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SC Court of Appeals

STATE OF SOUTH CAROLINA
ADMINISTRATIVE LAW COURT

Hugh Chapman, Petitioner, vs. South Carolina Department of Revenue, Respondent.	)	Docket No. 25-ALJ-17-0284-CC Docket No. 25-ALJ-17-0359-CC **ORDER DENYING PETITIONER'S MOTION FOR RECONSIDERATION**

This matter comes before the South Carolina Administrative Law Court (ALC or Court) upon a Motion for Reconsideration (Motion) filed by Petitioner Hugh N. Chapman (Petitioner) pursuant to Rule 29(D) of the Rules of Procedure for the Administrative Law Court (SCALC Rules) asking the Court to reconsider its June 16, 2026 order (Order) granting South Carolina Department of Revenue's (DOR's or the Department's) Motion for Summary Judgment and denying Petitioner's applications for angel investor tax credits for tax years 2023 and 2024 pursuant to the High Growth Small Business Job Creation Act, S.C. Code Ann. §§ 11-44-10 et seq. (Supp. 2025) (Act). For the reasons set forth below, the Court denies Petitioner's Motion.[1]

DISCUSSION

In his Motion, Petitioner maintains that his 2023 and 2024 contributions into JOTW Art, LLC (JOTW) are "qualified investments" for purposes of the Act, notwithstanding the fact that he was the sole owner and member of JOTW at the time of those investments, because his contributions increased the value of his equity interest in JOTW. Petitioner contends this satisfies the Act's requirement that—in order to constitute a qualified investment—a cash contribution must be made "*for* common or preferred stock or an equity interest or a purchase for cash of subordinated debt in a qualified business." S.C. Code Ann. § 11-44-30(6) (Supp. 2025). (Emphasis added).

In support of this position, Petitioner cites a federal tax statute, 26 U.S.C. § 351(a), which contains similar language to the foregoing language of the Act. Section 351(a) provides:

[1] The Department filed a Response to Petitioner's Motion for Reconsideration (Response) on July 6, 2026, agreeing with the Court's Order.

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> No gain or loss shall be recognized if property is transferred to a corporation by one or more persons **solely in exchange for stock in such corporation** and immediately after the exchange such person or persons are in control (as defined in section 368(c))[2] of the corporation.

(Emphasis added.) Petitioner notes that Section 315 and its predecessor statutes have been interpreted to apply even in circumstances where a person receives no stock in exchange for property transferred to a corporation, if the person already held all the shares of the corporation to which the property was contributed.

Petitioner first cites to *King v. United States*, 10 F. Supp. 206 (D. Md. 1935), aff'd, 79 F.2d 453 (4th Cir. 1935) for the proposition that a contribution to a corporation from a shareholder who already owns all of the shares of that corporation is the equivalent of an issuance of stock to the shareholder, because it increases the value of that shareholder's shares. In *King*, the sole owner of a corporation transferred to that corporation, without stock issuance or other consideration, shares of stock in a separate entity, which shares he had purchased eight years prior. The corporation later sold the separate-entity shares, which had increased in value. At issue in *King* was whether the plaintiff (the sole owner's daughter responsible for discharging the tax obligations of the since-dissolved corporation) should be taxed based on the increase in value of the contributed shares since the time of they were transferred into the corporation or based on the increase in value since the shares were first acquired by her father. 10 F. Supp. at 207-08. At the time of *King*, Section 203(b)(4) of the Revenue Act of 1926, a statutory predecessor to Section 351, provided:

> No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation....

See King v. United States, 79 F.2d 453, 455 (4th Cir. 1935). The federal district court reasoned that even though the statute mentioned that gain or loss would not be recognized at the time of the transfer of property if it was "in exchange for stock or securities" in the transferor-controlled corporation, there would be no shares to be issued to a transferor who already owned all of the shares, and that it would not "do any great violence to the language of the statute to treat the transaction in substance as the issuance of securities for property transferred" because he owned all

[2] Section 368(c) provides that "the term 'control' means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation." 26 U.S.C. § 368(c).

the shares of the corporation, and "the conveyance of additional property to the corporation resulted in an increased value of the stock which had originally been issued to its sole stockholder ...." *King*, 10 F. Supp. at 209.

