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Tax Problems Associated With the Incorporation of a Partnership: Revenue Ruling 70-239

*H. Peter Olsen**

I. Introduction

Revenue Ruling 70-239[1] announced the Internal Revenue Service's position that upon the "midstream" incorporation of an ongoing partnership business, the partnership is viewed as the transferor of partnership assets regardless of the actual form of the incorporation. The Ruling considers three different state-law methods of accomplishing the incorporation of a partnership. In the first form described in the Ruling, the partnership transfers its assets and liabilities to the newly created corporation and receives in exchange all of the stock of the corporation. The partnership then distributes to each partner his proportionate share of the stock, and the partnership terminates. In the second method of incorporation, assets are transferred indirectly. That is, the partners first terminate the partnership, each partner receiving his proportionate share of the assets and liabilities of the business. Each partner then exchanges his share of those assets and liabilities for his proportionate share of the stock of the new corporation. Lastly, in the third method of incorporation considered by the Ruling, partnership *interests* are exchanged for the stock of the corporation. Each partner transfers his interest in the partnership business to the new corporation, and, in exchange, each receives his proportionate share of the outstanding stock. The termination of the partnership results from these exchanges, and the business resumes in corporate form. The Ruling concludes, in pertinent part:

> Since the Federal income tax consequences of the plan are the same whether the transfer of assets is made by the partnership, whether the partnership is terminated and the assets are transferred by the partners, or whether the partners transfer their partnership interests to the corporation followed by a termination of the partnership, *it is held that each of the situations described above is regarded as a transfer under section 351 of the Code by . . . [the partnership] of all of its assets subject to its liabilities to . . . [the corporation] in exchange for all the outstanding stock of the . . . corporation.* The subsequent distribution of the stock to the partners in proportion to their

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1. Rev. Rul. 70-239, 1970-1 Cum. Bull. 74.

> partnership interests will not violate the control requirements of section 368(c) of the Code. The basis of the property acquired by each corporation will be the same as its basis in the hands of the transferor partnership. Section 362(a) of the Code. The basis of the stock received by a partner will be an amount equal to the adjusted basis of his partnership interest. Section 732(b) of the Code.[2]

The publication of Revenue Ruling 70-239 creates concern with respect to the possible impact of the very broad language of the Ruling in areas not specifically covered. This concern relates to the availability of an ordinary loss deduction under section 1244;[3] various personal holding company[4] and "subchapter S"[5] problems; the impact on section 357(c)[6] and section 1239;[7] the effect on basis computations[8] and the control requirement of section 351;[9] and holding period considerations under section 1223.[10] This article will attempt to examine Revenue Ruling 70-239 with a view to (1) evaluating the accuracy of the conclusion that all three corporation alternatives produce the same tax consequences; (2) determining the scope of the Ruling, potential as well as actual; and (3) determining its contribution to the development of the "control" concept in incorporation transactions.

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2. *Id.* (emphasis added)

3. INT. REV. CODE OF 1954, § 1244. Section 1244 allows taxpayers limited ordinary loss treatment on the sale of qualifying § 1244 common stock. The qualifying requirements include (1) size limitations on the issuing corporation, (2) a $500,000 limitation on the amount of the § 1244 issue, (3) a requirement that the issuer be an operating company, and (4) a mandatory plan for the issuance of the shares. The § 1244 issue must be common stock, and it may be issued only for money or other property. Ordinary loss treatment under § 1244 is available only to individual taxpayers who are the original transferees of the stock, and the amount of ordinary loss treatment available to an individual in any one year is limited to $25,000. *See generally* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 4.11 (1971) [hereinafter cited as BITTKER & EUSTICE].

