July 1986

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INTERNAL REVENUE CODE SECTION 351: PRINCIPLES, APPLICATION, AND STRATEGIES FOR INCORPORATING FAMILY FARMS

Michael Fanning

I. INTRODUCTION

Currently many farmers and ranchers¹ are recognizing and seeking the multiple benefits of incorporating their operations.² The corporate farm offers several advantages over other business forms, such as lower corporate income tax rates, continuity of life, centralized management, benefits regarding health plans and benefits to shareholders.³ Certain collateral hazards should not be overlooked, however.⁴ Recently Montana courts have been the forum for battles involving family farm corporations.⁵ These disputes underscore the importance of carefully considering a change in business form and thorough preincorporation planning.⁶

This note assumes that the decision to incorporate has been made⁷ and focuses on another important step in the incorporation,

¹. From 1978 to 1982 the total number of farms in the United States decreased from 2,255,000 to 2,239,000. The number of individually or family held farms and farm partnerships decreased, but the number of corporate farms increased 20% from 50,000 to 60,000. U.S. DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 638, No. 1126 (106th ed. 1986).
². Montana law allows incorporation of any lawful business except banking and insurance. MONT. CODE ANN. § 35-1-107 (1985). Some states, however, have attempted to promote family farms by prohibiting or restricting farm corporations. See KAN. STAT. ANN. § 17-5904 (1981); MINN. STAT. ANN. § 500.24 (West 1986); N.D. CENT. CODE § 10-06-01 (1985); OKLA. STAT. ANN. tit. 18, § 951 (West 1985); S.D. CODIFIED LAWS ANN. § 47-9A-1 (1983); TEX. AGRIC. CODE ANN. § 57.021 (Vernon 1986). These states apparently fear the demise of family farms due to takeovers by large corporations. Of the nearly 60,000 farm corporations in the United States, 88.1% are family held corporations and 11.9% are held by “other corporations.” Corporations with eleven or more stockholders only amount to 1.9% of all corporate farms. U.S. DEP’T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 638, No. 1127 (106th ed. 1986).
⁴. Corporations face additional administrative requirements and expenses which are not found in other business forms such as organization and incorporation expenses, potential double taxation (to corporation and then to the shareholders through dividends), annual meetings etc. See generally 6 N. HARL, supra note 3, at § 51.02(5).
⁶. See 6 N. HARL, supra note 3, at § 51.01.
⁷. A careful discussion of the advantages and disadvantages of incorporation is beyond the scope of this note. For discussions of the various considerations in a farm incorporation see J. KRAMER & T. ENGLEBRECHT, FEDERAL TAXATION OF FARMERS & RANCHERS 325 (1980) (considerations in selecting the proper form for a farming or ranching enterprise); Id. app.
the exchange of property for stock or securities in the newly formed corporation. While the Internal Revenue Code [hereinafter Code] generally requires that a taxpayer recognize gain whenever the taxpayer sells or exchanges property, section 351 creates an exception to the general rule and allows property to be transferred to a corporation without immediately recognizing gain.

To aid the general practitioner whose practice may involve assisting clients with the incorporation of their family farm or ranch, this note will: (1) examine section 351 principles; (2) give examples of the application of section 351 and typical calculations; and (3) discuss strategies and case law of particular interest in farm and ranch incorporations.

II. Basic Principles of Section 351

Section 351 allows an individual to change the form of an enterprise without incurring tax liability. Thus, a taxpayer may avoid recognition of gain "where a gain or loss may have accrued in a constitutional sense, but where in a popular and economic sense there has been a change in the form of ownership and the taxpayer has not really 'cashed-in' on a theoretical gain, or closed out a losing venture." The policy of section 351 is to allow taxpayers to incorporate their businesses without facing a prohibitive tax.

The general rule allowing the transfer of property to a corporation without recognition of gain is simple. Section 351(a) states:

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.

This facially simple provision raises several difficult questions. For

366 (Tax Variables in Selection of a Business Form 366); J. O'BYRNE & C. DAVENPORT, FARM INCOME TAX MANUAL §§ 1001-1011(b) (7th ed. 1984); J. WHEELER, TAX DESK BOOK FOR FARMING AND RANCHING ¶ 801-802.2 (2d ed. 1978). For a checklist of incorporation steps see 6 N. HARL, supra note 3, app. 51G at 51G-1 to 14; J. WHEELER, ¶ 802.2 at 249.
8. I.R.C. § 1001(c) (1982) [hereinafter all citations to the Code are to the 1982 version or to the 1985 West Supplement whichever is most recent] provides, in part: "[t]he entire amount of the gain or loss . . . on the sale or exchange of property shall be recognized."
9. In fact, the nonrecognition rule is mandatory—the importance of this is discussed below. See infra text accompanying notes 55-81.
10. Estate of Kamborian v. Commissioner, 469 F.2d 219, 221 (1st Cir. 1972) (quoting Portland Oil Co. v. Commissioner, 109 F.2d 479, 488 (1st Cir. 1940), cert. denied, 310 U.S. 650 (1940)). Taxpayers and practitioners should note that taxpayers may not claim a loss on a § 351 exchange. I.R.C. § 351(a), (b); see also § 267(a), (b) (disallows loss deduction on the sale or exchange of property between related taxpayers).
instance, it fails to define "property," "stock or securities," and "control." The following sections address these fundamental questions.

A. Property

Neither the Internal Revenue Code nor the Treasury regulations define "property." With few exceptions, virtually any type of real or personal property qualifies for nonrecognition under section 351. Thus, section 351 property may include money, accounts receivable, patent rights and trade secrets, property owned in equitable or legal form, leaseholds, and goodwill. Taxpayers may not treat items such as services performed for the corporation, nor certain debts and interest as section 351 property. The regulations require recognition of gain when the property transferred "is of relatively small value in comparison to the stock and securities already owned (or to be received for services) by the person who transferred such property. . . . if the primary purpose of the transfer is to qualify under this section the exchanges of property by other persons transferring property." 3

The transfer of non-section 351 property to the corporation may have serious tax consequences. Assume, for example, husband and wife contribute land and other farm assets to the corporation.

15. I.R.C. § 351(d)(1); Treas. Reg. § 1.351-1(a)(1)(i), (ii) [All citations to regulations are to regulations under the 1954 Code, as amended to date of publication, unless otherwise indicated.]. Montana law allows shares in a corporation to be paid for "in money or other property, tangible or intangible, or in labor or services actually performed for the corporation." MONT. CODE ANN. § 35-1-606(1) (1985). The same section, however, expressly prohibits its future services as "payment or part payment for shares of a corporation." MONT. CODE ANN. § 35-1-606(2) (1985).
16. Section 351(d)(2), (3) also excludes from the definition of property: "indebtedness of the transferee corporation which is not evidenced by a security, or (3) interest on indebtedness of the transferee corporation which accrued on or after the beginning of the transferor's holding period for the debt."
in exchange for 70% of the corporation’s stock. The couple’s son and daughter agree to contribute their services to the corporation, each receiving 15% of the corporation’s stock. The 30% of the stock controlled by the son and daughter will not apply to the section 351 control requirement because section 351 excludes services from the definition of property. Since section 351 excludes the 30%, nonrecognition does not apply to the husband’s and wife’s transfer because they will not control sufficient stock to satisfy the 80% control rule. Therefore, the son and daughter will incur ordinary income tax liability to the extent of the value of the stock received as salary. The husband and wife will be subject to taxation on their gain realized, based upon appreciation of the land—a result that most farmers usually would want to avoid.

