to a subchapter C corporation. For instance, if a cash basis taxpayer who is in the 70 percent tax bracket contributes accounts receivable (not constituting earned income within section 1348) with a $100K fair market value and a zero adjusted basis to a wholly-owned subchapter C corporation, the maximum tax on the accounts receivable at the corporate level would be 48 percent, assuming the income would be taxed to the corporation. This would be an immediate tax saving of $22K ($70K minus $48K). If the shareholder later sold his stock, he would have capital gains of $52K in respect of the contributed accounts receivable on which he would pay a tax of $15.6K.[139] The total double tax would be $63.6K, a tax saving of $6.4K. Such transfers of unripe income are distinguishable from the normal transfer of appreciated property, the gain on which will be realized and recognized only on taxable disposition. The former will generate income at some certain point in time without any further action by the corporation other than collection of the income, whereas in the latter case, the corporation would have to dispose of the property before the income would be realized. The utility of the device has been somewhat mitigated by the enactment of section 1348 which imposes a maximum tax of 50 percent on earned income. Consequently, if the unrealized receivables in the above example would constitute earned income, it would not be economically advantageous for the taxpayer to incur the double tax by transferring them to a corporation.

In attacking the use of section 351 as a device for assignments of income, the Commissioner might attempt to circumscribe the breadth of the term "property" in section 351(a). If he is successful in asserting that the unripe income transferred is not property, then the transferor would receive immediate recognition in the amount of the stock or securities received in exchange therefor.[140] Also, the Commissioner might attempt to use the clear reflection of income provision of section 446(b) to tax income collected by the corporation to the trans-

[139] This assumes that the corporation is not collapsible (see section 341) and that the capital gains would be taxed at a rate of 30 percent. *See* I.R.C. § 1201(a).

[140] *See* Bittker & Eustice at 3–58.

feror shareholder.[141] Section 482 might be used to reallocate items between the corporation and shareholders.[142] As an alternative to these statutory provisions, the Commissioner might attempt to use the judicial doctrines of assignment of income, tax benefit, business purpose or step transaction in order to reallocate items between shareholders and corporations.[143] Each of these statutory provisions and judicial doctrines is designed to deal with problems caused by the disparity between the fair market value and the adjusted basis of property contributed to corporations in exchange for ownership interests.

Adjustments in Business Bargain as a Way of Compensating for the Assignment of Tax Detriment. The assignment of tax detriment can be mitigated for each of the three forms by adjusting the business bargain. An estimate of the tax cost in respect of contributed property can be taken into account in valuing the property for purposes of determining the amount of each investor's capital contribution.[144] For instance, the contributing investor's property might be valued at less than its actual fair market value for purposes of determining the amount of ownership interest he will receive in exchange for this property. The discount from the actual fair market value should equal the present value of the expected tax detriment the noncontributing investor will suffer in respect of such property. Alternatively, a compensating security interest or other ownership interest, such as preferred stock or a limited partnership interest, could be given to the noncontributing investors to compensate them for the expected tax detriment. In the above *AB* example, *A* and *B* might agree that the tax detriment which *A* will suffer in respect of *B*'s property has a present value of *X* dollars. *A* could then be compensated for the tax detriment by receiving a greater percentage of the ownership interests equal to *X* dollars, or alternatively, securities or preferred stock or a limited partnership interest in the amount of *X* dollars. The latter method would not upset the equal ownership of the enterprise's principal equity. The preferred stock option is only available in the case of subchapter C corporations, because there is a statutory prohibition against more than one class of stock in a subchapter S corporation.[145] If securities

[141] *Id.* at 3–59.

[142] *Ibid.*

[143] *Id.* at 3–59 to 3–62.

[144] For a discussion of this method with respect to partnerships, see WILLIS at 125. *See generally* Herwitz, *Allocation of Stock Between Services and Capital in the Organization of a Close Corporation,* 75 HARV. L. REV. 1098 (1962).

[145] I.R.C. § 1371(a)(4).

are distributed to compensate *A* there will, in general, be nonrecognition treatment to *A*.[146]

Another option is to have the owner of the property with a disparate fair market value and adjusted basis sell it to the enterprise.[147] There is, however, a complex of statutory provisions which must be negotiated in structuring sales of property to enterprises.[148] The property may be sold, alternatively, to other investors who could contribute the property to the enterprise with the selling investor contributing the cash.[149] This type of transaction may raise problems with the step transaction doctrine.[150] Another option is to lease the property to the enterprise with the lease payments equaling the depreciation calculated on the fair market value of the property rather than its adjusted basis.[151] Finally, the property could be sold to a third party with the investor contributing the proceeds.

