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Taxation: Organization of a Corporation as a Tax-Free Exchange Under Revenue Code 112(b)(5).

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ORGANIZATION OF A CORPORATION AS A TAX-FREE EXCHANGE UNDER INTERNAL REVENUE CODE 112(b) (5).

In 1926, four partners decided to incorporate the partnership business and organize petitioner corporation. The partners transferred assets to the corporation and received stock in exchange therefore, of the following values respectively:

	Net Value Transferred	Net Value Received	Gain	Loss
A	$393,750.	$392,300.		$1,450.
B	56,250.	58,700.	$2,450.	
C	45,000.	49,500.	4,500.	
D	45,000.	39,500.		5,500.
Totals	$540,000.	$540,000.	$6,950.	$6,950.

Included in the net value transferred to the petitioner were two parcels of land with a fair market value at date of transfer of $290,000 and $85,000, respectively.[1] In 1942, the first parcel was sold for $20,000, and petitioner corporation claimed a loss on its 1942 income tax return of $270,000. In 1943, the second parcel was sold for $2,500, and petitioner corporation claimed a loss on its 1943 income tax return of $82,500. Petitioner computed these losses using as a basis the cost of the realty to it,[2] i.e. the fair market value of the property at the date of transfer. The Commissioner of Internal Revenue disallowed the loss,[3] contending that under section 112(b) (5) of the Internal Revenue Code,[4] the incorporation of the partnership was a tax-free exchange, and the basis for the two parcels of realty was the same as it was in the

[1] The parcels in question were improved at date of transfer, but that fact is unimportant.

[2] INT. REV. CODE § 113(a) "The basis of property shall be the cost of such property . . ."

[3] The Commissioner was upheld in the Tax Court of the United States. The Tax Court applied the relative values test (discussed in following paragraphs), but took into consideration an amendment to INT. REV. CODE § 112(b) (5) made in 1939 which is not here under discussion. 7 TC 1440.

[4] INT. REV. CODE § 112(b) (5) "No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation, but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange. . . ." In the facts and opinion of the present case the Court always refers to the predecessor of INT. REV. CODE § 112(b) (5), section 203(b) (4) of the Revenue Act of 1926, the Act in effect at the time of the exchange. The provision under discussion was introduced into the Internal Revenue Code as section 202(c) (3) of the Revenue Act of 1921, 42 STAT. 229 (1921), the wording of the section was altered and it was renumbered section 203(b) (4) by the Revenue Act of 1924, 43 STAT. 256 (1924). The section remained the same but was renumbered when the entire Internal Revenue Code was enacted in 1939, becoming the present section 112(b) (5). However, the continual reference to section 203(b) (4) of the Revenue Act of 1921 gives the impression that the basis of the stock in issue is dependent upon the wording of the section at the time of the transfer, viz. 1926. But is this so? Does the law applicable to the year in which the exchange was made fix the basis, no matter when the thing exchanged

hands of the tranferors,[5] a much lower figure than fair market value at date of transfer. Petitioner contended there was no tax-free exchange under that section because the amount of the stock and securities received by each transferor was not substantially in proportion to his interest in the property prior to the exchange.[6] It was held that the method to be used in determining whether or not the "amount of the stock and securities received by each transferor is substantially in proportion to his interest in the property prior to the exchange" requires that the "proportionate interest transferred by each be compared with the proportionate interest each received". Using this method, the amount of assets transferred to petitioner by the four partners was substantially in proportion to the amount of stock of petitioner received by them. Therefore, the exchange met the conditions of section 112(b)(5) of the Internal Revenue Code, and the basis of the property to the petitioner is the same as in the hands of the transferors.[7]