4. INT. REV. CODE OF 1954, §§ 541-47. *See* note 42 *infra* and accompanying text.

5. INT. REV. CODE OF 1954, §§ 1371-79. *See generally* BITTKER & EUSTICE ¶¶ 6.01-.04.

6. INT. REV. CODE OF 1954, § 357(c). Section 357(c) provides an exception to the general rule of § 357(a) that a corporation's assumption of liabilities in the incorporation transaction does not constitute "boot" property to the transferor taxpayer. Section 357(c) dictates that where the aggregate liability assumed or taken subject to exceeds the aggregate adjusted basis of the property transferred to the corporation, that excess must be recognized as "boot." Section 357(c) is applied on a person-by-person basis, despite the ambiguity of the section and regulations on this point. *See* Rev. Rul. 66-142, 1966-2 CUM. BULL. 66.

7. INT. REV. CODE OF 1954, § 1239. *See* note 26 *infra* and accompanying text.

8. *See* notes 30-34 *infra* and accompanying text.

9. INT. REV. CODE OF 1954, § 351. Section 351 is the basic non-recognition provision applicable to incorporation transfers between an individual taxpayer and a corporation that, immediately following the transfer, is "controlled" by the taxpayer within the meaning of § 368(c). Section 368(c) defines "control" for § 351 purposes as ownership of 80% of tbe voting power and 80% of each class of stock immediately after the transfer. *See generally* BITTKER & EUSTICE ¶¶ 3.01-.10.

10. INT. REV. CODE OF 1954, § 1223. *See* notes 38-40 *infra* and accompanying text.

II. The Scope of Revenue Ruling 70-239

A. *In General.*—One apparent objective of the publication of Revenue Ruling 70-239 was to confirm that the "control" requirement for nonrecognition of gain under section 351 was satisfied in each of the described transactions.[11] Previously, it could have been concluded that there was a section 351 control question where, as in the first method of "midstream" incorporation described by the Ruling, the transfer of assets by the partnership to the corporation in exchange for stock is followed by the distribution of the stock by the partnership to the partners in liquidation. It would appear that the Ruling eliminates any question of the effect of the liquidation of the partnership following the incorporation and, thus, should be of aid in planning incorporation transactions. A problem is created, however, because the ruling neither delimits its scope nor suggests an accurate evaluation of the Service's rationale for its position.

B. *Effect on Section 1244.*—It would appear that the ordinary loss deduction under section 1244[12] upon the worthlessness of stock of the transferee-corporation is threatened by the Ruling. If the analysis described in the Ruling is considered applicable in testing the application of section 1244, ordinary loss treatment will be severely restricted.

The legislative history of section 1244 and the regulations promulgated thereunder explicitly state that stock issued to a partnership pursuant to a section 1244 plan will generate an ordinary loss deduction only if the stock is owned, and retained, by the partnership.[13] Therefore, any losses from section 1244 stock will be passed through to the partners who were partners at the time the partnership acquired the stock.[14]

Since to qualify for the ordinary loss treatment the qualifying stock must be held by the individual or partnership to whom issued, however, loss on the stock issued to the partnership and distributed to a partner before the loss was sustained would not qualify.[15] More-

11. Under § 351 one of the requirements for securing nonrecognition of gain treatment upon an incorporation is that the transferors be in control (as defined in § 368(c)) of the corporation "immediately after the exchange." American Bantam Car Co., 11 T.C. 397 (1948), *aff'd per curiam*, 177 F.2d 513 (3d Cir. 1949), *cert. denied*, 339 U.S. 920 (1950). *See* note 9 *supra*. *See generally* Bittker & Eustice ¶ 3.10.

12. Under § 1244 an individual's loss on "section 1244 stock" instead of being treated as a capital loss, may be deducted from ordinary income to a limited extent. *See* note 3 *supra*.

13. Treas. Reg. § 1.1244(a)-1(b); Conf. Rep. No. 2632, 104 Cong. Rec. 17807, 17819 (1958) (reprinted at 1958-3 Cum. Bull. 1188, 1230).