None of these methods, however, comports more with economic reality than does the section 704(c)(2) allocation available to the partnership form. There are inherent frailties in attempting to set a dollar value on the tax cost or benefit in respect of contributed property because of the uncertainty of future tax payments. A sale to the enterprise or other investor, or a lease transaction would each be merely a back handed manner of accomplishing what can be accomplished more directly by the section 704(c)(2) partnership allocation provision. The only instance in which the section 704(c)(2) allocation will not completely eliminate the tax distortion in respect of contributed property is when the property is depreciable and the adjusted basis is less than the amount of depreciation which would have been

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[146] *See* discussion in text accompanying N. 36 *supra.*

[147] For a brief discussion of this method with respect to partnerships, see WILLIS at 121.

[148] Sales of property to enterprises are beyond the scope of this article.

[149] In the partnership area the sale may be of an undivided interest in the property equal to the noncontributing partners' relative shares of the partnership interests. Pursuant to section 704(c)(3), the gain, loss, depletion, and depreciation with respect to contributed property in which the partners hold undivided interests will be determined as if such property had not been contributed to the firm, unless the partnership agreement provides otherwise. *See* WILLIS at 122 and the text accompanying N. 138 *supra.*

[150] The sale may be considered a mere transitory step in the transaction and, therefore, be ignored. In such case the transaction would be viewed as though the selling investor had contributed the property directly and the purchasing investors had contributed the cash.

[151] For a discussion of this method with respect to partnerships, see WILLIS at 123. With respect to corporations, see NESS & VOGEL, TAXATION OF THE CLOSELY HELD CORPORATION 2-64 to 2-65 (1972).

allocable to the noncontributing investor if the fair market value and adjusted basis had not been disparate.[152]

Tax Policy Implications of Assignment of Tax Detriment or Benefit

Tax Policy Issue

The tax policy issue is whether there should be mandatory provisions which guard against the assignment of tax detriment or benefit on the contribution of appreciated or depreciated property to each of the three forms. Such prophylactic provisions would benefit the Treasury to the extent they prevented the reduction of taxes by the assignment (deliberate or not) of (1) tax detriment to lower bracket taxpayers or (2) tax benefit to higher bracket taxpayers. Also, such anti-assignment provisions would eliminate the use of business forms as vehicles for traditional assignment of income schemes. Even more importantly, such provisions would infuse a greater degree of equity into the tax structure by protecting unsophisticated investors from incurring hidden taxes. Balanced against these benefits is the additional complexity such provisions would generate.

The additional complexity may be illusory, however. There can be no doubt that both (1) the general rule of section 704(a) of the partnership provisions and (2) the structure of subchapters C and S create a potential for the assignment of tax detriment or benefit on the contribution of property with a disparate adjusted basis and fair market value. This means that in the absence of some type of adjustment to offset the tax distortion, some investor or investors will be economically worse off and others economically better off than they would have been had the adjusted basis of the contributed property equaled the fair market value. In an arm's length transaction between informed investors an adjustment in the business bargain will be made because each party will act in his own best interest. There are at least three instances in which there will not be an adjustment: (1) When the distortion is *de minimis,* (2) when the parties are unaware of the tax distortion and (3) when the parties are deliberately effecting a scheme for the assignment of tax detriment or benefit. It follows, therefore, that the simplicity inherent in the absence of mandatory provisions guarding against the assignment of tax detriment or benefit is logically sound only when the tax distortion is *de minimis.*

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[152] This will occur when, for instance, in the *AB* equal partnership, *A* contributes cash of $50K and *B* contributes depreciable property with a fair market value of $50K and an adjusted basis of less than $25K.

Two questions are suggested by the tax policy issue: (1) Should the section 704(c)(2) allocation provision be made mandatory for partnerships, at least in some cases, and (2) should a mandatory or elective allocation provision analogous to section 704(c)(2) be extended to subchapter C and S corporations?

Partnership Provisions

In the case of partnerships with numerous investors, it would probably be extremely burdensome to require the partners to make section 704(c)(2) allocations. Further, where numerous partners are involved it is probably less likely that the tax distortions will be substantial because the partners are likely to be sophisticated, and the motivations (particularly where the partners are unrelated) for assignment of tax detriment or benefit small. Therefore, the present elective system appears appropriate in such cases. On the other hand, it would not be extremely burdensome to require partnerships with few partners to make such allocations. It is with closely held partnerships that the motivations for assignment of tax detriment or benefit are most likely to be high, particularly where the partners are related and sophisticated.

For instance, if a father and son agreed to form an equal partnership with the father contributing a building with a fair market value of \$100K and an adjusted basis of \$10K and the son contributing a building with a fair market value and adjusted basis of \$100K, there is a clear and unmitigated assignment of tax detriment from the father to the son with respect to both depreciation and potential gain. Further, there is an assignment of tax benefit from the son to the father with respect to depreciation. The father will get a greater depreciation deduction (and the son a lesser) after the formation of the partnership. This is a clear tax benefit to the father particularly if he is in a higher tax bracket than the son. If the building contributed by the father is sold, the son will be taxed on half the gain, but the firm's capital would be shared equally. This also is a clear tax benefit to the father.

