C-Lec Plastics, Inc. v. Commissioner, 76 T. C. 601, 1981 U. S. Tax Ct. LEXIS 144 (1981)

When property is transferred to a corporation in exchange for stock under Section 351, the corporation's basis in the property is the same as the transferor's basis, regardless of the stated value of the stock issued.

Summary

In C-Lec Plastics, Inc. v. Commissioner, the U. S. Tax Court ruled that the corporation's basis in certain plastic molds, which were transferred to it by its sole shareholder in exchange for stock, was zero because the shareholder's basis in the molds was zero. The court rejected the corporation's argument that the transaction should be treated as a purchase, emphasizing that the substance of the transaction was an exchange under Section 351 of the Internal Revenue Code. Consequently, the corporation could not claim a casualty loss deduction when the molds were later destroyed by fire, as its basis in the molds was the same as the shareholder's zero basis.

Facts

C-Lec Plastics, Inc. initially created certain plastic molds and rings for a contract. After abandoning these assets, Edward D. Walsh, the company's president and sole shareholder, acquired them with a zero basis. When a new market emerged for products made with these molds, C-Lec reacquired them from Walsh on June 1, 1973, in exchange for issuing 500 shares of common stock valued at $40,000. The transaction also included a $2,982. 23 reduction in Walsh's loan account with the company. The molds were destroyed by fire on December 1, 1973, and C-Lec claimed a casualty loss deduction based on the stated value of the stock issued for the molds.

Procedural History

The Commissioner of Internal Revenue issued a deficiency notice disallowing C-Lec's casualty loss deduction, asserting that the corporation's basis in the molds was zero. C-Lec petitioned the U. S. Tax Court for a redetermination of the deficiency. The Tax Court heard the case and ruled in favor of the Commissioner, holding that the transaction was an exchange under Section 351, resulting in a zero basis for the corporation in the molds.

Issue(s)

1. Whether the transfer of the molds from Walsh to C-Lec Plastics, Inc. in exchange for stock was a taxable sale or an exchange under Section 351 of the Internal Revenue Code.

2. Whether C-Lec Plastics, Inc. 's basis in the molds was the stated value of the stock

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issued or the same as Walsh's basis in the molds.

Holding

1. No, because the substance of the transaction was an exchange of the molds for stock, falling within the purview of Section 351.
2. No, because under Section 362(a), C-Lec Plastics, Inc. 's basis in the molds was the same as Walsh's zero basis, as no gain was recognized by Walsh on the transfer.

Court's Reasoning

The court applied the principle that the substance of a transaction, rather than its form, controls for tax purposes. It found that the transaction was an integrated exchange of the molds for stock, not a purchase. The court rejected C-Lec's argument that the transaction was a sale, noting that the issuance of stock and the reduction of the loan account were inseparable components of a single transaction. The court emphasized that Section 351 applies regardless of the parties' intent, and since Walsh recognized no gain on the transfer, C-Lec's basis in the molds was the same as Walsh's zero basis under Section 362(a). The court also noted that Walsh's failure to report any gain on his personal returns supported the conclusion that the transaction was an exchange.

Practical Implications

This decision clarifies that when property is transferred to a corporation in exchange for stock under Section 351, the corporation's basis in the property is the transferor's basis, regardless of the stated value of the stock issued. Practitioners should carefully consider the substance of transactions involving property transfers to corporations, as the form of the transaction may not control for tax purposes. This ruling may affect how businesses structure asset transfers to corporations, particularly when the transferor has a low or zero basis in the transferred property. Later cases, such as *Peracchi v. Commissioner*, have applied this principle in similar contexts.

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