B. Stock and Securities

The Internal Revenue Code does not provide a definition of either stock or securities. The regulations, however, do indicate that “stock rights and stock warrants are not included in the term ‘stock or securities.’” Beyond the regulation’s mention of stock rights and stock warrants, the Code leaves the definition of stock and securities to case law.

Courts generally look at the result of the exchange to determine if the transferor maintained an interest in the business. If so, the courts conclude that the stock or securities received fall within the meaning of section 351. If the transferor did not maintain an interest in the business, the courts hold that the exchange was not for section 351 stock and securities.

Courts interpreting section 351 also exclude exchanges for short term notes because the transferor’s receipt of short term notes more closely resembles a sale than a bona fide exchange of property for stock in which the transferor maintains an interest in

18. I.R.C. § 351(d).
21. Gain realized is calculated by subtracting the adjusted basis of the property from the fair market value of the stock and securities received in exchange. I.R.C. § 1001(a). The character of the gain must be determined individually for each asset transferred. Rev. Rul. 68-55, 1968-1 C.B. 140.
22. In some instances taxpayers seek to avoid the nonrecognition provisions, arguing a taxable transaction occurred, to take advantage of a stepped-up basis in the property and therefore greater depreciation deductions. See infra text accompanying notes 55-58.
23. “[T]he conjunction ‘or’ denotes both the conjunctive and the disjunctive . . . . [T]he provisions are complied with if ‘stock and securities’ are received in exchange as well as if ‘stock or securities’ are received.” Treas Reg. § 1.368-2(h).
the business. In *Pinellas Ice and Cold Storage Co. v. Commissioner*, the United States Supreme Court held that transfer of cash and promissory notes payable within one hundred five days was "mere evidence of obligation to pay the purchase price—[and] were not securities within the intendment of the act and were properly regarded as the equivalent of cash." The Court found, in substance, the transaction to be a sale; gain should have been recognized on the exchange.

In many instances it appears that the term of a note will be determinative when considering if a note qualifies as a section 351 security. Many courts hold that notes of five years or less are not section 351 securities; yet, courts almost always construe notes of ten or more years to be section 351 securities. However, taxpayers frequently cite *Camp Wolters Enterprises, Inc. v. Commissioner* for the proposition that the term of the note is but one factor to consider when determining if a note is a section 351 security.

The test to determine whether notes are securities is not a mechanical determination of the time period of the note. Though time is an important factor, the controlling consideration is an overall evaluation of the nature of the debt, degree of participation and continuing interest in the business, the extent of proprietary interest compared with the similarity of the note to a cash payment, the purpose of the advances, etc.

Applying this far-reaching test, courts examining the interest retained by the transferor have developed a "continuity of interest" test to determine if the transferor retained a sufficient interest in the business. In *LeTulle v. Scofield*, the transferor contracted to convey all of the assets of one company for cash and bonds of a

25. See generally B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 3.04 at 3-16 (4th ed. 1979) [hereinafter cited as BITTKER & EUSTICE].

26. 287 U.S. 462 (1933).

27. Id. at 468-69.

28. Id. at 470.

29. Lloyd-Smith v. Commissioner, 116 F.2d 642 (2d Cir.), cert. denied, 313 U.S. 588 (1941); L. & E. Stirn, Inc. v. Commissioner, 107 F.2d 390 (2d Cir. 1939); Cortland Specialty Co. v. Commissioner, 60 F.2d 937 (2d Cir. 1932), cert. denied, 288 U.S. 599 (1933); Raich v. Commissioner, 46 T.C. 604 (1966).


31. 230 F.2d 555 (5th Cir.), cert. denied, 352 U.S. 826 (1956).

32. Id. at 560 (quoting the Tax Court, 22 T.C. at 751).

33. 308 U.S. 415 (1940).
second company. The Court required the transferor to retain a "definite and substantial interest in the affairs of the transferee." Ignoring the term of the bonds, the Court held that the transferor did not retain a proprietary interest in the business when the transferor received only the corporation's bonds or bonds and cash in the exchange. Thus, the Court required recognition of gain.

Courts have widely accepted the LeTulle rule. "Accordingly unsecured short term obligations have been regarded as not coming within the meaning of 'securities' since they do not furnish any such continuity of interest as is required to satisfy that term." Thus, the Internal Revenue Service [hereinafter Service] will tax farmers exchanging property for short term notes.

In addition to the "continuity of interest test," courts have developed a second test to determine if the transfer falls within section 351: the business purpose test. This test examines the business substance of the transaction. One court held that the business purpose test is a special application of the continuity of interest test which examines whether the transaction is more than a mere device to effect a scheme beyond the intent of the statute. Another court held that to satisfy the business interest test, the transaction must achieve some goal besides tax savings.

The parties to an exchange may receive a greater or lesser percentage of the corporation's stock than the proportional value of property each contributed. However, where the stock received is disproportionate to the amount of property transferred, the transaction will be given a "tax effect in accordance with its true nature." Thus, the Service may treat the exchange as a two-step..

34. Id. at 416.
35. Id. at 418 (quoting Scofield v. LeTulle, 103 F.2d 20, 22 (5th Cir. 1939)).
36. Id. at 420-21.
37. See also Cortland Specialty Co., 60 F.2d at 940; Lloyd-Smith, 116 F.2d 642, 643; Southwest Natural Gas Co. v. Commissioner, 189 F.2d 332, 334 (5th Cir.), cert. denied, 342 U.S. 860 (1951).
38. Lloyd-Smith, 116 F.2d at 643.
40. Electrical Securities Corp. v. Commissioner, 92 F.2d 593, 595 (2d Cir. 1937).
41. Treas. Reg. § 1.351-1(b)(1). Under the 1939 Internal Revenue Code, the equivalent of § 351 permitted nonrecognition "only if the stock and securities received by each transferor are 'substantially in proportion' to the interest of such transferor in the property prior to the exchange." H. Rep. No. 1337, 83d Cong., 2d Sess. ___, reprinted in 1954 U.S. Code Cong. & Ad. News 4017, 4254. Now no gain or loss is recognized "irrespective of any disproportion of the amount of stock or securities received." Id. at 4254-55. See also Bodell v. Commissioner, 154 F.2d 407, 411-12 (1st Cir. 1946).
42. Treas. Reg. § 1.351-1(b)(1).
transaction: (1) a proportional exchange of property for stock or securities; and (2) a subsequent transfer "used to make gifts (section 2501 and following), to pay compensation (section 61(a)(1)), or to satisfy obligations of the transferor . . . ." 43

An example demonstrates this rule. Assume a father and son incorporate a ranch. The father contributes property worth $80,000, and the son contributes property worth $20,000. If the son receives 80% of the stock, the nonrecognition rule applies, but the Service may treat the transaction as a taxable gift to the son to the extent the value of the stock received exceeds the value of the property transferred. 44 If the Service determines the son received the excess stock and securities as compensation for services to the corporation, the transaction will not satisfy the 80% control provision of section 351. The father will be forced to recognize gain, and the son must recognize compensation income.

