D'Angelo Associates, Inc. v. Commissioner, T.C. Memo. 1979-252

For a transfer of property to a corporation to qualify as a tax-free exchange under Section 351, notes received by the transferor can be considered 'securities,' and seemingly separate transactions can be integrated to establish 'control' immediately after the exchange.

Summary

D'Angelo Associates, Inc. sought to depreciate assets based on a stepped-up basis, arguing a sale occurred when Dr. and Mrs. D'Angelo transferred property to the newly formed corporation in exchange for cash and notes. The Tax Court disagreed, holding that the transfer was a tax-free exchange under Section 351. The court found that the transfer of property and cash for stock were integrated steps, the demand notes constituted 'securities,' and the D'Angelos maintained 'control' immediately after the exchange, even though most stock was gifted to their children. Therefore, the corporation had to use the transferors' basis for depreciation, and deductions for life insurance premiums and some vehicle expenses were disallowed.

Facts

Dr. D'Angelo formed D'Angelo Associates, Inc. Shortly after incorporation, Dr. and Mrs. D'Angelo transferred real property, office equipment, and an air conditioning system to the corporation. In exchange, they received $15,000 cash, assumption of a mortgage, and demand notes totaling $111,727.85. Simultaneously, for a $15,000 cash contribution, the corporation issued stock: 10 shares to Mrs. D'Angelo and 50 shares to their children (held in trust by Dr. D'Angelo). The D'Angelos reported the property transfer as a sale, claiming a capital gain offset by prior losses. The corporation then claimed depreciation based on a stepped-up basis and deducted life insurance premiums and vehicle expenses.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in D'Angelo Associates, Inc.'s federal income tax. D'Angelo Associates, Inc. petitioned the Tax Court to contest the deficiency.

Issue(s)

1. Whether the transfer of assets to D'Angelo Associates, Inc. constituted a nontaxable exchange under Section 351(a) of the Internal Revenue Code, thus requiring the corporation to use the transferors' basis for depreciation.
2. Whether the demand notes issued by D'Angelo Associates, Inc. to Dr. D'Angelo constituted 'securities' for purposes of Section 351.
3. Whether Dr. and Mrs. D'Angelo were in 'control' of D'Angelo Associates, Inc. 'immediately after the exchange' when most of the stock was directly issued to their children.

4. Whether premiums paid by D’Angelo Associates, Inc. for life insurance on Dr. D’Angelo were deductible as ordinary and necessary business expenses under Section 162(a).
5. To what extent vehicle expenses claimed by D’Angelo Associates, Inc. are deductible under Sections 162(a) and 167(a).

Holding

1. Yes, because the transfer was part of an integrated plan and met the requirements of Section 351.
2. Yes, because the demand notes represented a continuing proprietary interest in the corporation and were not the equivalent of cash.
3. Yes, because Dr. and Mrs. D’Angelo had the power to designate who received the stock, and the gift to children was considered a disposition of stock after control was established.
4. No, because D’Angelo Associates, Inc. was indirectly a beneficiary of the life insurance policy as it secured a loan guarantee, thus falling under the prohibition of Section 264(a)(1).
5. Partially deductible; vehicle expenses were deductible only to the extent they were ordinary and necessary business expenses of the corporation, not for Dr. D’Angelo’s personal use.

Court’s Reasoning

The Tax Court reasoned:

- **Section 351 Applicability:** The court applied the substance over form doctrine, finding the cash transfer for stock and property transfer for notes were integrated steps in a single plan to incorporate Dr. D’Angelo’s practice. The court quoted *Nye v. Commissioner*, 50 T.C. 203, 212 (1968), noting the lack of business reason for dividing the transaction, inferring they were ‘inseparably related.’
- **‘Securities’ Definition:** The court adopted the ‘ Camp Wolters’ test from *Camp Wolters Enterprises, Inc. v. Commissioner*, 22 T.C. 737 (1954), focusing on the ‘overall evaluation of the nature of the debt, degree of participation and continuing interest in the business.’ The demand notes were deemed securities because they represented a long-term investment and continuing interest, not a short-term cash equivalent. The court noted, ‘securities are investment instruments which give the holder a continuing participation in the affairs of the debtor corporation.’
- **‘Control Immediately After’:** The court followed *Wilgard Realty Co. v. Commissioner*, 127 F.2d 514 (2d Cir. 1942), emphasizing the transferors’ ‘absolute right’ to designate who receives the stock. The gift to children was viewed as a disposition after control was achieved. The court distinguished *Mojonnier & Sons, Inc. v. Commissioner*, 12 T.C. 837 (1949), stating that in this case, Dr. D’Angelo had the power to direct stock issuance.

- **Life Insurance Premiums:** Citing *Rodney v. Commissioner*, 53 T.C. 287 (1969) and *Glassner v. Commissioner*, 43 T.C. 713 (1965), the court held that even as a guarantor, the corporation benefited from the insurance policy, making the premiums nondeductible under Section 264(a)(1). The court stated, 'the benefit requirement of section 264(a)(1) is satisfied where the insurance would ultimately satisfy an obligation of the taxpayer.'
- **Vehicle Expenses:** Applying *International Artists, Ltd. v. Commissioner*, 55 T.C. 94 (1970), the court disallowed deductions for personal use, allowing deductions only for the business portion of vehicle expenses, allocating based on the record.

Practical Implications

D'Angelo Associates clarifies several key aspects of Section 351 transfers:

- **Integrated Transactions:** Transactions occurring close in time and part of a unified plan will be viewed together for Section 351 purposes, preventing taxpayers from artificially separating steps to avoid nonrecognition rules.
- **'Securities' Broadly Defined:** The definition of 'securities' under Section 351 is flexible and depends on the overall investment nature of the debt instrument, not solely on the maturity date. Demand notes can qualify if they represent a continuing proprietary interest.
- **'Control' and Stock Gifts:** Transferors can satisfy the 'control immediately after' requirement even if they gift stock to family members, provided they have the power to direct stock issuance initially. This prevents taxpayers from easily circumventing Section 351 by gifting stock contemporaneously with incorporation.
- **Life Insurance Deductibility:** Corporations guaranteeing loans and taking out life insurance on principals as security are considered beneficiaries, preventing premium deductions under Section 264(a)(1).

This case is frequently cited in corporate tax law for its comprehensive analysis of Section 351, particularly regarding the definition of securities and the integration of steps in corporate formations. It serves as a reminder that substance over form prevails in tax law, and that Section 351 is broadly applied to prevent tax avoidance in corporate formations.