Section 704(a) is a clear statutory license for such schemes, and it does not appear that the Commissioner has ever challenged any such schemes. Indeed, as long as the partnership is itself bona fide, it would appear that section 704(a) denies the Commissioner the power to attack such schemes notwithstanding the tax motivations of the parties.

It is also true that with respect to closely held partnerships the partners are more likely to be unaware of the tax distortions, and may, therefore, inadvertently assign tax detriment or benefit.

A mandatory allocation provision for closely held partnerships would, therefore, have the following effects:

(1) It would eliminate the possibility of the deliberate assignment of tax benefit or detriment among the partners so as to reduce their overall tax liabilities.

(2) It would protect the unsophisticated partner from suffering hidden tax detriments.

These two effects would add a degree of equity to the tax system and the cost in terms of simplicity would appear to be nominal.

One problem, however, is determining the partnerships to which such a provision should apply. This should be determined by an evaluation of past partnership returns in order to ascertain at what point the problem (contributions of property with disparate fair market values and adjusted bases) becomes less acute. One would probably find that after the number of partners gets to be over ten the problem virtually disappears or alternatively the investors are sophisticated. In such cases they are likely to make other adjustments in the business bargain or elect the section 704(c)(2) treatment.

As an alternative to a required allocation in the closely held partnership case, the present structure could be retained but an additional provision could be added which would give the Commissioner authority to require a section 704(c)(2) special allocation in cases where he finds the presence of tax avoidance or evasion motivations. Such authority could be made applicable to all partnerships, both small and large. Such a provision would not, however, have the effect of protecting the unsophisticated partner in a small partnership from hidden tax detriments. It would appear, therefore, that the best course would be to amend section 704(c) to require the section 704(c)(2) allocations in cases where the number of partners is small, and to give the Commissioner authority to require an allocation where the number of partners is large and there are tax avoidance or evasion motivations.

Subchapter C Provisions

In approaching the question of whether a mandatory or elective allocation provision should be applicable to subchapter C corporations, it is helpful to set up a big firm and small firm dichotomy similar to the partnership case. In the case of the formation of a subchapter C corporation by numerous shareholders, say in excess of ten, the shareholders are likely to be sophisticated enough to take account of the potential assignment of tax detriment or benefit. Also, the likelihood of assignment of income schemes will be minimal in most such cases particularly if the shareholders are unrelated. In the case of closely held subchapter C corporations, the potential for the deliberate or inadvertent assignment of tax detriment or benefit is likely to be great. Moreover, a shareholder may not only find himself suffering from hidden taxes by bearing the burden of an inadvertently shifted tax detriment, but he also may find himself suffering a hidden double tax by reason of the fact that the subchapter C corporation is a separate taxable entity. The resolution of these problems depends on the relative merits of continuing to superimpose the corporate tax structure on precontribution income items as contrasted with a mandatory or elective allocation provision analogous to section 704(c)(2). This would mean that the subchapter C corporation would be treated like a partnership with respect to precontribution income items. There would have to be a basis provision, analogous to section 705(a), providing for an increase or decrease in the adjusted basis of the shareholder's stock.

In the case of the closely held subchapter C corporation, it would be desirable to have a mandatory allocation provision for the same reasons such allocations should be required for closely held partnerships and for the following additional reasons:

(1) The double tax can act as an additional penalty on the unsophisticated shareholder, whereas it may be avoided by the sophisticated.

(2) The earnings and profits generated by the sale of contributed appreciated property and the negative earnings and profits generated by the sale of contributed depreciated property are artificial because they are attributable to factors which occurred before the property was put in corporate solution.

There would be an added measure of complexity associated with the implementation of such an anti-assignment device, but the benefits would also be substantial. The scheme would completely eliminate the possibility of utilizing the subchapter C corporation as an assignment of income device. An anti-assignment provision is inherently logical, particularly in view of the fact that a subchapter C corporation is a separate taxable entity. Moreover, notwithstanding the increased complexity of such a provision, the complexity inherent in attempts to heuristically adjust the business bargain to compensate for the potential tax detriment or benefit would be eliminated.

In the case of the subchapter C corporation with a large number of investors, it would be desirable (for the same reasons as apply in the case of a large number of partners) for the corporation to be able to elect the allocation treatment, and the Commissioner should have the authority to require an allocation in cases where there are tax avoidance motivations. Giving the Commissioner the authority to make such allocations would be a codification of the principles of *Lucas v. Earl* and *Helvering v. Horst* and would add a degree of certainty to the area by eliminating the Commissioner's reliance on a hodgepodge of statutory provisions and judicial doctrines, to prevent unmitigated assignment of income schemes.