Additionally, transferors may face gift tax liability when the value of the stock is based on the basis of the property rather than the property's fair market value less indebtedness. Suppose a father and son contribute property of roughly equal income tax basis in exchange for an equal number of shares in the corporation. Assume further that the father contributes land with a fair market value exceeding the property's basis due to appreciation. As in the example above, the transaction may be treated as a gift of stock to the son to the extent that the value of the stock he received exceeds the fair market value of the property he transferred to the corporation. 45 To avoid such gifts one commentator suggests that unless there is only one transferor or all the transferors have an

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43. Id. See also Rev. Rul. 76-454 1976-2 C.B. 102.
44. Treas. Reg. § 1.351-1(b)(2) Ex. 1. The legislative history of this section indicates that if two transferors contribute equally but one receives all of the stock nonrecognition will still apply, however, when the stock is later disposed of, the transaction will be taxed according to its "true nature." H. Rep. No. 1337, 83d Cong., 2d Sess. ----, reprinted in 1954 U.S. Code Cong. & Ad. News 4017, 4254. Apparently the subjective intent of the transferor determines those "appropriate cases" in which the Service will treat the transaction as a gift. Treas. Reg. § 1.351-1(b)(1). Treating the exchange as a gift of stock to the son may result in the loss of a portion of the father's unified credit in addition to federal gift tax liability.
45. Assume both father and son contribute property with an adjusted basis of $100,000. Assume further that the son's contribution was equipment with a fair market value equal to $100,000, but the father contributed land which had appreciated in value to $150,000. If the stock is valued according to the adjusted basis of the property transferred and each receives an equal share of the corporation's stock, then the Service may treat the transaction as a gift to the son of $25,000—the difference between the fair market value of the property the son transferred ($100,000) and the value of the stock he received in exchange (one-half of the $250,000 total or $125,000).
equal basis-to-fair-market ratio,46 "stock and debt securities should not be issued for income tax basis in a farm or ranch operation."47 To avoid such a gift, stock must be issued for the transferred property's fair market value less indebtedness.48

C. Control

The term "control" is defined by section 368(c).49 Control requires "ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation."50 Section 368 omits any detail regarding when control must be secured and how long after the transaction the transferor must maintain control to fall within the nonrecognition provision of section 351.

The Treasury regulations address the "when" question. The regulations make clear that section 351's timing clause, requiring control "immediately after the exchange," does not demand a simultaneous exchange.51 All that is necessary is "a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure."52 Applying this rule, the Service has approved a transaction for nonrecognition when the transaction was completed over a two-week period.53

The Code and regulations leave many questions unanswered. The question of "control" may engender more litigation than any other provision under section 351. The primary area of litigation arises when the transferors originally control the corporation, but later lose control when the corporation issues more stock or when the transferors dispose of enough shares to lose their 80% control.

46. In most instances each transferors' property will not have appreciated or depreciated in perfect proportion. Such a situation might arise when both parties only contribute similar adjoining tracts of land.


48. Id.

49. I.R.C. § 368(c)(1). Section 368 sets out definitions relating to corporation reorganizations.

50. Id. See also Treas. Reg. § 1.351-1(a)(1). The Code allows an exchange "by one or more persons" if "such person or persons are in control." I.R.C. § 351(a). The Code defines "person" as an individual, trust, estate, partnership, association, company or corporation. I.R.C. § 7701(a)(1).


52. Id.

Neither the Code nor the regulations provide specific guidance for these control questions.

The Code contemplates only one control question. Section 351(c) addresses a special control case: “In determining control . . . the fact that a corporate transferor distributes part or all of the stock which it receives in the exchange to its shareholders shall not be taken into account.” Thus the Code only provides guidance for control questions when a corporation receives and distributes another corporation’s stock which it received in an exchange. In all other cases the control question is left to the courts.\(^\text{54}\)

In some cases the transferor, seeking a stepped-up basis for a greater depreciation deduction for the corporation, argues that the transaction was taxable because the control requirement was not satisfied. Generally the corporation’s basis in property will be that which the transferor had.\(^\text{55}\) This basis may be less than the property’s fair market value if the farmer has reduced the basis by taking depreciation deductions\(^\text{56}\) or the property’s value has appreciated. If the transaction is a sale, then the property’s basis to the corporation is the purchase price—presumably the fair market value of the property\(^\text{57}\)—and the corporation receives a greater basis for depreciation.\(^\text{58}\) Thus, to take advantage of greater depreciation deductions, transferors may argue that the control requirement has failed and section 351 does not apply to the transaction.

The transferor may design a series of transactions meant to avoid nonrecognition, or the transferor may have the stock issued directly to others, such as family members, to avoid the control requirement. Hence, the Service may argue substance should govern over form. In *American Bantam Car Co. v. Commissioner*,\(^\text{59}\) the court looked beyond the form of a series of transactions to the transactions’ substance. In denying the corporation a stepped-up basis, the court wrote:

> In determining whether a series of steps are to be treated as a single indivisible transaction or should retain their separate identity, the courts use a variety of tests. . . . Among the factors considered are the intent of the parties, the time element and the pragmatic test of the ultimate result. An important test is that of

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57. I.R.C. § 1012.
58. I.R.C. § 167(g); I.R.C. § 168(d).
mutual interdependence. Were the steps so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series?60

The following discussion reviews cases in which the corporation claimed a stepped-up basis because the transferor had the stock issued directly to family members. In these cases the transferors argued that the transaction failed to meet the control requirement because the transferor never received 80% of the stock or securities in the corporation. A test that developed from these decisions turns on the transferor's freedom to dispose of or retain stock. If, after the exchange, the transferor can elect either to retain or dispose of the stock, he is in control for purposes of section 351.

In Wilgard Realty Co. v. Commissioner,61 the transferor was not taxed on the exchange (and the corporation did not receive a stepped-up basis) when the transferor gave three-fourths of the corporation's stock to his brother and adult children. The court found that the amount of time the transferor held the stock himself was immaterial. Further, the Second Circuit Court of Appeals found that after the exchange the transferor still controlled the stock and was not bound to dispose of it. The court distinguished this case and cases where the transferor was bound by some "restriction on his freedom of action" or where the transferor had "foregone or relinquished" control prior to the exchange [or] was bound by some prearrangement to dispose of the stock.62 Thus, the transfer was properly a nontaxable section 351 exchange and the court denied the taxpayer a stepped-up basis.63

In D'Angelo Associates, Inc. v. Commissioner,64 the Tax Court applied slightly different reasoning to find that section 351 nonrecognition applied to the transfer. In D'Angelo, a dentist gave the newly formed corporation $15,000. The corporation issued ten shares of stock to Mrs. D'Angelo and ten shares each to the
D'Angelos' five children. The corporation issued no stock to Dr. D'Angelo. 66 Nine days after they organized the corporation, the D'Angelos "sold" a building and equipment to the corporation for $15,000 and the corporation claimed a stepped-up basis in the property "purchased." 66 The D'Angelos argued that the exchange and a subsequent sale represented separate transactions and therefore the nonrecognition provisions should not apply. The Commissioner responded, terming the transactions "contemporaneous events that were in substance integral parts of a single transaction." 67

The court developed a substantive test to determine if such events constitute independent or integrated transactions. "[T]he boundaries are defined by including events contemplated for the success of the business plans from which they emanate." 68 The court found there was no reason for the corporation to exist if the D'Angelos did not also transfer the property, 69 and further found the success of the corporation motivated the transactions. 70 Specifically addressing the control issue, the court held that Dr. D'Angelo had "an absolute right" to designate who would receive the stock. 71 This power satisfied the 80% control requirement.