14. Int. Rev. Code of 1954, § 702.

15. Jerome Prizant, 30 CCH Tax Ct. Mem. 817, 821-22 (1971); Treas. Reg. § 1.1244(a)-1(b) & (c), example (2); Conf. Rep. No. 2632, 104 Cong. Rec. 17807, 17819 (1958) (reprinted at 1958-3 Cum. Bull. 1188, 1230).

over, it is clear that issuance of the stock directly to the partners would not avoid the above limitation, because the partners would not have been issued stock in exchange for money or other property transferred by them to the corporation.[16]

If Revenue Ruling 70-239 dictates the characterization of the incorporation for purposes of section 1244, it then would be necessary to keep the partnership in existence following the incorporation in order to hold the shares of stock issued by the corporation in the exchange. If shares are erroneously issued directly in the names of the partners and this issuance is viewed as a transfer of the beneficial ownership of the shares by the partnership to the partners, section 1244 treatment will be lost notwithstanding the continued existence of the partnership. It would appear, then, that the Service's position as expressed in the Ruling is unduly broad as applied to the section 1244 problem. Whether the Service will apply the analysis of Revenue Ruling 70-239 in a manner that stringently limits the availability of section 1244 remains to be determined.

C. *Effect on the "Subchapter S" Election.*—The problem presented by Revenue Ruling 70-239 involving subchapter S relates to the effect of the Ruling's single characterization of several possible incorporation transactions on the *timing* of the subchapter S election.[17] Since the existence of a partnership-shareholder will invalidate the election[18] and since Treasury Regulation 1.1371-1(d)(1) specifies that the partnership, and not the partners, is deemed to be the shareholder of stock owned by the partnership, it is important that beneficial as well as record ownership of the stock pass to the partners *prior* to the expiration of the deadlines for making the subchapter S election.

If the sole characterization of the three incorporation transactions described in the Ruling is applied to subchapter S, a very real trap is created when stock is initially issued in the names of the partners in exchange for their partnership interests. Under Revenue Ruling 70-239, the stock may be viewed as having been beneficially owned by the transferor partnership at the time of the subchapter S election, thereby invalidating the election.[19] It is not clear what action short of liquidation and dissolution of the partnership would

16. Treas. Reg. § 1.1244(c)-1(f)(1) & (2), example (iii).

17. Subchapter S of the Internal Revenue Code (§§ 1371-79) allows businesses to select their legal entity free of undue tax influence, aiding small husinesses by taxing the corporation's income to shareholders who may be in lower brackets than their corporations, and permitting the shareholders of corporations that are suffering losses to offset the losses against individual income from other sources. INT. REV. CODE OF 1954, §§ 1371-79.

18. Treas. Reg. § 1.1371-1(e) (1959).

19. Morris Kates, 27 CCH TAX CT. MEM. 1423 (1968).

assure the transfer of beneficial ownership of the stock to the partners. What is apparent is that mere issuance of the shares in the names of the partners may not suffice.[20]

Where the transferee corporation is newly created, the subchapter S problem can be avoided by assuring that the partnership is liquidated and all of its assets distributed to the partners prior to filing a timely subchapter S election. In the case of a pre-existing subchapter S transferee corporation, however, the threat to the election by a partnership's transfer of its assets to the corporation in a section 351 exchange is more troublesome if the characterization described in Revenue Ruling 70-239 applies since the momentary ownership of the stock of the corporation by the partnership might destroy the election.[21] Again, it would appear to be an open question and as with the section 1244 problem discussed above, Revenue Ruling 70-239 should be clarified with respect to this point.

D. *Effect on Section 357(c).*—The rigid characterization imposed by Revenue Ruling 70-239 may affect the *partners'* ability to eliminate the operation of section 357(c)[22] in the event the partnership's liabilities exceed the adjusted basis of its assets. Assume that general partnership *A* with equal partners *X* and *Y* has liabilities of 100,000 dollars and assets with an adjusted basis of 90,000 dollars. If the partnership transfers its assets to a corporation in a section 351 transaction in exchange for stock and assumption of its liabilities, the partnership will recognize 10,000 dollars gain by reason of section 357(c).