Subchapter S Provisions

The potential for assignment of tax detriment or benefit which is present with partnerships is also present with subchapter S corporations. The reasons which support a mandatory allocation provision for closely held partnerships also support a mandatory allocation provision for subchapter S corporations because the number of shareholders in a subchapter S corporation is limited to ten. The reasons are prevention of tax avoidance or evasion and protection of the unsophisticated investor. The committee reports do not indicate that Congress even considered the possibility of the assignment of tax detriment or benefit on the contribution of property to a subchapter S corporation.[153] The justification for the absence of either a mandatory or elective provision would apparently be simplification, as is the case with partnerships. But, simplification may be illusory in view of the possibility of major tax distortions. When the benefits of a mandatory special allocation provision are balanced against the cost associated with the deliberate or inadvertent use of the subchapter S corporation as a device for the assignment of tax detriment or benefit, one is led to the unavoidable conclusion that there should also be a mandatory provision for subchapter S corporations.

There is another reason which supports a mandatory allocation provision. In the case of a sole shareholder, all of the income items of the subchapter S corporation will be taxed to the shareholder. Consequently, any precontribution items attributable to the period during which the shareholder owned the contributed property will automatically be allocated to the shareholder. The subchapter S corporation with a sole shareholder is, therefore, treated analogously to the partnership with a section 704(c)(2) special allocation. A mandatory allocation provision would simply extend this result to instances of multiple shareholders.

[153] H.R. REP. No. 775, 85th Cong., 1st Sess. (1957); S. REP. No. 1983, 85th Cong., 2d Sess. (1958).

Summary

The following anti-assignment rules are proposed:

(1) With respect to partnerships, there should be a mandatory special allocation provision for closely held partnerships and an optional special allocation provision for partnerships with a large number of partners, say greater than ten. Also, the Commissioner should have the authority to mandate a special allocation in a case of a partnership with a large number of partners where there are tax avoidance or evasion motivations.

(2) With respect to subchapter C corporations, the rules should be the same as those for partnerships. Whenever there is a special allocation there would, of course, have to be an adjustment to the adjusted basis of the contributing shareholder's stock.

(3) With respect to subchapter S corporations, there should be a mandatory allocation provision.

Double Tax

Comparative Analysis of Potential for a Double Tax

Outline of Problem

With respect to each of the forms there is a potential for a double tax in respect of contributed appreciated property. This is caused by the substituted basis to the investor and the carryover basis to the enterprise. The investor holds an ownership interest with a built in potential gain, and the enterprise holds an asset with a built in potential gain. The possibility of a double tax is limited when the enterprise is either a partnership or subchapter S corporation, and the partnership provisions provide a mechanism for eliminating the possibility of a double tax. The double tax may apply to the same investor or may be split between investors. The incidence of the double tax depends on whether the asset is sold prior to either the sale of the ownership interest or liquidation of the firm. As will be pointed out in the discussion of the tax policy implications, the mandatory anti-assignment provisions recommended earlier would eliminate much of the potential for a double tax.

Sale of Appreciated Asset Prior to Sale of Ownership Interest or Liquidation of Firm

Partnership Provisions. If a partnership disposes of a contributed appreciated asset before the contributing partner disposes of his ownership interest, the possibility of a double tax on the gain is eliminated, provided a section 704(c)(2) special allocation is in effect.[154] The gain realized by the partnership will cause an increase in the adjusted basis of the contributing partner's partnership interests,[155] thereby eliminating the potential for a double tax. If a section 704(c)(2) special allocation provision is not in effect there will be a shifting of tax detriment and a possibility of a double tax on part of the gain.

For instance, assume that *A* contributes cash of $50K and *B* contributes property with a fair market value of $50K and an adjusted basis of $25K to the *AB* equal partnership. If the partnership disposed of the asset at a gain of $25K, other things being equal, each partner would have income of $12.5K and would increase the adjusted basis of his partnership interest by $12.5K. *A*'s basis would be $62.5K and *B*'s basis would be $37.5K. The fair market value of each partner's interest would be $50K. If *B* sold his interest, he would have a gain of $12.5K. There would, therefore, have been a tax on gain of $37.5K, whereas the actual gain built into the asset was only $25K. There would be an offset, however, if *A* sold his partnership interest, because *A* would have a $12.5K loss on sale. If *A* held his interest until death, the loss offset would vanish by reason of the step-down in basis at death which would be required by section 1014.

If the partnership elected the section 704(c)(2) special allocation provision the double tax would be eliminated. The $25K gain would be allocated to *B*. *B*'s adjusted basis for his partnership interest would be increased by $25K to $50K. If he then sold his partnership interest, there would be no gain. The same results would obtain if the partnership were liquidated.

