The Contemporary Tax Journal

Volume 6
Issue 1 *The Contemporary Tax Journal Volume 6, No. 1 – Summer/Fall 2016*

Article 6

9-19-2016

When is a Transfer of Assets to a Controlled Corporation by Related Parties a Sale or Contribution of Capital?

Ophelia Ding
San Jose State University

When is a Transfer of Assets to a Controlled Corporation by Related Parties a Sale or Contribution of Capital?

By: Ophelia Ding, *MST Student*

Substance Over Form

Tax consequences are often determined by the substance of the transactions, not the form. Courts and the IRS view a transaction that is lacking in substance or business purpose as a potential shield for tax evasion. The earliest interpretation of the substance over form tax doctrine traces back to a 1924 Supreme Court case, in which the Court clearly stated that it is more important to examine "what was actually done, rather than the declared purpose of the participants."[1]

Another landmark and often-cited Supreme Court case, further introduced the doctrine of substance over form.[2] The IRS assessed that the taxpayer understated her tax liabilities by creating transactions that were lacking any real substance. In this case the taxpayer created a new corporation to transfer the shares she owned of a different company into this new company. The taxpayer then immediately dissolved the new company and distributed the shares to herself which were subsequently reported as a net capital gain. The taxpayer asserted that the transactions between the corporations and herself should be respected as a corporate reorganization with the resulting capital gain treatment. However, the IRS contended that there was no economic substance in the purported business reorganization, with the new company being formed merely for the purpose of transferring shares to the taxpayer without any other business purpose or function, except to have the transfer of stock to the newly-formed corporation avoid ordinary income treatment to the taxpayer.

The *Gregory* case manifested the substance over form doctrine by stating that transactions need a business purpose to be considered as having economic substance. It is crucial to examine the motivations behind the transactions to ensure they did not just serve the purpose of lowering the taxpayer's tax liabilities. Although over 80 years have lapsed since the ruling, the doctrine still applies today. This was demonstrated recently in a tax court case which reinforced that transactions without a real business purpose at arm's length are not considered to have economic substance, and taxes will be assessed accordingly.[3]

As we might remember, many properties went "under water" during the years of the Great Recession of the late 2000s (where the fair market value of the properties were lower than the amount owed to the lenders). As a result, many lenders acquired properties at foreclosure from these "under water" borrowers. These are known as Real Estate Owned (REO) properties. Many lenders used third-party brokers to assist in the repossessing of the properties and preparation of the properties for resale. The brokers then entered into agreement with the lenders to sell the properties.

[1] *Weiss v. Stearn*, 265 U.S. 242 (1924).
[2] *Gregory v. Helvering*, 14 AFTR 1191 (USSC, 1935).
[3] *J.M. Bell, et ux. v. Commissioner*, TC Memo 2015-111.

In the *J.M. Bell case* the taxpayers were Mr. Bell, a licensed real estate broker and his wife, Mrs. Bell, who was a licensed real estate agent and appraiser. Mr. Bell was mainly operating his real estate business through his sole proprietorship (Michael Bell & Associates, dba Realty World MBA ("MBA")) prior to 2008. However, with the increase of his REO business, he decided to incorporate his sole proprietorship business ("MBA") in September of 2008. After the minutes of the new corporation (MBA Real Estate, Inc. ("MBA Inc.")) were signed to appoint Mr. Bell and Mrs. Bell as President/Treasurer and Vice President/Secretary, respectively, of the new corporation the board of directors authorized MBA Inc. to purchase the assets of MBA.

The agreement MBA Inc. entered into with the taxpayers was to purchase all tangible and intangible assets of the sole proprietorship for a total purchase price of $225,000. Without any appraisal, the taxpayer allocated $25,000 of the purchase price to a franchise license agreement the taxpayer had with Realty World Northern California and the remaining $200,000 evenly to the 40 contracts between the taxpayer and the existing clients of MBA to sell REO properties. Of the 40 contracts, 39 had no certainty of income.

Under the agreement, MBA Inc. would pay the taxpayer the purchase price through monthly installments of $10,000 or more, and each unpaid installment amount would be subject to 10% interest. There was no security for the purchase price, nor was there a promissory note. The taxpayer reported their earnings from the "installment sales" as long-term capital gains. The IRS sent a deficiency notice recharacterizing the entire gain from the sale as ordinary income instead.

The main issue before the court was whether the transfer of assets from MBA to the newly incorporated MBA Inc. was a sale or a capital contribution subject to §351 (transfer to corporation controlled by transferor). If the transfer was treated as a §351 capital contribution, then the monies paid by MBA Inc. to the taxpayer would be treated as dividend income by the taxpayer with no corresponding deduction for the corporation. On the other hand, if the transfer was treated (as it was on paper) as a sale, then capital gain would generally result for the taxpayer over a number of years until the installment method with no required carryover of the basis of the assets to the corporation. The taxpayer asserted that the form of the transaction (a sale) should be upheld by the court. The position of the IRS was that the entirety of the transactions fit the requirements of a §351 capital contribution.