The decision in the case turned upon the interpretation of the following phrase of Internal Revenue Code section 112(b)(5): "... but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange." Two interpretations of this language have arisen in the litigated cases. The first interpretation, known as the proportionate in-

is sold? INT. REV. CODE § 113(a)(8), which is the section governing the basis of a tax-free exchange of the type here considered, makes no reference to any earlier Code provisions but only to INT. REV. CODE § 112(b)(5) which must be complied with. By exclusion, then, it can be said that basis is made to depend upon compliance with INT. REV. CODE § 112(b)(5) and not a corresponding section of any earlier act. This conclusion is borne out by competent authority: Forstman v. Rogers, 128 F.(2d) 126 (C.C.A. 3rd 1941); Budd International Corporation v. C.I.R., 143 F.(2d) 784, 790 fn.3 (C.C.A. 3rd 1943); III-2 Cum. Bull. 26 (1924); Philip D.C. Ball v. C.I.R., 27 BTA 388 (1932); Securities Company v. C.I.R., 64 F.(2d) 330 (C.C.A. 2d 1933), in which A. Hand, J. states the rule thus: "The law applicable to the year in which the exchange was made is invoked, not to fix the basis, but only to determine the amount of loss recognized in that year for the purpose of subtraction from basis calculated under law of 1924." Thus, although the Court speaks of section 203(b)(4), it should have properly spoken of INT. REV. CODE § 112(b)(5). The wording of the two sections is identical in this case, but the reference to the earlier act seems clearly erroneous. In this discussion, INT. REV. CODE § 112(b)(5) will appear in all instances rather than section 203(b)(4).

[5] INT. REV. CODE § 113(a)(8): "If the property was acquired after December 31, 1920, by a corporation by the issuance of its stock or securities in connection with a transaction described in section 112(b)(5) . . . then the basis shall be the same as it would be in the hands of the transferor. . . ."

[6] There was no question that the property was transferred solely in exchange for stock or securities in the petitioner; or that the transferors had control of the corporation after the transfer. Thus, these two conditions of INT. REV. CODE § 112(b)(5) were not contested.

[7] Mather & Co. v. C.I.R., 171 F.(2d) 864 (C.C.A. 3rd 1949); *cert. denied,* 337 U.S. 907 (1949).

terest test,[8] may be stated thus: substantially in proportion requires "... a comparison between the proportionate shares of each transferor in the total assets before the exchange and his proportionate share in the total issue of stock after the exchange."[9] Restated, the theory becomes: the value of assets transferred by each transferor divided by the value of total assets transferred by all transferors compared with the value of assets of the corporation received by each transferor divided by the value of total assets of the corporation received by all transferors. It is the comparison of these two percentages which determines whether or not the proportionate interest requirement has been met as to each transferor.[10] The second interpretation, called the relative values test, may be stated thus: to determine whether or not there is a substantial proportion requires a comparison "between the value of the share of each transferor in the total assets before the exchange and the value of its shares of stock or interest in the corporation after the exchange."[11] Restated, the theory becomes: the difference between the values of assets transferred by each transferor and the value of assets received by each transferor divided by the value of assets transferred by each transferor. This formula is applied to all transferors and the figures as to each are compared to see if there is a substantial proportion.

It appears that the conflict of opinion is based upon two divergent interpretations of legislative intent. The proportionate interest adherents hold that whether or not a party comes out of the corporate organization with substantially the same control of the total assets as he had before is the important thing. The adherents of the relative values test hold that whether or not a party comes out of the corporate dealings with substantially the same value of holdings as he had before the transfer is the important thing. The adherents of this latter test argue:

> "We feel that in the provisions under discussion Congress was concerned with value rather than control. Whether a man has a proportionately greater or less control of the assets received than of the assets transferred is not relevant to income taxation. Income taxation deals with money values, money gains and losses. For this reason we believe that a comparison of values rather

[8] Also called the "control" or "comparative control" test.

[9] United Carbon Co. v. C.I.R., 90 F.(2d) 43 (C.C.A. 4th 1937). In the cited case, the Court, while rejecting the proportionate interest theory, gave the excellent statement of the theory quoted above.

[10] On the question of what constitutes a tolerable disproportion, a disparity of 11.04% was held to be excessive in Bodell v. C.I.R., 154 F.(2d) 407 (C.C.A. 1st 1946). In the present case the disparity as figured by the Court was 1.86% and this was held to be substantially in proportion. Further, the Court, at page 869, while discussing another point in the opinion, indicated that a disparity of 3.27% would also be a substantial proportion.