Subchapter C Provisions. In the case of a subchapter C corporation, there is a built in possibility of two taxes (and in some cases three) on the gain in respect of contributed appreciated property. For instance, if a sole shareholder contributed to a newly organized subchapter C corporation property with a fair market value of $50K and an adjusted basis of $25K, the basis of his stock would be $25K by reason of the substituted basis provisions of section 358, and the corporation would have a $25K adjusted basis for the asset by reason of the application of the section 362(a) carryover basis rule. The fair market value of his stock would be $50K (assuming a purchaser would value the stock by reference to the fair market value of the underlying corporate assets). However, because of the potential tax liability at the corporate level on the gain in respect of the contributed

[154] *See generally* text accompanying Ns. 125–39 *supra.*
[155] I.R.C. § 705.

asset, the stock could very well have a fair market value lower than that of the underlying asset.[156] For the purposes of discussion here, however, the fair market value of the stock will be assumed to be equal to the fair market value of the asset undiminished by the potential tax liability in respect of the gain. There is an immediate built in potential gain of $25K at both the shareholder level and the corporate level.

Assuming the asset would be given capital gain treatment on sale and the corporation's tax rate on such gain would be 30 percent,[157] the corporation would be subject to a tax of $7.5K on sale of the asset and it would have earnings and profits of $17.5K.[158] Theoretically, after the sale and payment of the tax, the fair market value of the corporation would drop to $42.5K, the net after-tax proceeds of the sale. If the shareholder then sold his stock, he would have a gain of $17.5K. Assuming the gain would be given capital gain treatment and the shareholder's capital gain rate was 30 percent,[159] the tax on such gain would be $5.25K. The total tax at both the corporate and shareholder levels would be $12.75K. In the event the corporation had distributed as a dividend the after-tax gain of $17.5K, the shareholder would have had a dividend in that amount because of the corporation's $17.5K earnings and profits after sale and payment of the tax.[160] This dividend would have been subject to taxation at the ordinary income tax rates. If the shareholder was in the 60 percent bracket, the tax would have been $10.5K, and the total tax at both the corporate and shareholder levels would have been $18K.

This potential double tax should be contrasted with the one tax which would have obtained if the investor had contributed the property to a partnership which elected the 704(c)(2) special allocation (thereby allocating to him any gain in respect of such contributed property), and the partnership thereafter sold the property. As a result of the sale the partner would be taxed on the $25K gain. The basis of his ownership interest would have been increased by $25K to $50K. Both the fair market value and adjusted basis of his partnership interest would then be $50K, and there would only be one tax on the gain. The tax, assuming the asset would be given capital gain treat-

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[156] The value of the stock might be equal to the fair market value of the underlying asset minus the present value of the potential tax in respect of the underlying asset.

[157] I.R.C. § 1201(a).

[158] Earnings and profits, in general, are calculated by subtracting from taxable income (which in this case is $25K) the tax liability in respect thereof (which in this case is $7.5K). *See* Reg. § 1.312–6(b).

[159] I.R.C. § 1201(b).

[160] I.R.C. §§ 301, 316.

ment and the taxpayer was in the 30 percent bracket for capital gains, would have been $7.5K.

The same results would obtain on the taxable liquidation of the corporation. If there were a nontaxable liquidation the potential for a double tax would be deferred by reason of the carryover basis.[161]

Subchapter S Provisions. The results for subchapter S corporations are the same as those for the partnership when no section 704(c)(2) special allocation is in effect.[162] When there is only one shareholder of a subchapter S corporation all of the gain will be allocated to him, and the economic effect is the same as that for a partnership with a section 704(c)(2) special allocation.

Sale of Ownership Interest Prior to Sale of Asset or Liquidation of Firm

Partnership Provisions. In the case of the partnership provisions, the possibility of a double tax in respect of contributed property exists where the contributing partner sells his partnership interests before the firm sells the contributed asset. In such a case the selling partner will, by reason of the substituted basis rule, be taxed on the gain at the time of sale of his partnership interest. The purchasing partner potentially will be taxed on the same gain when the firm disposes of the asset. This potential for a double tax can be avoided, however. The partnership can elect under section 754 to increase (pursuant to section 743(a)) the basis of the assets held by the partnership by the amount of the purchase price attributable to the appreciation in such assets.[163] If the partnership then sold the assets there would be no tax. The double tax would have been avoided.

For example, if a contributing partner transferred to a partnership an asset with a fair market value of $50K and an adjusted basis of $25K in exchange for a 50 percent partnership interest which he later sold for $50K, he would have a $25K gain.[164] The purchasing partner would have a basis of $50K for his partnership interest.[165] If the section 754 election were in effect the partnership's basis of the contrib-

[161] I.R.C. § 732.

[162] If a subchapter S corporation sold the property the gain would pass through to the shareholders pursuant to section 1373, and the basis of the shareholder's stock would be increased by the amount of the gain pursuant to section 1376, thereby eliminating the gain in respect of the ownership interest.