In a contrary holding, Fahs v. Florida Machine & Foundry Co., 72 the Fifth Circuit Court of Appeals allowed a corporation a stepped-up basis in the transferred property because a prior agreement executed between the owner and his son prevented the father from acquiring 80% control. 73 Three years prior to the incorporation, the father and son had executed an agreement which stated that the son would acquire a one-half interest in the business if he continued to work for his father. 74 When he formed the corporation, the father retained a slight controlling interest insufficient to meet the control requirement of section 351. 75 The court respected the prior agreement between the father and son, and held that under the agreement the father could only control one-half of the corporation's stock. The court refused to impose nonrecognition on

65. Id. at 128.
66. Id. at 129.
67. Id.
68. Id. at 130.
69. Id.
70. Id. at 130-31.
71. Id. at 132.
72. 168 F.2d 957 (5th Cir. 1948), aff'g 73 F. Supp. 379 (S.D. Fla. 1947).
73. Id. at 959.
74. Id. at 958.
75. The father was issued 1181 shares, slightly over 50% of the stock. His son received 1176 shares and three individuals received one share each. Id. at 958.
the exchange and allowed the corporation a stepped-up basis.\textsuperscript{78}

The taxpayers in \textit{Intermountain Lumber Co. v. Commissioner}\textsuperscript{77} also received a stepped up basis in the transferred property when they successfully argued that the stock sale requirement of their incorporation agreement denied them 80\% control. Shook, the owner of a lumber mill, wished to rebuild his mill and incorporate, but he lacked sufficient capital. Wilson agreed to guarantee a loan, but as a condition he demanded that Shook sell him an equal share of the corporation's stock. Eight months after the mill's incorporation Wilson transferred cash to the corporation for his share of the stock.\textsuperscript{78}

The Commissioner argued that the taxpayers should not receive a stepped-up basis because at the time of incorporation Shook retained all of the corporation's stock and Wilson had a mere option to purchase stock from Shook. Therefore, the Commissioner argued, Shook was still in control of the corporation, satisfying the control requirement of section 351.\textsuperscript{79}

The Tax Court rejected the Commissioner's argument. To determine if Shook controlled the corporation, the court examined Shook's "obligations and freedom of action with respect to the stock" he received.\textsuperscript{80} The court found that Shook did not control the corporation, stating: "If the transferor, as part of the transaction by which the shares were acquired, has irrevocably foregone or relinquished at that time the legal right to determine whether to keep the shares, ownership in such shares is lacking for purposes of section 351."\textsuperscript{81} Thus, the court found that Shook did not control the corporation, because the incorporation agreement obligated him to transfer the stock to Wilson. As a result, nonrecognition did not apply, and the taxpayers received a stepped-up basis in the property transferred to the corporation.

Courts usually will not allow taxpayers to avoid nonrecognition by manipulating the control requirement. Courts will hold that the transferor is not in control of the corporation only where he enters a contract prior to the exchange, obligating him to relinquish control of the corporation. If the transferor retains authority to give the stock to another or to direct the corporation to issue the stock directly to another, courts generally will find that the

\begin{verse}
\textsuperscript{76} Id. at 959.
\textsuperscript{77} 65 T.C. 1025 (1976).
\textsuperscript{78} Id. at 1031.
\textsuperscript{79} Id.
\textsuperscript{80} Id.
\textsuperscript{81} Id.
\end{verse}
transferor retained sufficient control to fall within the nonrecognition provisions of section 351.

Absent such a binding, preincorporation agreement, it is unlikely that a farmer can receive a stepped-up basis in transferred property by avoiding section 351 nonrecognition. Most farmers should be more concerned with avoiding recapture of depreciation deductions which could occur if the property was sold to the corporation to receive the stepped-up basis.

D. Recapture

If section 351 does not apply to a transaction, the farmer's gain recognized on the exchange may trigger the depreciation provisions and investment tax credit provision. The depreciation recapture provisions apply when a taxpayer disposes of certain depreciable personal property and real property. The Code imposes a second type of recapture when a taxpayer disposes of property on which he claimed an investment tax credit [hereinafter ITC]. Farmers may also incur ordinary income tax liability for deductions taken for soil and water conservation expenses and land clearing expenses, and federal cost sharing payments. Transferors should carefully review the recapture provisions, because the effect of recapture can be "stunningly adverse."

When a taxpayer disposes of certain types of property for which he has taken depreciation deductions, sections 1245 and 1250 require the taxpayer to recapture those deductions as ordinary income. These sections override other Code provisions permitting nonrecognition. Sections 1245 and 1250, however, limit the recaptured amount to the "amount of gain recognized to the transferor on the transfer of such property . . . ." Therefore, if the taxpayer recognizes no gain on the exchange, he will escape recapture liability. Conversely, if the farmer must recognize gain because, for example, the farmer received money and short term notes in exchange for the property transferred, he may face signifi-

82. I.R.C. § 1245.
83. I.R.C. § 1250.
84. I.R.C. § 47(b).
88. I.R.C. §§ 1245(a)(1) (gain from the disposition of certain personal property); 1250(a)(1)(A) (gain from disposition of certain realty). See also KRAMER & ENGLEBRECHT, supra note 7, at 348-49.
89. I.R.C. §§ 1245(d); 1250(i).
90. I.R.C. §§ 1245(b)(3); 1250(d)(3).
cant recapture on his gain recognized.

Section 47(b) provides an exception to the general ITC recapture rule which may exclude farm incorporations from the recapture rules.\textsuperscript{91} Section 38(a) allows taxpayers a credit for certain business investments,\textsuperscript{92} but taxpayers face recapture liability if they dispose of the ITC property before the close of the useful life of that property.\textsuperscript{93} Section 47(b) excludes the exchange of property for stock or securities from those dispositions which result in recapture of the ITC credit. Section 47(b) provides that no recapture will result "by reason of a mere change in the form of conducting the trade or business so long as [1] the property is retained . . . as section 38 property and [2] the taxpayer retains a substantial interest in such trade or business."\textsuperscript{94}

Treasury regulation section 1.47-3(f)(1) limits the ITC recapture exception to certain transfers. To fall within the recapture exception, (1) the transferor must retain section 38 property as section 38 property in the same trade or business;\textsuperscript{95} (2) the transferor must retain a substantial interest in the business; (3) the transferor must transfer substantially all the assets (whether or not section 38 property) necessary to operate the business; and (4) the corporation must determine the basis of the property by reference to the property's basis in the hands of the transferor.\textsuperscript{96} This regulation raises other important questions regarding the meaning of "substantial interest" and "substantially all of the assets."

The regulations define "substantial interest" as an interest "substantial in relation to the total interest of all persons" and "equal to or greater than his interest prior to the change in form."\textsuperscript{97} In Soares v. Commissioner,\textsuperscript{98} the taxpayer and a large corporation were partners in a cement hauling business with forty-
eight and fifty-two percent shares, respectively. Soares exchanged his partnership share for seven percent of the stock in the corporation. The Service argued that the taxpayer disposed of his section 38 property and, therefore, should recognize recapture income. Although the value of the interests were equal, the Tax Court held “substantial interest” means control, not value; therefore the taxpayer did not fall within the mere change of business form exception of section 47(b), and the court required the taxpayer to pay the tax on the recaptured income.

