Tilden v. Commissioner, 1942 Tax Ct. Memo 402 (1942)

When property is transferred to a corporation in exchange for stock, and there are resulting trusts among the transferors, the determination of whether the stock was distributed substantially in proportion to the transferor's interest in the property is made after considering the effect of those trusts.

Summary

Tilden and his family transferred several tracts of land to a newly formed corporation in exchange for stock. The Commissioner argued that the transfer was tax-free under Section 112(b)(5) of the Revenue Act of 1936 because the stock distribution was proportional to the property contributed. Tilden argued that the land tracts conveyed were of unequal value, and thus the equal distribution of stock violated the proportionality requirement. The Tax Court held that the transfers were subject to resulting trusts to equalize the value of each family member's contribution, thereby meeting the proportionality requirements for a tax-free exchange.

Facts

L.W. Tilden owned several tracts of land. To refinance his indebtedness, he conveyed portions of this land to his wife and children via warranty deeds. These deeds, recorded at the time, purported to convey absolute title to specific properties. Ten applications were submitted to Land Bank with intention that properties would be farmed and operated by L.W. Tilden as one unit. In 1936, Tilden formed a corporation, and the family members transferred their land to the corporation in exchange for equal shares of stock. For the 1935 and 1936 tax years, L.W. Tilden and his wife filed joint income tax returns, on which results of the operation of all the properties were disclosed, and later amended to reflect a partnership return that allocated profits equally amongst family members.

Procedural History

The Commissioner determined that the 1936 transaction was a non-taxable exchange. Tilden contested this determination, arguing that the stock distribution was not proportional to the property contributions. The Tax Court reviewed the Commissioner's determination.

Issue(s)

Whether the exchange of properties for stock was a nontaxable exchange under Section 112(b)(5) of the Revenue Act of 1936, as amended, requiring that the amount of stock received by each transferor be substantially in proportion to their interest in the property prior to the exchange.

Holding

Yes, because despite the unequal value of the land conveyed, resulting trusts existed among the family members that equalized their contributions, thus satisfying the proportionality requirement of Section 112(b)(5).

Court's Reasoning

The court reasoned that while the deeds appeared to convey unequal interests, the circumstances indicated a prior understanding that the Tilden family intended to distribute the properties equally among themselves. The Court found it significant that the deeds were all "given subject to 1/10 of the outstanding mortgage indebtedness now against the grantor's properties." and that the Land Bank application stated that the property described "consists of approximately one-tenth (1/10) of the property owned by L. W. Tilden (same being approximately one-tenth (1/10) in amount of value of said property), said property having been recently conveyed to the applicant by L. W. Tilden." Further evidence of this understanding included the filing of partnership returns that allocated profit equally among the Tilden family members. Therefore, the court concluded that the grantees in the deeds from Tilden took, with resulting trusts, any excess above their pro rata equal shares in all Tilden's net property, in trust for his other grantees who received less than such shares. As such trusts can be established by parol evidence, the court determined the stock distribution was proportional to each transferor's actual interest in the property after accounting for the resulting trusts, thereby satisfying the requirements of Section 112(b)(5).

Practical Implications

This case clarifies that the proportionality requirement of Section 112(b)(5) should be applied by considering the economic realities of the transaction, including any side agreements or understandings among the transferors. It demonstrates that courts may look beyond the face of formal conveyances to determine the true nature of the transferor's interests. In planning corporate formations, practitioners must consider any existing trusts or agreements among transferors that could affect the determination of proportionality. The case also serves as a reminder that parol evidence may be admitted to establish resulting trusts. This case has been cited in subsequent rulings regarding tax-free corporate formations and the interpretation of Section 351 of the Internal Revenue Code, the modern codification of similar principles.