In addition to their general partnership *A*, assume that *X* and *Y* are also equal partners in general partnership *B*, which has liabilities of 10,000 dollars and property with an adjusted basis of 50,000 dollars. If the assets of both partnerships *A* and *B* were transferred to the same corporation in a section 351 transaction in exchange for

20. There is one case, however, in which the Commissioner did not assert a position that the partnership was the beneficial owner of the stock where the stock was issued directly to the partners following the transfer hy the partnership of its assets to the corporation. James L. Stinnett, Jr., 54 T.C. 221 (1970). *See also* Ray Guzowski, 26 CCH TAX CT. MEM. 666, 668 (1967).

21. INT. REV. CODE OF 1954, § 1372(e)(3). Note, however, Rev. Rul. 72-320, 1972-1 CUM. BULL. 270 and Rev. Rul. 73-496, 1973 INT. REV. BULL. No. 1973-46, at 17. These rulings would appear to allow a 30-day grace period within which to take any necessary corrective action. In effect, ownership of the stock of the corporation by the partnership, if disposed of within 30 days, would not invalidate the election of a pre-existing subchapter S transferee corporation. If this rationale is carried over to Rev. Rul. 70-239, the difficulty would be avoided in most instances.

22. Under § 357(c), if the liabilities encumbering the transferred property or assumed by the transferee corporation exceed the aggregate adjusted basis of the properties transferred, in a § 351 transfer, the excess is considered as a gain from the sale or exchange of such property. *See* note 6 *supra*.

stock and an assumption of their liabilities, partnership *A* would still recognize 10,000 dollars of gain by reason of section 357(c). This gain would be recognized because, where there are two or more transferors, section 357(c) is applied on an individual transferor basis rather than aggregating all property and liabilities transferred.[23]

On the other hand, if the assets of both partnerships *A* and *B* were first transferred to the partners in liquidation of the partnerships, each partner remaining personally liable on both partnerships' liabilities, *X* and *Y* would each then own a share of the former partnership's assets with basis of 70,000 dollars. Both *X* and *Y* would each incur 55,000 dollars in the former partnership's liabilities. If *X* and *Y* then transferred the former partnership's assets to the corporation in a section 351 transaction in exchange for stock and the assumption of their liabilities, section 357(c) gain would not be recognized since, as a result of *X*'s or *Y*'s transfer, the corporation would not have assumed or taken property subject to liabilities in excess of the adjusted basis of the assets of the former partnerships.

Now assume that general partnership *C* has 100,000 dollars in liabilities and assets with an adjusted basis of 90,000 dollars. *X* and *Y* are equal partners in *C*, but because *X* purchased his partnership interest from a former partner, and no section 743 election[24] was made at the time, *X* has a cost basis of 50,000 dollars in his partnership interest. If partnership *C* were to transfer its assets subject to its liabilities to a corporation in a section 351 exchange, it would recognize 10,000 dollars gain pursuant to section 357(c). However, should partnership *C* choose to liquidate first, *X* would have a basis of 50,000 dollars in his share of the former partnership assets. *Y* would have a basis of 45,000 dollars in his share of such assets. Both *X* and *Y* would each have liabilities of 50,000 dollars. Upon the subsequent transfer of the former partnership assets to a corporation in a section 351 transaction in exchange for stock and the assumption of their liabilities, only *Y* would incur section 357(c) gain, and this in the amount of 5,000 dollars.