The regulation’s provision requiring the transfer of “substantially all of the assets” necessary to operate the business also has confused section 351 transfers. In Revenue Ruling 76-514, the Service held that a transfer of 70% of the assets was insufficient to meet the substantially all requirement. This Revenue Ruling effectively prevented farmers from incorporating their operating assets but retaining personal ownership of real estate.

In Loewen v. Commissioner, however, the Tax Court ignored Revenue Ruling 76-514 and held that farmers who incorporated grain inventories, cattle, machinery, and equipment, but retained personal ownership of their land, had complied with section 47(b) and Treasury regulation section 1.47-3(f)(1). Rather than incorporating all of their farm assets, the individuals retained personal ownership of the land and leased it to the corporation. The court refused to impose ITC recapture and approved the lease arrangement because the land was essential to the operation of the corporation. The court added that since the Loewens had to use the land in their business, this holding would not frustrate the purpose of the recapture provisions. “The purpose of [ITC] recapture

99. Id. at 910.
100. Id. at 912.
101. Id. at 914. See also Rev. Rul. 77-361, 1977-2 C.B. 6.
103. Rev. Rul. 76-514, 1976-2 C.B. 11, specifically addressed the “substantially all” requirement of Treas. Reg. § 1.47-3(f)(1)(ii)(c). A dentist transferred dental and office equipment (representing 70% of the total assets) to the corporation, but retained the office building in his personal ownership (representing 30% of the total assets). The Ruling held that first it is necessary to determine the taxpayer’s trade or business. Then, under the facts and circumstances of each case, the Service will look at the omitted asset and determine if that asset is necessary to operate the trade or business of corporation “in the same manner as before the transfer.”
104. See infra text accompanying notes 136-47.
106. Id. at 95-96. The court noted that the taxpayers may have retained personal ownership of the land to avoid a Kansas statute restricting corporate ownership of farmland. Id. at 94. See supra note 2.
107. 76 T.C. at 92.
was to prevent a quick turnover of assets in an effort by a taxpayer to obtain multiple tax credits.\textsuperscript{108} Furthermore, if the corporation disposed of the section 38 property or if it ceased to be section 38 property, or if the taxpayers failed to retain a substantial interest in the corporation, then the taxpayer would face ITC recapture.\textsuperscript{109}

Following the Tax Court's decision in \textit{Loewen}, the Service acquiesced. It will not apply Revenue Ruling 76-514, but the Service will require that "the properties, including the section 38 property, must continue to be used not only in the same trade or business, but a trade or business that uses the same general assets."\textsuperscript{110} Now it appears that farmers can apply different incorporation strategies and avoid ITC recapture as long as the taxpayer continues to use the nonincorporated property in his farm business.

\section*{III. Typical Calculations Required Under Section 351.}

\subsection*{A. Calculating Gain Recognized}

The general section 351 rule requires the transferor to give property to the transferee corporation "solely in exchange for stock or securities."\textsuperscript{111} Special rules apply when the transferor receives "other property or money," referred to as "boot."\textsuperscript{112} Boot may include any property received by the corporation other than qualified stock and securities. A farmer typically will not receive "other property or money," but if he does, gain must be recognized to the extent of money and the fair market value of other property received.\textsuperscript{113}

The following example illustrates gain recognized when the farmer receives "other property or money" in addition to stock and securities. Assume a farmer transfers machinery with an adjusted basis of $15,000 and a fair market value of $25,000 to a corporation and in exchange receives stock worth $20,000, $2,000 in cash, and other property with fair market value of $3,000.

\textsuperscript{108} \textit{Id.} at 95.
\textsuperscript{109} \textit{Id.} (citing Treas. Reg. § 1.47-3(f)(5)(i), (ii)).
\textsuperscript{111} I.R.C. § 351(a).
\textsuperscript{112} I.R.C. § 351 (b).
\textsuperscript{113} I.R.C. § 351(b)(1).
In this instance the gain realized is $10,000, but the Code limits the taxable gain recognized to the amount of money ($2,000) and the fair market value of other property ($3,000) received in addition to stock in the corporation. In this example the gain recognized equals $5,000.

When the farmer recognizes gain under section 351(b), "each asset transferred must be considered to have been separately exchanged."114 The character of the asset transferred determines if it will be taxed as ordinary income or as a capital gain.118 Thus, when the farmer anticipates that gain will be recognized, care should be taken to select property which will qualify for the more favorable capital gain treatment.116

More likely than not, a rancher will transfer encumbered property. Formerly, if a taxpayer transferred encumbered property, section 351 nonrecognition was inapplicable. Following the Supreme Court's holding in United States v. Hendler,117 if a corporation assumed the rancher's liability, the rancher received a form of boot. The Service realized that many exchanges that had been treated as tax-free would be taxable under the Hendler rule.

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115. See I.R.C. § 1221. The Code defines capital assets as property held by the taxpayer, but the Code excludes (among other assets): stock in trade which is included in the taxpayer's inventory or property held primarily for sale to customers, I.R.C. § 1221(1), and depreciable property or real property used in the trade or business, I.R.C. § 1221(2).

116. I.R.C. § 1202(a) provides: "If for any taxable year a taxpayer other than a corporation has a net capital gain, 60% of the amount of the net capital gain shall be a deduction from gross income." "[N]et capital gain' means the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year." I.R.C. § 1222(11).

117. 303 U.S. 564 (1938). As part of Hendler Creamery Company's merger with the Borden Company, Borden agreed to assume over $500,000 of debts owed by Hendler. Citing Old Colony Trust Co. v. Commissioner, 279 U.S. 716, 719 (1929), the Court found that Borden's assumption of Hendler's debt was taxable income to Hendler. The assumption of liabilities, however, fell outside the scope of the nonrecognition provision and Hendler was taxed on the $500,000 gain. Id. at 566-67.
This meant that in many cases the corporation was entitled to a stepped-up basis in the property transferred, the transferor received a stepped-up basis in the stock, and only a few transferors with largely unencumbered property would ever be entitled to take advantage of the section 351 nonrecognition rule.

In response to Hendler, Congress enacted section 357 to remedy the uncertain result when a corporation assumes a transferor's liability. Section 357 states that a corporation's assumption of a liability "shall not be treated as money or other property, and shall not prevent the exchange from being within the provisions of section 351." A corporation now can assume a liability in an exchange and the transaction will still fall under the nonrecognition provision of section 351.

Additionally, section 357(b) prevents game-playing; the taxpayer can no longer "bail out" from a liability. Formerly, a taxpayer could borrow against the property he intended to transfer, receive cash, and then transfer the asset to the corporation, avoiding liability on the debt. Under section 357, if the transaction appears as if the transferor undertook the liability to avoid tax, or absent a bona fide business purpose, the total liability assumed by the corporation will be treated as money received by the taxpayer. Thus, if the taxpayer "bails out" from a liability, the taxpayer must recognize gain (if any) to the extent of the liability.