[11] *Supra*, note 9. The relative values test was adopted.

than a comparison of control is the proper method for determining substantial proportion."[12]

The Court, in this case, was confronted squarely with the task of choosing between the two theories, and it decided to apply the proportionate interest test. In choosing what is now a minority view, the Court advanced three reasons: (a) the purpose of the statute is to eliminate the incidence of taxation from transactions resulting in only technical gains and losses, and the proportionate interest test will accomplish this; (b) the statute requires that the interest in the property acquired by each person be in substantial proportion to his interest in the property prior to the exchange (Property, as used in this section, means all of the property transferred by all the transferors, and not just the property that each has transferred. The proportionate interest test is necessary for such an interpretation of property.[13]); (c) insofar as section 112(b)(5) was but a rewording of section 202(c)(3) of the Revenue Act of 1921,[14] the application of the relative values test is out of the question.

It is difficult to criticize the reasoning of the Court. Certainly the intent of the statute is to eliminate taxation of transfers that result only in a technical gain,[15] but the application of the relative values test will also fulfill this intention. As for the interpretation of the word "property", the section is worded in such a way that it may be interpreted as the Court in this case has done, but it may also be interpreted to mean *only* that property transferred by each transferor, which is the interpretation pressed by the adherents of the relative values test. The meaning of property is a matter of judicial gloss, and not of expression in the Code as this case maintains. The argument based upon the wording of section 202(c)(3) of the Revenue Act of 1921, does not seem to add weight to the Court's argument. This section can just as easily be interpreted as demanding the relative values test, despite what the Court says.[16] It can be fairly stated that the Court has left us with no argument that definitely improves the position of the proportionate

[12] Bodell v. C.I.R., 154 F.(2d) 407 (C.C.A. 1st 1946).

[13] The question, thus, in their theory is: "Is each transferor's interest in the entire mass of property substantially the same after as it was before the transfer?"

[14] ". . . and the amounts of stock, securities, or both received by such persons are substantially the same proportion as their interests in the property before such transfer." Revenue Act of 1921, § 202(c)(3), 42 STAT. 299 (1921).

[15] Halliburton v. C.I.R., 78 F.(2d) 265 (C.C.A. 9th 1935).

[16] Comparing the two sections, 202(c)(3) (*supra,* note 14) and 112 (b)(5) (*supra,* note 4), we find that the former uses the plural— "amounts", "persons", "their interests—which this court interprets as meaning that the property of all transferors must be together in determining substantial proportion. The latter section uses the singular—"amount", "each", "his interest". Does this distinction actually change the meaning of the sections? There is no reason why it should.

interest theory. However, the case does mark the first approval of the proportionate interest test by a Circuit Court of Appeals,[17] and has resulted in the first split of opinion on this question in the Circuit Courts.[18] This split in the Circuit Courts should justify a Supreme Court decision, but that Court has refused to review the question on certiorari.[18a]

Beyond the theoretical aspects of the problem, what are its practical effects? Under the proportionate interest test the number of tax-free exchanges will be enormously increased. From the table of values in the instant case, a gain by C of $4,500 and a loss by D of $5,000 was considered by the Court as not substantially changing their proportionate interests,[19] yet such gains and losses would change their relative values in a very substantial way.[20] Another example can be found in the *United Carbon* case.[21] There the Court ruled out a tax-free ex-

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[17] The principal case cited as authority for its holding two cases, Hartford-Empire Co. v. C.I.R., 137 F.(2d) 540 (C.C.A. 2d 1943), and Budd International Corporation v. C.I.R., 143 F.(2d) 784 (C.C.A. 3rd 1943). Neither of these cases discussed either of the two theories, and while there is language in the Hartford-Empire case that supports the proportionate interest test, it cannot be said that such language indicates a reasoned choice between the two theories. In the Budd case, while the method used in determining "substantially in proportion" was that of the proportionate interest test, the Court cites the United Carbon and Lincoln-Boyle cases, both supporters of the relative values test.