Because Revenue Ruling 70-239 treats all transfers as having been made by the partnership, the Ruling raises the question whether partners will be able to cure a potential section 357(c) problem by liquidating one or more partnerships prior to incorporation. Nor is it clear that the problem could be solved by having the

23. Rev. Rul. 66-142, 1966-1 CUM. BULL. 66.

24. INT. REV. CODE OF 1954, § 743. Section 743 provides an optional adjustment to the basis of partnership property upon the transfer of a partnership interest by sale or exchange upon the death of a partner, where an election under § 754 is in effect.

partners contribute cash or other property to their partnership prior to incorporation in order to make up the difference between the liabilities and adjusted basis of the other partnership assets. It is possible that a transfer of capital to the partnership by the partners immediately before the incorporation would be viewed by the Service as a contribution by the partners directly to the corporation, rather than as a transfer to the partnership occurring prior to and independent of the incorporation.[25] In this event, section 357(c) gain would still be recognized to the partnership (and ultimately, therefore, to the partners) by reason of the assumption of the partnership liabilities in an amount exceeding the basis of the transferred partnership assets.

E. *Potential Limitation on the Applicability of Section 1239.* —Section 1239 provides that gain recognized on the sale or exchange of depreciable property between an *individual* and a corporation more than eighty percent of the value of the stock of which is owned by the individual shall constitute ordinary income.[26] The Commissioner has been successful in applying section 1239 to gain recognized under Code sections 357(b) and (c) in an incorporation transaction.[27]

By characterizing all partnership incorporation transactions as entity-level exchanges, Revenue Ruling 70-239 may restrict significantly the applicability of section 1239 to "boot" or section 357(c) gain recognized in the exchange. While the Service has taken the position that a transfer from one controlled corporation to another would trigger ordinary income to the common shareholder under section 1239,[28] this position has been rejected by the Tax Court.[29] Accordingly, by using Revenue Ruling 70-239 to treat a partnership as the transferor in a case where the actual transferors are the former partners of the liquidated partnership, taxpayers may escape section 1239 or boot consequences that clearly would be present if the transaction were analyzed in accordance with its actual form.

F. *Effect on Basis Computations.*—From a purely technical viewpoint, the major flaw in Revenue Ruling 70-239 becomes apparent when one considers the basis computations under varying forms of the incorporation transaction. As indicated, the Ruling states that the federal income tax consequences of the three described

25. Rev. Rul. 73-16, 1973-1 CUM. BULL. 186.
26. INT. REV. CODE OF 1954, § 1239.
27. Velma W. Alderman, 55 T.C. 662 (1971); Rev. Rul. 60-302, 1960-2 CUM. BULL. 223.
28. Rev. Rul. 69-109, 1969-1 CUM. BULL. 202.
29. 10-42 Corp., 55 T.C. 593 (1971); note, however, Rev. Rul. 72-172, 1972-1 CUM. BULL. 265.

transactions are the same. This conclusion is inaccurate, as the following example will demonstrate.

Partnership A is capitalized with 50,000 dollars, which amount is contributed equally by partners *X* and *Y* who share profits and losses equally. The partnership purchases investment property costing 50,000 dollars that appreciates over the years to 100,000 dollars. *Y* sells his interest to *Z* for 50,000 dollars. No section 743(b) election is in effect.[30] *X* and *Z* agree to incorporate the partnership's property by first liquidating the partnership and then transferring the appreciated property to the corporation.

If the analysis of the incorporation transaction articulated in Revenue Ruling 70-239 is correct, then regardless of the form the incorporation transaction takes, the partnership's 50,000-dollar basis in the property will carry over to the corporation.[31] On the other hand, if the actual liquidation of *A*, distribution of the partnership's property to *X* and *Z*, and transfer of the property by *X* and *Z* to the corporation are recognized for tax purposes, the aggregate basis of the property in the partners' hands following the liquidation of the partnership[32] will be 75,000 dollars (25,000 dollars for *X* and 50,000 dollars for *Z*). Following the transfer of the property to the corporation in a section 351 exchange, the 75,000-dollar basis of the property carries over to the corporation.[33] Thus, the corporation has property with a basis 25,000 dollars higher than it would have had if Revenue Ruling 70-239 were applicable.[34]

The purpose of the example is to illustrate that the federal income tax consequences of at least two variations of the incorporation transaction are not the same. It would appear by reason of this difference in result that delineation of the scope of the Ruling would be proper.