Section 357 also sets out the formula for calculating gain when the corporation assumes liabilities in excess of the adjusted basis of property transferred to the corporation. Gain equals the excess of the aggregate of liabilities assumed over the aggregate adjusted basis of property transferred to the corporation. If a farmer transfers land with a basis of $15,000, subject to a mortgage of $45,000, section 357(c) requires the $30,000 excess to be treated as gain from a sale. If the farmer also transfers unencumbered machinery to the corporation, the transfer increases the aggregate adjusted basis and correspondingly decreases the excess of aggregate liabilities over aggregate adjusted basis. For example, suppose the

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118. I.R.C. § 357(a).
119. I.R.C. § 357(b)(1)(A), (B).
120. I.R.C. § 351(b). In cases where the Service applies § 351(b), "The taxpayer must prove his case by such a clear preponderance of all the evidence that the absence of a purpose to avoid Federal income tax on the exchange, or the presence of a bona fide business purpose is unmistakable." Treas. Reg. § 1.357-1(c).
121. I.R.C. § 357(c); Treas. Reg. § 1.357-2. Each asset must be examined to determine the character of the gain. If the asset is a capital asset, then whether the gain is "long- or short-term capital gain shall be made by reference to the holding period to the transferor of the assets transferred." Treas. Reg. § 1.357-2(a); Treas. Reg. § 1.357-2(b) Ex. 1, 2.
farmer transfers unencumbered machinery with an adjusted basis of $10,000 in addition to the land in the fact pattern above.

TABLE TWO

<table>
<thead>
<tr>
<th>Aggregate liabilities</th>
<th>$30,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>less aggregate adjusted basis:</td>
<td></td>
</tr>
<tr>
<td>land</td>
<td>$15,000</td>
</tr>
<tr>
<td>machinery</td>
<td>$10,000</td>
</tr>
<tr>
<td></td>
<td>&lt;$25,000&gt;</td>
</tr>
<tr>
<td>Gain recognized</td>
<td>$5,000</td>
</tr>
</tbody>
</table>

Thus, by including unencumbered assets along with the encumbered assets, the farmer may significantly reduce gain recognized. Some commentators suggest that gain and loss might be more accurately stated if aggregate liabilities were not measured against aggregate basis. Income might be more clearly reflected if each asset were considered independently.\(^{122}\) A literal reading of the statute, however, seems to preclude this view.\(^{123}\)

Another problem arises when two or more transferors contribute property to the corporation, one contributing encumbered assets and the other contributing unencumbered assets. The Code and the regulations are unclear about the treatment of the liability as between the two transferors. A literal reading of the Code suggests that the simple aggregate rule applies in this instance as well. The Code imposes a tax on the transaction to the extent the aggregate liabilities assumed by the corporation exceed the aggregate adjusted basis of property transferred to the corporation without regard to the origin of the liabilities.\(^{124}\)

Arguably, under this rule the transferor exchanging encumbered property unfairly avoids recognition of gain, while the second transferor suffers because the basis in the stock he received is decreased.\(^{125}\) A revenue ruling addressing the question avoided this theoretical result by holding, "[T]he provisions of section 357(c) apply separately to each transferor . . . without regard to the adjusted basis and liabilities of any other transferor."\(^{126}\)

Since farmers frequently own encumbered property, practitioners and farmers should use particular care to avoid transferring

\(^{122}\) Bittker & Eustice, supra note 25, ¶ 3.02 at 3-32.

\(^{123}\) The flush language of the statute requires a comparison of "the sum of the amount of liabilities assumed" against "the total of the adjusted basis of the property transferred." I.R.C. § 357(c)(1).

\(^{124}\) Id.

\(^{125}\) Treas. Reg. ¶ 1.358-3.

property subject to liabilities in excess of adjusted basis. To prevent ordinary income tax liability, the practitioner should examine each asset transferred to the corporation to assure that the aggregate adjusted basis of property transferred to the corporation exceeds the property's aggregate liabilities.

B. Calculating the Transferor's Basis

Section 358(a) outlines the general rule for calculating the transferor's basis in the stock received. As a general rule the transferor's basis in the stock equals the basis of the property exchanged.\(^{127}\) Three factors decrease the basis: (1) the value of other property received in the exchange; (2) the amount of money received; and (3) the amount of loss recognized.\(^{128}\) The basis is increased by the amount treated as a dividend and the amount of gain recognized.\(^{129}\) The basis of "other property" received is its fair market value.\(^{130}\)

Assume the farmer exchanges property worth $100,000 with an adjusted basis of $60,000 for $75,000 of stock, $15,000 cash and other property having a fair market value of $10,000.

TABLE THREE

<table>
<thead>
<tr>
<th>Amount realized</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less adjusted basis</td>
<td>60,000</td>
</tr>
<tr>
<td>Gain realized</td>
<td>40,000</td>
</tr>
<tr>
<td>Gain recognized to extent of boot:</td>
<td>25,000</td>
</tr>
<tr>
<td>15,000 + $10,000</td>
<td>25,000</td>
</tr>
<tr>
<td>Basis of &quot;other property&quot; equals FMV</td>
<td>10,000</td>
</tr>
<tr>
<td>Basis of the stock:</td>
<td></td>
</tr>
<tr>
<td>Basis of property transferred to the corporation</td>
<td>60,000</td>
</tr>
<tr>
<td>less: cash</td>
<td>15,000</td>
</tr>
<tr>
<td>FMV of other property received</td>
<td>10,000</td>
</tr>
<tr>
<td>&lt;25,000&gt;</td>
<td></td>
</tr>
<tr>
<td>add: gain recognized</td>
<td>25,000</td>
</tr>
<tr>
<td>$ 60,000</td>
<td></td>
</tr>
</tbody>
</table>

The stock valued at $75,000 has a basis of $60,000. If the transferor later disposes of the stock, he presumably will be taxed on the $15,000 of gain realized. This $15,000, together with the

\(^{127}\) I.R.C. § 358(a).
\(^{130}\) I.R.C. § 358(a)(2).
$25,000 of gain recognized at the time of the exchange, totals $40,000: the original gain realized. Thus, the farmer is eventually taxed on the entire amount of gain, but section 351 nonrecognition allows deferral of part of the tax.

The Code requires that the basis of the “stock or securities” received be allocated between the different stocks or securities issued.\textsuperscript{131} The farmer calculates the basis for stocks and bonds received in exchange for farm property as follows. Assume the farmer exchanges land with a basis of $60,000 ($130,000 fair market value) and machinery with a basis of $40,000 ($70,000 fair market value) for stock worth $150,000 and bonds worth $50,000. The $100,000 total basis transferred to the corporation must be ratably allocated between the stocks and bonds. Basis of the stock [bonds] = (Total basis of property transferred) x (fair market value of stock [bonds] - fair market value of stock [bonds])/fair market value of stock [bonds]).\textsuperscript{132}

\begin{table}[h]
\centering
\begin{tabular}{ l c c c r }
\hline
Basis of stock & $100,000 \times \frac{\$150,000}{\$200,000} & = & $75,000 \\
Basis of bonds & $100,000 \times \frac{\$50,000}{\$200,000} & = & + 25,000 \\
Total basis & & & $100,000 \\
\hline
\end{tabular}
\end{table}

If the transferee corporation assumes a liability from the transferor, section 358 treats the liability as money received by the transferor,\textsuperscript{133} which decreases basis under the rule stated in section 358(a)(1)(A).