Petitioner also notes that the Second Circuit Court of Appeals similarly interpreted Section 351 in *Lessinger v. Comm'r of Internal Revenue*, in which it stated: "[T]he exchange requirements of section 351 are met where a sole stockholder transfers property to a wholly-owned corporation even though no stock or securities are issued therefor. Issuance of new stock in this situation would be a meaningless gesture." 872 F.2d 519, 522 (2nd Cir. 1989) (citations omitted). Respondent further adds that the Internal Revenue Service has adopted the same interpretation of Section 351 in Revenue Ruling 64-155, 1964-1 C.B. 138, finding that the operation of Section 351 does not require the issuance of actual stock shares when the contributor of property to a corporation already owns 100% of the shares of that corporation.

Petitioner argues that, just as Section 315 and its predecessor statutes have been interpreted to apply even where a person receives no stock in exchange for property contributed to a corporation controlled by them (i.e., because the person already held all the shares of the corporation to which they contributed property), Section 11-44-30(6) of the Act should receive an analogous construction under which a qualified investment could include contribution *not* made "for common or preferred stock or an equity interest or a purchase for cash of subordinated debt" if the qualified business is already wholly owned by the contributor of the funds.

This Court finds the foregoing authorities to be inapposite to the state tax credit provision at hand, as Section 351 and the Act at issue serve very different purposes. Section 351 is intended to address capital gain and loss recognition in the context of business incorporation and reorganization, and therefore "is designed to give present tax relief for internal rearrangements of the taxpayer's own assets, accompanied by no sacrifice of control and no real generation of income for the owner–and to defer taxation until a true outside disposition is made." *E. I. Du Pont de Nemours & Co. v. United States*, 471 F.2d 1211, 1214 (Ct. Cl. 1973); *see also Hempt Bros. v. United States*, 354 F. Supp. 1172, 1176 (M.D. Pa. 1973), aff'd, 490 F.2d 1172 (3d Cir. 1974) ("[T]he purpose of the provision is to facilitate movement into the corporate form by preventing immediate recognition of gain or loss when there has been a mere change in the form of ownership."). Section 351's purpose is "to save the taxpayer from an immediate recognition of a gain, or to intermit the claim of a loss, in certain transactions where gain or loss may have accrued in a constitutional sense, but where in a popular and economic sense there has been a mere change in the form of ownership and the taxpayer has not really 'cashed in' on the theoretical gain, or closed out a losing venture." *Portland Oil Co. v. Comm'r of Internal Revenue*, 109 F.2d 479, 488 (1st Cir. 1940) (discussing Section 112(b)(5) of the Revenue Act of 1928,[3] predecessor statute to Section 351); *Black & Decker Corp. v. United States*, 436 F.3d 431, 438 (4th Cir. 2006) (noting that "the 'purposes' of § 351, which are the purposes of gain or loss recognition, as indicated by the opening words of § 351(a) ('No gain or loss shall be recognized ...'")); *Caruth v. United States*, 688 F. Supp. 1129, 1140 (N.D. Tex. 1987), *aff'd sub nom. Caruth Corp. v. United States*, 865 F.2d 644 (5th Cir. 1989) (Section 351 "was designed to permit 'readjustments' without present recognition of gain or loss by allowing property to be transferred to a controlled corporation by an individual, a partnership, a corporation, or others.") (quoting *Helvering v. Cement Investors*, 316 U.S. 527 (1942)). Like its statutory predecessors, Section 351 does not operate to *preclude or avoid* taxation but merely affects the timing of when gains or losses are recognized and assessed for purposes of taxation. *Easson v. Comm'r*, 294 F.2d 653, 655–56 (9th Cir. 1961) ("The purpose of § 112(b)(5) [of the Internal Revenue Code of 1939][4] is not to exempt gain from taxation but to postpone the taxable event to a later time.").