G. *Effect on the Control Requirement of Section 351.*—The mandatory characterization of Revenue Ruling 70-239 may affect the partners' ability to transfer the assets of a partnership in a nonrecognition exchange under section 351[35] to an operating corporation owned by them.

In the event the partners desire to incorporate their business by a transfer of its assets to their existing wholly-owned corporation that has been actively engaged in the conduct of a business, the

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30. *See* note 24 *supra*.

31. INT. REV. CODE OF 1954, § 362(a)(1).

32. *Id.* § 732(b).

33. *Id.* § 362(a)(1).

34. J. PENNELL & J. O'BYRNE, FEDERAL INCOME TAXATION OF PARTNERS AND PARTNERSHIPS, 310-17 (2d ed. 1971).

35. *See* notes 9 & 11 *supra*.

apparent rulings policy of the Service has been to apply the control requirement of section 351 at the partnership level. If this approach were sustained, section 351 would be inapplicable unless the transferred partnership property was sufficiently valuable in relation to the pre-existing corporate assets so that eighty percent of the stock of the corporation was owned by the partnership immediately after the transfer. On the other hand, if the partner-shareholders transferred their partnership interest to the corporation in exchange for additional stock, the control requirement of section 351 would unquestionably be satisfied since the partner-shareholders would own one hundred percent of the stock immediately after the transfer. Here again the mandate of Revenue Ruling 70-239 could seriously impede sound tax planning and impose a tax in what clearly ought to be a tax-free transaction.

The application of the "control" test in the case of multi-step incorporation transactions has received the continued attention of the courts, the Commissioner, and tax practitioners for a number of years. Revenue Ruling 70-239 may constitute a significant statement of the Commissioner's position in this regard, but the Ruling contains no explanation of his rationale. In the absence of such an explanation, it is difficult to ascertain whether the control requirement is satisfied because the partners are treated as the true beneficial owners of the stock from the outset, or because momentary ownership of the stock by the partnership prior to its liquidation is disregarded, or because the stock is considered as having been owned by the partnership for a sufficient period so that the partnership satisfies the eighty percent control test notwithstanding the subsequent distribution of the stock to the partners.[36] In *Jerome Prizant*,[37] the Tax Court conceded that partners intended to hold stock of the corporation issued directly to them as individuals rather than as an asset of the partnership but refused to recognize the incorporation of the business of the partnership as a termination of the entity and a distribution of the beneficial ownership of its assets without further action by the partnership. Thus, *Prizant*, although not involving a question of control, might suggest a view that the ownership of the stock by the partnership, for whatever amount of time, cannot be disregarded in applying the "control" test of section 351.

Regardless of the form utilized, the section 351 control requirement should be considered satisfied in any case where the partners

36. INT. REV. CODE OF 1954, § 351(c).
37. 30 CCH TAX CT. MEM. 817 (1971).

have the requisite eighty percent stock interest in the corporation following completion of the entire transaction.

H. *Effect on the Holding Period of Stock Received by the Partners.*—The partners' holding period with respect to stock received in the incorporation may vary depending upon the form of the incorporation transaction. Applying Revenue Ruling 70-239, the partnership's holding period for the stock of the transferee-corporation will be the same as that of the assets transferred, provided such assets are capital assets or section 1231 assets.[38] Upon liquidation of the partnership, the partners will take the partnership's holding period for the stock.[39] If, on the other hand, the partners transfer their partnership interest to the corporation in exchange for stock, and such form is given effect, the stock will take the same holding period as did the partnership interests.[40] This difference in determining holding period is further evidence of inconsistencies in the statement of Revenue Ruling 70-239 that the federal income tax consequences of the three forms of incorporation are the same.

