Intermountain Lumber Co. & Subsidiaries, etc. v. Commissioner, 65 T. C. 1025 (1976)

A binding agreement to sell stock immediately after its receipt from a corporation as part of the incorporation transaction precludes the transferor from having the requisite control for tax-free treatment under Section 351.

Summary

In *Intermountain Lumber Co. & Subsidiaries, etc. v. Commissioner*, the U. S. Tax Court held that a binding agreement to sell stock received in exchange for property transferred to a newly formed corporation prevented the transferor from having control immediately after the exchange, thus disqualifying the transaction from tax-free treatment under IRC Section 351. Dee Shook transferred property to S & W Sawmill, Inc. in exchange for stock, but had simultaneously agreed to sell half of his stock to Milo Wilson. The court determined that this agreement deprived Shook of the necessary control for a tax-free exchange, as he was obligated to sell the stock immediately upon receipt.

Facts

Dee Shook owned a sawmill and, after it was damaged by fire, he and Milo Wilson decided to incorporate as S & W Sawmill, Inc. to rebuild and expand the business. On July 15, 1964, Shook transferred his sawmill assets to S & W in exchange for 364 shares of stock. On the same day, Shook entered into an irrevocable agreement to sell 182 of those shares to Wilson for $500 per share, payable over time. The agreement included interest payments and a forfeiture clause if Wilson failed to make timely payments. Shook deposited the stock certificates in escrow and granted Wilson a proxy to vote those shares for one year. Wilson made payments in 1965 and 1966 and claimed interest deductions on his tax returns.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the petitioners' income taxes for the fiscal years ending June 30, 1965, 1967, 1968, and 1969. The cases were consolidated for trial, brief, and opinion. The Tax Court heard arguments on whether the formation of S & W Sawmill, Inc. qualified for tax-free treatment under IRC Section 351, specifically focusing on whether Shook had the requisite control immediately after the exchange.

Issue(s)

1. Whether the transfer of property to S & W Sawmill, Inc. by Dee Shook in exchange for stock, followed by an immediate agreement to sell half of that stock to Milo Wilson, constituted a tax-free exchange under IRC Section 351.

Holding

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1. No, because Shook did not control the requisite percentage of stock immediately after the exchange due to the binding agreement to sell half of his shares to Wilson.

Court's Reasoning

The court analyzed whether Shook's agreement to sell stock to Wilson immediately after receiving it from S & W deprived him of control under IRC Section 368(c), which defines control for Section 351 purposes. The court concluded that the agreement was a binding sale, not an option, as evidenced by the payment terms, interest deductions claimed by Wilson, and other contemporaneous documents. The court held that Shook's obligation to sell the stock upon receipt meant he did not have the requisite control immediately after the exchange, thus disqualifying the transaction from tax-free treatment. The court cited precedents such as *Stephens, Inc. v. United States* and *S. Klein on the Square, Inc.* to support its conclusion that legal title and voting rights alone are not determinative of ownership for control purposes under Section 351.

Practical Implications

This decision clarifies that a binding agreement to sell stock received in an incorporation transaction can prevent the transferor from having the necessary control for tax-free treatment under Section 351. Practitioners should carefully structure such transactions to ensure that any agreements to transfer stock do not take effect until after the requisite control period has passed. This ruling may impact how businesses plan incorporations involving multiple parties with pre-existing agreements to transfer ownership. Subsequent cases like *James v. Commissioner* have cited *Intermountain Lumber* in analyzing control under Section 351, emphasizing the importance of the timing and nature of any stock transfer agreements.

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