[163] A thorough discussion of the operation of the section 754 election is beyond the scope of this article. *See generally* WILLIS at 259–85.

[164] I.R.C. § 741.

[165] I.R.C. § 742.

uted asset would be increased by $25K pursuant to section 743(a).[166] In the absence of the section 754 election, there would be another tax in respect of the same gain on the disposition of the asset by the partnership. Any gain to the purchasing partner from such disposition would increase the basis of his partnership interest,[167] thereby generating the possibility of an offsetting loss deduction when he sold his interest or the partnership was liquidated in a taxable transaction.

The benefit of section 743 is not limited to contributed property. The potential for double taxation in respect of all assets is eliminated by section 743.

Subchapter C Provisions. If a contributing shareholder of a subchapter C corporation sells his stock before the corporation sells the asset, there would only be one tax on the gain with respect to the shareholder. Assuming capital gains and a 30 percent tax rate, the shareholder who contributes the asset with a fair market value of $50K and an adjusted basis of $25K will have a tax liability on sale of his stock of $7.5K.[168] This is the same liability which would have obtained if the shareholder had contributed the property to a partnership which elected a 704(c)(2) allocation, and the firm sold the asset. Although the contributing shareholder would avoid the double tax on himself, the double tax in respect of the same gain still attaches. The corporation still has the potential gain although there is a new shareholder. Consequently, when the contributing shareholder sells his stock before the corporation sells the asset, he is shifting the ultimate burden of the corporate tax to the purchasing shareholder.

Moreover, if after selling the asset the corporation distributes the after-tax gain proceeds as a dividend to the new shareholder, he will bear the burden of a third tax on the dividends which were generated

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[166] This assumes (1) that a section 704(c)(2) special allocation provision was in effect so that in the absence of a section 743 adjustment the purchasing partner would be charged with all the gain on the assets and (2) that the adjusted basis of the partnership's other assets was equal to the fair market value of such other assets.

The section 743 basis adjustment, although made at the partnership level, is in respect of the purchasing partner's interest only. Thus, for instance, any additional depreciation or reduced gain attributable to such adjustment would inure to the benefit of the purchasing partner.

The section 754 election is a double edged sword: it will require under section 743 a basis reduction to the extent the purchase price of a partnership interest is attributable to partnership assets which have a fair market value less than the adjusted basis of such assets.

[167] I.R.C. § 705.

[168] This assumes that the value of the stock is equal to the fair market value of the contributed asset.

by the gain in respect of the contributed asset.[169] The purchasing shareholder is compensated somewhat, however. To the extent the corporation's fair market value is decreased by the amount of both the corporate tax on the gain and the dividend distribution, the shareholder may get a loss deduction on the sale of his stock or on liquidation of the corporation. If the purchasing shareholder paid $50K for the stock and the corporation sold the asset for $50K the corporate tax would be $7.5K. If the corporation distributed the $17.5K after-tax gain proceeds the shareholder would have a dividend of $17.5K, on which he would pay a tax at the ordinary income rates. The value of the corporation, other things being equal, would then be $25K and if the shareholder sold his stock or the corporation were liquidated, he would get a loss deduction of $25K.

Subchapter S Provisions. In the case of a subchapter S corporation, the potential for a double tax when a sale of stock occurs before the corporation sells the asset is unavoidable, because there is no optional basis adjustment provision as is the case with partnerships. Thus, if the stock of a subchapter S corporation is sold prior to the corporation's sale of the appreciated asset, one tax will be imposed on the selling shareholder and another on the purchasing shareholder at the time the subchapter S corporation sells the asset. The purchasing shareholder will, however, have the possibility of an offsetting loss deduction on sale of the stock or taxable liquidation of the corporation because the sale of the asset will cause an increase in the basis of his stock.[170]

Possibility of Double Loss Deduction

Contributions of depreciated property to a firm will produce results analogous to but the converse of the results on the contribution of appreciated property. The potential results can be summarized as follows:

Partnerships. The potential for a double loss deduction attaches only in a case where there is a sale of a partnership interest prior to the sale of the asset by the partnership and there is no section 754 election in effect. In the case where the section 754 election is in effect, section 743(b) will require a basis reduction analogous to the section 743(a) basis step up and there would be only one loss.

Subchapter C Corporations. The potential for a double loss deduction, analogous to the double tax on gain, attaches in both the case

[169] I.R.C. §§ 301, 316.
[170] I.R.C. § 1376(a).

where the shareholder sells his stock first and in the case where the corporation sells the asset first.

Subchapter S Corporations. There is a potential for a double loss deduction when the shareholder sells his stock before the corporaiton sells the asset. If, however, the corporation sells the asset first, the loss will lower the shareholder's basis for his stock, thereby preventing the possibility of a double loss.