I. *Personal Holding Company Problems.*—Sections 541 through 547 of the Internal Revenue Code[41] operate to tax at a seventy percent rate[42] the undistributed "personal holding company income" of certain corporations. The general rules for determining which corporations may be subject to the extraordinary tax are, first, that ". . . [a]t least 60 percent of [the corporation's] adjusted ordinary gross income . . . for the taxable year is personal holding company income . . . , and . . .",[43] secondly, that "[a]t *any* time during the last half of the taxable year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals [or certain specified "organizations" or trusts]."[44]

The statutory definition of personal holding company income[45] includes two items of particular importance to the newly incorporated partnership enterprise: payments received by the corporation for the use of corporate property where any twenty-five percent shareholder is among those entitled to use that property,[46] and

38. INT. REV. CODE OF 1954, § 1223(1).

39. *Id.* § 735(b).

40. *Id.* § 1223(1); Thornley v. Commissioner, 147 F.2d 416 (3d Cir. 1945); Rev. Rul. 55-68, 1955-1 CUM. BULL. 372.

41. INT. REV. CODE OF 1954, §§ 541-47.

42. *See id.* § 541.

43. *Id.* §542(a)1.

44. *Id.* § 542(a)2 (emphasis added).

45. *Id.* § 543.

46. *Id.* § 543(a)6. This section operates only where the corporation has *other* personal holding company income in excess of 10% of its ordinary gross income.

amounts received under personal service contracts where (1) either the contract itself names the individual who is to perform the services or someone other than the company is empowered to make that designation[47] and (2) the individual who performs the services is a twenty-five percent shareholder at some time during the taxable year.[48]

The difficulty posed by Revenue Ruling 70-239, then, is that its mandatory characterization of the incorporation may operate to cause some shareholders of the newly created corporation to become twenty-five percent shareholders, thereby turning otherwise "innocent" rental payments and personal services receipts into personal holding company income. This danger is amplified by the attribution rules of section 544(a) that characterize *each* partner as the constructive owner of all partnership-owned stock.[49] The Commissioner might argue, for example, that the personal services contract receipts of a newly incorporated eight-man equal partnership are subject to the seventy percent rate in the first year of its corporate existence, since the Ruling and the attribution rules can be viewed as having created *eight* one hundred percent shareholders for a period, however brief, during that year,[50] a clearly unwarranted result.

III. Correctness of the Mandatory Characterization Imposed by Revenue Ruling 70-239

If variations in tax consequences, whether justified or not, are possible depending upon the form of the transaction, we must then ask whether the Service is correct in viewing all three forms of the incorporation of the business of a partnership in the same manner for federal income tax purposes. It is suggested that the mandatory characterization imposed by Revenue Ruling 70-239 will not be accepted by the courts, particularly if the characterization serves to restrict the availability of section 1244 and subchapter S or if it precludes variations in basis or holding period computations.

In *Miller Bros. Electric, Inc.*,[51] assets of a partnership were transferred to a corporation, and the stock of the transferee was issued directly to the partners. The corporation sought to avoid the application of section 351 and thereby obtain a stepped-up basis in

47. Int. Rev. Code of 1954, § 543(a)7(a).

48. *Id.* § 543(a)7.

49. *Id.* § 544(a). Since §§ 543(a)(6) and (7) require 25% stock ownership only at *any* or *some* time during the taxable year, even transitory ownership gives rise to this problem.

50. *See* Rosen, *New Partnership Incorporation Ruling May Create Unforeseen Problems in Many Areas*, 33 J. Taxation 329 (1970).