The Act at issue, however, serves a completely different purpose. The General Assembly set forth its intent for the Act in S.C. Code Ann. § 11-44-20 (Supp. 2025), and its very first goal for the Act was to "encourage individual angel investors to invest in early stage, high-growth, job-creating businesses ..." in sectors specified in S.C. Code Ann. § 11-44-30(5)(e) (Supp. 2025). Thus, the Act envisions the use of tax credits to attract investors to come to the aid of (i.e., be "angels" to) early-stage qualified businesses who otherwise might not get sufficient financing due to the risk of being in the early stages of development, by making qualified investments. The Act defines the term "qualified investment" as follows:

> "Qualified investment" means an investment by an angel investor of cash in a qualified business for common or preferred stock or an equity interest or a purchase for cash of subordinated debt in a qualified business. Investment of common or

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[3] Section 112(b)(5) of the Revenue Act of 1928 provided in pertinent part that "[n]o gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation…."

[4] Like other statutory predecessors to 26 U.S.C. § 351, Section 112(b)(5) of the Internal Revenue Code of 1939 "provide[d] that no gain or loss is to be recognized when property is transferred to a corporation solely in exchange for stock of the corporation, if immediately after the transfer, the transferor is in control of the corporation." *See Easson*, 294 F.2d at 654.

> preferred stock or an equity interest or purchase of subordinated debt does not qualify as a qualified investment if a broker fee or commission or a similar remuneration is paid or given directly or indirectly for soliciting an investment or a purchase.

S.C. Code Ann. § 11-44-30(6) (Supp. 2025). The Act sets forth a requirement that, in order to be entitled to a tax credit, an angel investor must receive, in exchange for contributed cash, "common or preferred stock or an equity interest or … subordinated debt in a qualified business."

Unlike the "solely in exchange for stock or securities" phrase in Section 351, the phrase in Section 11-44-30(6) is not merely incidental to the purpose of the statute, but sets forth an absolute prerequisite that must be met in order for a contribution of funds to a qualified business to qualify for a tax credit; indeed, this requirement is at the very heart of the definition of the term "qualified investment" and consistent with the common understanding of angel investing.[5] Thus, while the intent of Congress underlying Section 351 may allow *that* statute to be interpreted so as to apply even where the transferor does not receive stock or securities in certain circumstances, the legislative intent of the Act does not permit Section 11-44-30(6) to be construed in a similar manner.[6] Again, the purpose of the Act is to provide a tax credit—not a delay of taxes owed—and it sets for the specific criteria that must be met to obtain that credit. Therefore, the Court is not persuaded that an increase in the value of Petitioner's pre-existing and plenary equity interest in JOTW equates to receiving common or preferred stock, an equity interest, or subordinated debt as used in Section 11-44-30(6).

There is no dispute as to the fact that Petitioner received no subordinated debt in exchange for his 2023 and 2024 cash investments in JOTW, so the Court will now address his arguments with respect to "common or preferred stock" and "equity interest."

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[5] *See, e.g.*,; J. Brad Bernthal, *The Evolution of Entrepreneurial Finance: A New Typology*, 2018 B.Y.U. L. Rev. 773, 777 (2018) (describing an angel investor as "an investor who takes an ownership stake in exchange for a capital contribution to the company"); Abraham J.B. Cable, *Fending for Themselves: Why Securities Regulations Should Encourage Angel Groups*, 13 U. Pa. J. Bus. L. 107, 127 (2010) (noting that angel investors usually receive preferred stock); John L. Orcutt, *Improving the Efficiency of the Angel Finance Market: A Proposal to Expand the Intermediary Role of Finders in the Private Capital Raising Setting*, 37 Ariz. St. L.J. 861, 882, 895 (2005) (observing that typical angel investor funding "will involve a non-public offering of equity securities of the start-up" and that many angel investors are "content to receive common stock, rather than convertible preferred stock"); *see also NVST.com Inc. v. NVST, LLP*, 32 F. App'x 207, 212 (9th Cir. 2002) (describing angel investors as "wealthy individuals seeking equity stakes in emerging companies")