Tax Policy Implications of Potential Double Tax

Dimensions of Problem

In the discussion of the Tax Policy Implications of the Assignment of Tax Detriment or Benefit it was proposed, inter alia, that the pre-contribution gain or loss in respect of contributed property be allocated directly to the contributing investor. This proposal applies to each of the three forms. This is in essence the treatment which is presently accorded in both the case of a partnership which has elected the section 704(c)(2) allocation and a subchapter S corporation with a sole shareholder. This proposal would automatically eliminate the double tax in respect of contributed property in cases where the enterprise disposes of the property before the investors dispose of their ownership interests.

The question to be addressed here, therefore, is whether the section 754 optional basis adjustment provision for partnerships should be extended to subchapter C and S corporations with respect to contributed property. It must be emphasized that consideration will not be given here to the question of whether an optional basis adjustment should also be available for noncontributed property which is the case for partnerships.

Genesis of Double Tax Problem

With respect to noncontributed property, the double tax for subchapter C corporations has been the general rule since the enactment of the first Revenue Act under the sixteenth amendment. There have been certain exceptions to this general rule. One of the first judicially developed exceptions (now codified in section 311) originated in *General Utilities & Operating Co. v. Helvering,*[171] which stands for the proposition that a corporation does not have income on the distribution of appreciated property. This rule of nonrecognition also applies

[171] 296 U.S. 200 (1935), *reversing* 74 F.2d 972 (4th Cir.).

to liquidating distributions (now codified as section 336). Precontribution gain was not subjected to a double tax until 1924 with the enactment of section 204(a)(8) of the Revenue Act of 1924.[172] Section 204(a)(8) is the predecessor of section 362(a). It provided that a corporation would have a carryover basis for property received in an organization transaction. The purpose of the provision was to check evasions.[173] The effect of the provision was explained:

> Under the existing law, if A owns an asset which cost him $10,000 and is now worth $50,000, he may transfer it to the X corporation in exchange for all the stock of the X corporation (no gain or loss from the exchange being recognized either under the existing law or under the bill) and the new corporation may take up the asset on its books for the purpose of determining gain or loss from subsequent sale and depreciation and depletion of $50,000, its fair market value at the date of transfer. Paragraph (8) of the bill provides that the basis of the asset so transferred shall be $10,000.[174]

Before 1924 there was no tax at the corporate level on precontribution gain. The Revenue Act of 1921 which first provided nonrecognition treatment for contribution transactions did, however, provide for a substituted basis to the contributing shareholders.[175] The substituted basis provision was described as a safeguard.[176] Presumably the safeguard was aimed at the possibility of a shareholder avoiding gain on sale of an asset by contributing the asset in a nonrecognition exchange to a newly organized corporation, taking a fair market value basis for the stock, and then selling the stock. The substituted basis provision prevented such schemes. However, since the corporation took a fair market value basis for the asset, the tax could be avoided by having the corporation sell the asset. The purpose of section 204(a)(8) was to prevent this side of the scheme. After 1924 taxpayers could no longer avoid tax on gain by contributing appreciated property to a corporation.

In preventing possible tax avoidance schemes the substitute and carryover basis provisions operate in tandem to produce a double tax in respect of precontribution gain. There is no indication in the legis-

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172 Revenue Act of 1924, ch. 234, § 204(a)(8), 43 Stat. 253.

173 S. Rep. No. 398, 68th Cong., 1st Sess. 18 (1924); 1939-1 (Part 2) C.B. 253; Seidman, Legislative History of Federal Income Tax Laws 1938-1861, at 704 (1938).

174 *Ibid.*

175 Revenue Act of 1921, § 202(d)(1).

176 S. Rep. No. 275, 67th Cong., 1st Sess. 12 (1921); 1939-1 (Part 2) C.B. 189; Seidman, Legislative History of Federal Income Tax Laws 1938-1861, at 801 (1938).

lative history that Congress intended to impose this double tax. The legislative history only indicates that Congress intended to eliminate the possible evasion of the one tax.

Elimination of Double Tax on Precontribution Gain

As was indicated previously, adoption of the proposals with respect to the assignment of tax detriment or benefit would eliminate the double tax problem in the case where the enterprise disposes of the contributed property prior to either the sale of the ownership interests by the investor or the liquidation of the enterprise. This is so because the gain would be attributed to the contributing investor who would receive a basis increase in the amount of the gain. The question, therefore, is whether a section 754 optional adjustment provision with respect to contributed property should be available to the purchasing shareholders of both subchapter C and S corporations.

Having decided that it is sound from a tax policy standpoint to impute precontribution gain (or loss) directly to the contributing investor, there would seem to be no sound reason for not providing for the elimination of the potential double tax in cases where the contributing investor first disposes of his ownership interest. If, for no other reason, an optional basis adjustment provision should be adopted for the purpose of eliminating the structural problem which would arise as a result of the adoption of the proposal for imputing precontribution gain or loss to the contributing investor. Once the contributing investor has disposed of his ownership interest, or any part thereof, he has in effect cashed in on his precontribution gain or loss or a part thereof. The optional basis adjustment provision would merely take account of this by making an appropriate basis adjustment to the contributed property. Another reason for providing for such a provision is that it does not appear that Congress ever considered the question of whether it is proper to apply a double tax to precontribution gain; it appears that precontribution gain in the corporate context was inadvertently subjected to a double tax.