Suppose the transferor exchanges property with an adjusted basis of $25,000, encumbered by a $50,000 mortgage, for stock with a fair market value of $50,000. Section 358 decreases the adjusted basis of the property received by the amount of the liability assumed and increases the adjusted basis by the amount of gain recognized on the transaction: $25,000 less $50,000 plus $25,000. In this case the basis of the stock received is zero.\textsuperscript{134}

\begin{itemize}
\item \textsuperscript{131} I.R.C. § 358(b)(1). The transferor must also allocate between different classes of stock and securities received. Treas. Reg. § 1.358-2(b)(2), (c).
\item \textsuperscript{132} Treas. Reg. § 1.358-2(c) Exs. 1, 2. \textit{See also} Treas. Reg. § 1.307-1(a), (b) which provides rules for calculating the basis of stock and stock rights acquired in a distribution.
\item \textsuperscript{133} I.R.C. § 358(d)(1).
\item \textsuperscript{134} Treas. Reg. § 1.358-3(b) Ex. 2.
\end{itemize}
C. Calculating the Transferee's Basis

Section 362 states the rule for determining the basis of the property acquired by the transferee corporation. The basis is simply the same as it was in the hands of the transferor, increased by any gain recognized by the transferor.\textsuperscript{135}

IV. Incorporation Considerations Peculiar to Farm and Ranch Incorporations

Once a farmer or rancher has decided to incorporate, what assets should be transferred to the corporation? This complex decision involves income tax planning, estate planning, and family considerations. This section examines some of the factors which farmers and ranchers must consider as they make this decision.

A. Determining Whether to Incorporate the Land

Many ranchers recognize the advantages of the corporate form, but fear losing the security of outright control of the operation. Ranchers may mitigate this fear by retaining ownership of the land and incorporating only the operating assets. This strategy (1) keeps the stock affordable, allowing family members to buy stock in the corporation without purchasing stock valued to reflect the high value of land; (2) allows more stock to be gifted without exceeding the annual gift tax exclusion;\textsuperscript{136} and (3) allows family members to demonstrate their management skills without denying the landowner the security of the real estate. Retaining personal ownership of the land allows the farmer the option of transferring the land to the corporation later, or selling it to his children or the corporation.\textsuperscript{137}

A farmer or rancher who owns appreciated land may be tempted to "sell" the land to the corporation instead of simply effecting a tax-free exchange under section 351 principles. A sale, rather than a nontaxable exchange, could provide both the transferor and corporation with benefits. For example, if the corporation immediately sells the land to a third party, the gain on the two sales will be split between the transferor and the corporation. The transferor will receive capital gains from the sale to the corporation\textsuperscript{138} (possibly on the installment method),\textsuperscript{139} and the corpora-

\textsuperscript{135} I.R.C. § 362(a); Treas. Reg. § 1.362-1(a).
\textsuperscript{136} I.R.C. § 2503(b) allows an annual exclusion of $10,000 per donee from the donor's taxable gifts.
\textsuperscript{137} See generally Wheeler, supra note 7, ¶ 802.2 at 251.
\textsuperscript{138} I.R.C. § 1231. Practitioners should note I.R.C. § 1239(a) which requires the tax-
tion may qualify for section 1231 treatment.\textsuperscript{140}

If the farmer does decide to sell the land to the corporation it must be a bona fide sale. Courts will look past the appearance of a transaction and seek its substance. It is unlikely that such a transfer in which the transferor receives stock or securities and other property, even couched in terms of a sale, will give the desired result.\textsuperscript{141} A farmer may, however, effect a true sale and avoid the mandatory provisions of section 351(a) and (b) if: (1) the transferor receives money or other property and receives no stock or securities; or (2) if the transferor does not acquire 80\% control of the corporation.

Another advantage of retaining personal ownership of the land arises when the family intends to sell the farm. If the children are not expected to continue the operation, and if the farm probably will be sold upon the death of the farmer, then it may be best to keep the land out of the corporation. As a general rule, a section 351 exchange allows the corporation to take the transferor's basis in the land.\textsuperscript{142} When the corporation later sells the farm, it will realize the full amount of the appreciated gain. If the farmer retains the land, the family members inheriting the land will receive it with the basis stepped-up to its present fair market value.\textsuperscript{143} Thus, they may considerably reduce their gain realized on the sale.

Excluding land from a section 351 transfer raises potential for ITC recapture. Substantially all of a business' assets must be transferred to the corporation to avoid ITC recapture.\textsuperscript{144} One com-

\textsuperscript{139.} I.R.C. § 453.
\textsuperscript{140.} I.R.C. § 1231(a)(1) allows capital gain treatment for the sale or exchange of property used in the trade or business. If the corporation sells the land immediately, the Service may not consider the land to have been used in the trade or business. I.R.C. § 1231(a)(3), (b). Practitioners should not overlook I.R.C. § 268 which disallows deductions from crop expenses when an unharvested crop is considered "property used in the trade or business" under I.R.C. § 1231(b)(4). See also Treas. Reg. § 1.1268-1; Treas. Reg. § 1.1231-1(f).

\textsuperscript{141.} Nye, 50 T.C. at 211-12.

\textsuperscript{142.} See supra text accompanying note 135.

\textsuperscript{143.} I.R.C. § 1014(a)(1). A full discussion of the tax treatment of corporate liquidations is beyond the scope of this note. See I.R.C. §§ 331-37. Section 2032A permits heirs to elect an alternative estate tax valuation for real property if the property is used for farming purposes and was acquired from or passed from the decedent. The heir may decrease the value of real property by as much as $750,000, I.R.C. § 2032A(a)(2), but if the heir disposes of the property or ceases to use it for a qualified use within ten years of the decedent's death, then the heir is liable for an additional tax.

\textsuperscript{144.} See supra text accompanying notes 91-96, 102-110.
mentator has suggested that the ITC recapture may be avoided by "spinning off" assets which will not be transferred to the corporation. By retaining only a leasehold interest in the asset and transferring this leasehold to the corporation the ITC recapture may be avoided. Recapture may also be avoided by transferring some assets to another corporation. This separates the assets, yet still satisfies the substantial interest test.

B. Allocating Income and Deductions

Farm or ranch incorporations will generally be in the nature of mid-stream incorporation—incorporations of an ongoing business. In the case of an ongoing operation, the transferor must consider income and expense factors in addition to the other requirements of section 351. A common example is the case of growing crops. A farmer may attempt to deduct the crop expenses individually and then incorporate, thinking the corporation will be taxed on the income. This transaction must pass the scrutiny of the assignment of income doctrine, as well as the provisions of sections 446(b) and 482. Section 446(b) requires taxpayers to apply an accounting method which clearly reflects income. Section 482 allows the Service to reallocate income and deductions between taxpayers to clearly reflect their respective incomes.

In a few instances the Service successfully applied assignment of income principles or section 482 to deny a taxpayer benefits claimed in a farm incorporation. The Service, however, will prevail in this argument in only very limited instances. The Service successfully reallocated corporate income to the transferor in Rooney v. United States. In Rooney, hop farmers contracted the sale of their crop, deducted their production expenses and then incorporated. The corporation reported the income from the contract and the individuals sought a net operating loss carryback due to the loss resulting from the expenses reported. To more clearly reflect income, the Service applied section 482 and reallocated the expenses of the growing crop from the individuals to the corporation.