The court noted that even though the transaction is a transfer between related parties, it does not automatically constitute as lacking of economic substance. The court referred to the 11 factors enumerated by the Ninth Circuit for determining whether the transfer should be considered a sale (debt) or a capital contribution (equity):

1. the names given to the certificates evidencing the indebtedness;
2. the presence or absence of a maturity date;
3. the source of the payments;
4. the right to enforce payment of principal and interest;
5. participation and management;
6. a status equal to or inferior to that of regular corporate creditors;
7. the intent of the parties;
8. "thin" or adequate capitalization;

9. identity of interest between creditor and stockholder;
10. payment of interest only out of "dividend" money; and
11. the ability of the corporation to obtain loans from outside lending institutions.[4]

As described in these factors, it is important to note that the court considers all the facts and circumstances of the case as a whole without singling out any factor as controlling.

Factors in Favor of the Taxpayer

Title of the Debt Instrument
The court considers the language of the instrument to determine if it is more like a typical promissory note or a stock certificate which in turn would determine if the transfer was a sale or a capital contribution. The agreement MBA Inc. entered with the Bells did not contain the language typical of a stock certificate but instead resembled a debt instrument.

Maturity Date
A capital contribution agreement generally does not come with a fixed maturity date as the payment is largely tied to the earnings of the business. The taxpayer's agreement with MBA Inc. had a fixed date for the latest repayment.

Intent of the Parties
This factor focuses solely on the objective evidence specifying the intent of the parties. Based on the evidence, the Bells intended to sell all of the sole proprietorship's assets of Mr. Bell. Additionally, the agreement they entered into is similar to a promissory note. This factor weighed in favor of a sale.

Factors in Favor of the IRS

Payment Source
The payment source determines if the transaction was a sale or capital contribution. The repayment of capital would usually depend on the earnings. Conversely, for a sale repayment would not be dependent upon the earnings of MBA Inc. Here, MBA Inc. had no means of repaying without income indicating that the payment source was the earnings of MBA Inc.

Right to Enforce Payments
There is usually an obligation of payment if the transaction was a sale. There was no security agreement in the repayment of the purchase price, Therefore, MBA Inc.'s obligation on repayment was not enforceable by the taxpayer. This resembles a stock instrument, which denies the stockholder's right to enforce payment.

"Thin" or Adequate Corporate Capitalization
Thin capitalization of the corporation indicates a capital contribution. MBA Inc. had no assets before the agreement, and its capitalization remained inadequate after the $500 cash contribution made by the Bells. This factor weighed in favor of a capital contribution. I**dentity of Interest**

[4] *Hardman v. U.S.*, 60 AFTR 2d 87-5651 (9th Cir. 1987).

A capital contribution will increase the shareholder's interest in the company. The taxpayer became MBA Inc.'s sole shareholders after the transfer, which evidenced a capital contribution.

Interest Paid Only with E&P

This criterion is similar to "Payment Source" described above. Even though the agreement did not indicate that payment would be made from the earnings, MBA was not able to pay the taxpayer if it did not have income. Therefore, the repayment shared the same characteristics of a dividend. This factor weighed in favor of a capital contribution.

Ability to Obtain Loans from Other Sources

If a corporation was able to borrow funds from other sources, it would be an indicator that the shareholder acted in the same manner as an outside creditor. With its "thin" capitalization and improbable source of income, it was highly unlikely MBA Inc. would be able to obtain any other funds from a third party that was at arm's length with the same terms and conditions. This factor weighed in favor of a capital contribution.

Neutral Factors

Participation and Management

Typically, a shareholder's percent of interest or voting rights would increase after a capital contribution. The taxpayers became MBA Inc.'s sole shareholders after the transfer, but the interest in the company and voting rights of the taxpayers did not increase as a result of the transfer.

Status in Relation to Other Corporate Creditors

Generally, equity participants are lower in the hierarchy of repayment in the event of a liquidation. There was no evidence indicating the Bells' right to repayment in relation to other creditors.

Although some of the above factors weighed in favor of a sale, when considering all 11 steps as a whole and utilizing the doctrine of substance over form, the court held that the transactions were part of an overall plan of a capital contribution rather than a sale.

The above case emphasizes that tax determinations look to the substance over form as they relate to the facts of a given case. On numerous occasions the courts have placed more weight on the motivations behind the economic transactions than the form of the transaction, especially in the event the form is used solely for tax reduction purposes. It is therefore incumbent on the tax preparer and taxpayer to be cognizant of this issue while they choose their strategies to minimize tax liabilities.