[18] The relative values test has been approved in the following Circuit Courts of Appeal: Bodell v. C.I.R., 154 F.(2d) 407 (C.C.A. 1st 1940); Blair v. C.I.R., 91 F.(2d) 992 (C.C.A. 2d 1937); Budd International Corporation v. C.I.R., 143 F.(2d) 784 (C.C.A. 3rd 1943); United Carbon Co. v. C.I.R., 90 F.(2d) 43 (C.C.A. 4th 1937); Snead v. Jackson Securities Investment Co., 77 F.(2d) 19 (C.C.A. 5th 1935) C.I.R. v. Lincoln-Boyle Ice Co., 93 F.(2d) 26 (C.C.A. 7th 1937).

[18a] *Supra*, note 7.

[19] The application of the proportionate interest test to the four partners in the principal case based on the table in the text, gives these results:

	Proportionate int. in all assets transferred.	Proportionate int. in all assets received.	Difference in proportion.
A	72.91%	72.64%	-0.27%
B	10.41%	10.87%	+0.46%
C	8.33%	9.16%	+0.83%
D	8.33%	7.31%	-1.02%

From this we can see that all of the partners maintained substantially the same proportions before and after the transfers, the total disparity being 1.85%.

[20] The application of this test to the four partners in the principal case based on the table in the text give these results:

	Percent of difference in value of each transferors assets before and after transfer:
A	-0.36%
B	+4.34%
C	+10.00%
D	-12.22%

From these figures it is apparent that all of the transferors would not maintain a substantial proportion in the transfer before and after. The amount of disparity is 22.22%, and this is beyond the tolerable range. See note 12, *supra*.

[21] *Supra*, note 9.

change when application of the relative values test resulted in a change totalling 50.03%. Under the proportionate interest test, the difference would be a mere 1.93%, and a tax-free exchange would have resulted. It appears then that large disproportions under the relative values test become insignificant disproportions under the proportionate interest test. From this we can deduce that a party wishing to achieve a tax-free exchange in order to escape tax liability where the property to be transferred has greatly increased over its basis to the transferor, or in a high income year, or to enable the corporation to have a high basis for depreciation, will seek to establish the proportionate interest test as controlling. On the other hand, a party wishing to achieve a taxable exchange in order to recognize a loss in a high income year, where the property to be transferred has a much lower value than its basis to transferor, or to recognize a gain in a low income year where the property has a greater value than its basis to transferor, will seek to establish the relative values test as controlling.

Two observations seem pertinent. Under section 112(b)(5) each transferor must retain his substantially proportionate interest before and after the transfer. Thus, the disparity of only one of a group of transferors will affect the tax liability of the entire group. Arguing from this group interrelation, can we not suppose that the liability of the group should also be determined by using the total value of the property transferred and assets received by the group as a basis for comparison in determining whether or not there shall be a tax liability? The proportionate interest test recognizes this logic. Further, the relative values test fails in a situation where one (or more) small contributor makes a small gain or loss while the gain or loss to large contributors is comparatively infinitesimal.[22] In such a case, this small gain or loss by a small contributor would prevent the tax-free exchange. This does not seem to be the idea behind section 112(b)(5). It is to encourage and stimulate business expansion and consolidation without tax incidence. The proportionate interest test will more fully carry out this intent.

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[22] Three men decide to organize a corporation. A contributes $999,998., B contributes $999,998., and C contributes $4., making a total of $2,000,000. A receives corporate assets worth $999,999., B receives $999,999., and C receives $2. Applying the relative values test to these figures we find that the change in relative values before and after the exchange to be: A, +.0002%; B, +.0002%; C, -50%. The total differential being 50.0002% would prevent this organization from being a tax-free exchange merely because an inconsequential transferor has lost $2. The proportionate interest test would result in a total differential of .00015% which would meet requirements of section 112(b)(5).