On appeal to the Ninth Circuit Court of Appeals, the taxpayers argued that section 482 conflicts with section 351 and the non-

145. Wheeler, supra note 7, ¶ 605.1 at 184.
147. Wheeler, supra note 7, ¶ 605.1 at 184.
148. 305 F.2d 681 (9th Cir. 1962).
149. Id. at 682.
recognition provision should prevail.\textsuperscript{150} The court found otherwise and held that section 482, requiring a clear reflection of income, takes precedence over section 351 nonrecognition. Therefore, the Commissioner did not abuse his discretion by forcing the taxpayers to report the gain on the sale of the crop.\textsuperscript{151}

\textit{Weinberg v. Commissioner}\textsuperscript{152} exemplifies the application of the assignment of income doctrine in the farm corporation setting. A farmer formed fourteen corporations from his partnership and purported to sell the growing crops to the corporations. The evidence showed that Weinberg drafted the bills of sale for crops, and the corporations issued stock to Weinberg after the partnerships completed the harvest.\textsuperscript{153} The court found that the partnership transferred only the proceeds from the crop, not the crops.\textsuperscript{154} Consequently the partnership incurred the tax liability from the crop proceeds.\textsuperscript{155}

A series of letter rulings indicates that the Service is no longer as willing to argue assignment of income or section 482 in farm incorporations, and suggests that the Service will challenge a non-taxable exchange only in exceptional cases. In one case the taxpayers transferred all of their assets and liabilities to the corporation at the end of their taxable year. The taxpayers normally sold their crop in the following year. Hence, the new corporation would report the income on the crop. The Ruling stated that the transaction did not distort income, and the Service refused to apply section 482 to reallocate income. In making this determination the Service noted that the taxpayers: (1) had transferred all of their assets and liabilities; (2) had asserted they had no tax motive for the transfer; and (3) had maintained their operation and timing of

\textsuperscript{150}\textit{Id.} at 686.

\textsuperscript{151}\textit{Id.} Another important case, Central Cuba Sugar Co. v. Commissioner, 198 F.2d 214 (2d Cir. 1952), rev'g 16 T.C. 882 (1951), cert. denied, 344 U.S. 874 (1952), examined nearly identical facts. The taxpayers incorporated their operation and claimed a loss carryback of $250,000. Construing I.R.C. § 45 (the predecessor to § 482), the circuit court required the taxpayers to report the income generated upon sale of their sugar crop. The court found a distortion of income and held, irrespective of tax evasion considerations, that reallocation of the deductions was necessary to clearly reflect income on what was generally an "extremely profitable" operation. \textit{See generally Brittner & Eustice, supra} note 25, ¶ 3.17 at 3-65 to 3-70.

\textsuperscript{152}44 T.C. 233 (1965), aff'd per curiam \textit{sub nom.} Sugar Daddy, Inc. v. Commissioner, 386 F.2d 836 (9th Cir. 1967).

\textsuperscript{153}\textit{Id.} at 241.

\textsuperscript{154}\textit{Id.} at 241-42.

\textsuperscript{155}\textit{Id.} at 241. For another example of assignment of income see Parkhill v. United States, 385 F. Supp. 204 (N.D. Tex. 1974) (the court found that a farmer's gift of growing crops to his children and subsequent loan of crop proceeds from children to farmer amounted to a sham to avoid tax liability).
sale as it was prior to incorporation. 156

In another letter ruling addressing proper allocation of crop expenses, 157 the Service held the assignment of income doctrine and section 482 inapplicable to a farm incorporation, but for slightly different reasons. The letter ruling stated there was no suggestion that a contract to sell the crop existed prior to incorporation. Thus, the Service found both the assignment of income and section 482 principles inapplicable. Additionally, the Service found that the corporation constituted a continuation of the same business conducted in essentially the same manner as it was prior to incorporation. Allocation of income back to the taxpayer would not reflect this continuity. Rather, allocation back to the transferor would result in treating the corporation as a completely different business. 158

Thus in most instances the Service will not use assignment of income or section 482 to reallocate income and deductions in a farmer's incorporation. The exception to this general rule arises when a farmer receives a windfall such as the significant loss deductions claimed in Rooney v. United States. 159

Farmers often use the cash method of accounting; 160 formerly this resulted in a skewed adjusted basis to liability ratio in the corporation. When a cash method rancher transferred accounts receivable and accounts payable to a corporation, the receivables had a zero basis, but the payables were liabilities assumed by the corporation and treated as boot. 161 Thus, the Code forced the farmer to recognize gain to the extent the liabilities exceeded the adjusted basis. 162 After several courts wrestled with this problem, 163 Con-

157. LTR 7935005 May 18, 1979. See also LTR 7942094 May 14, 1979.
158. See also Fanning v. United States, 568 F. Supp. 823 (E.D. Wash. 1983). The court found that the Commissioner abused his discretion under § 482 by reallocating $18,114 of expenses to the corporation when the taxpayer did not claim a net operating loss, the farm was operated in the same manner as before incorporation, and the taxpayer was not motivated by tax considerations. In its holding the court recognized LTR 7942094, May 14, 1979; LTR 8105025, Oct. 28, 1980; and LTR 7924003 Feb. 26, 1979. Id. at 824. Accord LTR 8303025 Oct. 15, 1982. Another similar Letter Ruling held that items that would have been income or deductions in the hands of the transferor, but for the incorporation, are properly charged to the corporation. LTR 7935005 May 18, 1979. See also LTR 7942094 May 14, 1979.

159. 305 F.2d 681.
160. I.R.C. §§ 447, 446; Treas. Reg. §§ 1.471-6(a), 1.446-1(a), 1.61-4(a).
162. See supra text accompanying notes 121-123.
gress enacted section 357(c)(3). This Code provision excludes from "property" liabilities which will give rise to a deduction when paid. Now the deductible accounts payable assumed by the corporation will not result in a tax to the transferor.\(^{164}\)

The Commissioner probably will not apply assignment of income or anticipation of income doctrines to reallocate income if "there is a valid business purpose for transferring the receivable to the corporation; and the amount of the receivables and liabilities transferred to the corporation are a product of normal business activity as contrasted to pre-incorporation manipulation by the transferor."\(^{165}\)

V. Conclusion

Internal Revenue Code section 351 allows taxpayers to incorporate without recognizing gain or loss on the change in business form. As more farmers and ranchers choose to incorporate, Montana attorneys must be aware of section 351's requirements and implications for farm incorporations. In most instances a farm incorporation is similar to any other incorporation. Section 351 allows a farmer to exchange the same wide variety of property as in any other incorporation; the 80% control requirement and the allowable stocks and securities are no different in a farm incorporation than in any other incorporation. The gain and basis calculations required are also similar to other incorporations.

Farmers and ranchers, however, face concerns that are not found in other types of incorporations. For instance, nearly all farm incorporations will be mid-stream changes. This requires the practitioner to use caution to avoid recapture of depreciation and ITC. Farm incorporations may also involve special arrangements, such as retaining land in personal ownership, to effect some estate planning or business planning goals. Additionally, the practitioner must allocate expenses and income from growing crops and livestock. These special concerns should not prevent a qualified general practitioner from accepting farm and ranch incorporations. Attorneys, however, should realize the hazards before assisting a client with a farm incorporation.

164. I.R.C. § 357(c)(3).