51. 49 T.C. 446 (1968).

the assets of the partnership on the theory that the partners were not in control of the corporation following the exchange. The argument was based on an interpretation of the California community property laws that classified stock acquired with community funds as community property but excluded a partner's interest in the specific assets of the partnership from such classification. The corporation maintained that since the partners' spouses had no interest in the specific partnership property but did acquire an interest in the stock of the transferee, the transferor-partners did not possess the requisite control of the corporation immediately after the exchange.

The Tax Court in *Miller Bros.* rejected the corporation's attack on the "control" requirement by concluding that under California law the spouses were a part of the transferor group at the time of the transfer of the partnership assets to the corporation. Alternatively, the court concluded that if the exchange were viewed as between the partners (excluding their spouses) and the corporation, the transaction must be characterized as a transfer of assets by the partnership to the corporation, the constructive receipt by the partnership of the stock, and distribution by the partnership of the stock to the partners. In this last step, the spouses' community property interest would attach. The court stated:

> As a matter of law, we do not see how partners could transfer partnership property to a corporation in exchange for stock issued to them as individuals without either (1) a conversion of the partnership property to individual property immediately prior to transfer to the corporation, or (2) actual or constructive receipt by the partnership of the stock prior to its distribution to the individuals. In either case, the control requirements of section 351 would be met. The fact that the partnership as such never had physical possession of the stock is irrelevant for the purposes of section 351.[52]

The *Miller Bros.* decision is helpful in evaluating the propriety of the Service's single characterization of the three forms of incorporation transaction described in Revenue Ruling 70-239. The decision evidences the Tax Court's flexibility in viewing the exchange and suggests that if an incorporation transaction *actually* takes one of the two forms that are disregarded by the Ruling, the Commissioner will find it difficult to persuade a court to impose his mandatory characterization. Although this article does not relate directly to the possible problems of utilizing one of the two forms of incorporation transactions disregarded by Revenue Ruling 70-239, it is important to note that an attempted liquidation of a partnership which is actively engaged in business in order to employ a characterization

52. *Id.* at 451-52.

different from that imposed by the Ruling may not be recognized as a true liquidation of the partnership.[53]

IV. Conclusion

It is submitted that Revenue Ruling 70-239 is lacking in several respects:

1. The potential impact of the Ruling extends far beyond the subject matter specifically discussed therein. Although it is possible that the effects of the Ruling on section 1244 and subchapter S were unintentional, those effects should be rectified by a clarification of the Ruling.
2. The statement in the Ruling that the tax consequences of the three incorporation alternatives are the same appears to be inaccurate.
3. The Ruling poses several unanswered questions regarding the application of the control requirement of section 351.

Granting that a given result at the end of a straight line is not made different because reached by a crooked line, it must be recognized that no one of the three forms of partnership incorporation transactions described in Revenue Ruling 70-239 is "straighter" than any other. Accomplishment of the result in each instance requires two steps, the ultimate transfer of assets to the corporation and the ultimate receipt of stock of the transferee-corporation by the partners. Only the order of the steps is varied.

In these circumstances, unless progress along one route is belatedly halted and redirected, reconstruction of the two-part transaction to pivot it on a different point does not reach the "substance," for one form is no less real and no more direct than any other. This application of the step transaction doctrine twists two actual transactions into two transactions which never in fact occurred.

For the above reasons, a reconsideration of Revenue Ruling 70-239 is in order with the view to an amplification and possible modification of the Ruling. Taxpayers, tax practitioners, and Internal Revenue Service personnel would benefit from a statement of the Service's position with respect to questions raised by the Ruling. As previously stated, the section 351 control requirement should be satisfied in any case where the partners own eighty percent of the corporate stock following completion of all steps forming part of the overall plan. Most of the other problems discussed could best be

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53. Kinney v. United States, 228 F. Supp. 656 (W.D. La. 1964), *aff'd per curiam*, 358 F.2d 783 (5th Cir. 1966).

eliminated by permitting taxpayers to adopt whatever form they choose to accomplish the desired end result, and then determining all tax consequences on the basis of the form utilized.