It might be wise to make basis adjustments with respect to contributed property mandatory for each type of enterprise, unless the enterprise and the investors elect not to have the benefit. This would protect the unsophisticated purchasing investor.

The adoption of a basis adjustment provision with respect to precontribution gain or loss would not generate new possibilities for tax avoidance. It would promote a degree of equity primarily in cases where a shareholder is selling less than all the stock of a corporation which was recently organized. In the case of a sale of 100 percent of the stock, there is presently available the alternative of a section 337 liquidation which permits a corporation to sell its assets (with certain specified exceptions) without recognizing gain on the sale if the sale is followed by a taxable liquidation. Thus, if the assets are sold under section 337, the selling shareholders will be taxed on only one gain and the purchaser will not have the potential for a gain since the basis in the assets purchased will equal the amount paid therefor. From a tax policy standpoint, it may be more compelling to provide a basis adjustment provision than a section 337 provision, because the former will only eliminate a double tax on precontribution gain whereas the latter eliminates the double tax on all gain. As a corollary of a basis adjustment provision there would have to be an imputation to the selling shareholder of any recaptured gain (under section 1245 or section 1250) which would be eliminated by the step-up in basis.

Conclusion

Contributions of appreciated or depreciated property to partnerships, subchapter C corporations and subchapter S corporations should generate the same tax results.

Nonrecognition treatment should continue to apply to all the investors on the organization of a new enterprise. Nonrecognition treatment should also apply to contributions to operating enterprises of (1) massive amounts of capital by groups of investors and (2) substantial amounts of capital by a single investor. The determination of whether a contribution is massive or substantial should be determined by reference to the value of the outstanding ownership interests received for the property contributed. Contributions of property in exchange for at least 50 percent of the ownership interests determined as of immediately after the contribution should be considered massive contributions and contributions in exchange for at least 25 percent of the ownership interests determined as of immediately after the contribution should be considered substantial contributions. These rules would bring the law with respect to recognition treatment for contribution transactions more in line with the rationales which support nonrecognition and recognition treatment, respectively. Those transactions which the rules would treat as nonrecognition contributions both (1) more nearly resemble mere changes in form of ownership as opposed to exchanges amounting to pure sales and (2) are the types of contributions which are likely to have a significant impact on business development. Therefore, such contributions should be facilitated by exemption from the general rule of recognition. On the other hand, those transactions which would be given recognition treatment more nearly resemble exchanges amounting to pure sales and, therefore, should be treated as taxable.

In those cases in which nonrecognition treatment is accorded to contribution transactions, there is a potential for the assignment from the contributing investor to the noncontributing investor of tax detriment in the case of a contribution of appreciated property and tax benefit in the case of a contribution of depreciated property. In an arm's length transaction between informed investors an adjustment in the business bargain will be made to take account of the assignment of tax detriment or benefit. There are at least three instances where there will not be an adjustment: (1) when the tax effect of the assignment is *de minimis*, (2) when the parties are unaware of the tax distortion and (3) when the parties are deliberately effecting a scheme for the assignment of tax detriment or benefit. It necessarily follows, therefore, that in all cases where the tax effect is meaningful, an adjustment will be made or, in the event the investors are either unsophisticated or are engaging in tax avoidance schemes, should be made. Instances involving unsophisticated investors or tax scheming investors in most cases will arise with closely held enterprises. The most appropriate manner of adjusting for the tax detriment or tax benefit element on a contribution of appreciated or depreciated property is the section 704(c)(2) special allocation provision which is available to partnerships. Such a special allocation provision should be (1) mandatory with respect to all (a) closely held partnerships, (b) closely held subchapter C corporations and (c) subchapter S corporations; and (2) optional with respect to all partnerships and subchapter C corporations with a large number of investors. Also, in the case of partnerships and subchapter C corporations with a large number of investors, the Commissioner should have the authority to mandate a special allocation where there are tax avoidance or evasion motivations. The adoption of these rules with respect to subchapter C corporations would also require the adoption of a provision analogous to section 705 which would adjust the adjusted basis of the contributing investor's stock in the amount of the specifically allocated gain or loss.

In order to promote theoretical consistency with the above proposal for special allocations of tax detriment and benefit and for the further reason of eliminating the double tax or double loss with respect to precontribution gain or loss, an optional basis adjustment provision (analogous to the section 743 provision available to partnerships) should be applicable to both subchapter C and S corporations with respect to precontribution gain or loss.