[6] While the language of Section 11-44-30(6) is the best evidence of legislative intent and is dispositive of this contested case in itself, the Court notes that other provisions of the Act also presuppose that a qualified investment results in an angel investor receiving a capital asset, i.e., common or preferred stock, an equity/membership interest, or subordinated debt instrument, in exchange for their angel investment. *See, e.g.*, S.C. Code Ann. § 11-44-65 (Supp. 2025).

Common or Preferred Stock

The Court agrees with Petitioner that there would be no common or preferred stock issued by JOTW because it is an LLC, not a corporation, and LLCs do not issue stock. The Court also agrees that a membership certificate was not required to be issued by JOTW. The Court further agrees with Petitioner that a member's interest in the economic results of an LLC is his "distribution interest," and that according to S.C. Code Ann. § 33-44-101 (2006), a member has only one distribution interest—"**all** of a member's interest in distributions by the [LLC]." (Emphasis added). "'Distribution' means a transfer of money, property, or other benefit from a[n LLC] to a member in the member's capacity as a member or to a transferee of the member's distributional interest." *Id.* at (5). The Court even agrees with Petitioner that "a sole member's additional contribution … results in an increase in the value of the sole member's distributional interest." However, for the reasons discussed above, for purposes of Section 11-44-30(6), the Court disagrees with Petitioner's conclusions that an increase in value of an LLC's sole member's distribution interest—arising from the sole member's additional contribution to the LLC—equates to the issuance of stock, just as an increase in value of a sole member's distribution interest does not equate to the creation of a separate distribution interest for that member. Petitioner received no greater ownership interest in JOTW after he made his 2023 and 2024 additional contributions than he had before he made them because he already completely owned every interest in JOTW.

Equity Interest

Petitioner makes essentially the same argument with respect to his equity interest in JOTW, and the Court's view remains the same. The Court agrees with Petitioner that an equity interest in an LLC involves an ownership right or interest in the LLC, and that a distribution interest in an LLC is a member's interest in the economic results of the LLC. The Court again agrees that the value of Petitioner's distributional interest may have increased by his additional contributions in 2023 and 2024, and that pursuant to S.C. Code Ann § 33-44-501(b) (2006), "[a] distribution interest in a[n LLC] is personal property and, subject to Sections 33-44-502 and 33-44-503, may be transferred in whole or in part." However, while a distribution interest may provide a right to, or interest in, a portion (or in this case, all) of the economic results of an LLC, it does not equate to an equity interest, which is the membership/ownership interest in the LLC and which involves more rights than a distribution interest. The Comment to Section 33-44-101 states, in pertinent part, that "[t]he term ["distribution interest"] does not include a member's broader rights to participate in the management of the company." And while a distribution interest in an LLC is personal property that can be transferred, unless a transferor gives a transferee the right of membership by authority of the operating agreement or with the consent of all of the other members,[7] Section 33-44-502 provides that "[a] transfer of a distributional interest does not entitle the transferee to become or to exercise any rights of a member. A transfer entitles the transferee to receive, to the extent transferred, only the distributions to which the transferor would be entitled." This is echoed in Section 33-44-503(d), which provides that "[a] transferee who does not become a member is not entitled to participate in the management or conduct of the limited liability company's business, require access to information concerning the company's transactions, or inspect or copy any of the company's records. In other words, the mere transferal of a distribution interest to a transferee does not confer an ownership/membership interest in the LLC itself but only conveys the economic/distribution interest transferred. Thus, a member can still retain an equity interest in the LLC and exercise management, voting, and other rights of an owner even after transferring a distribution interest, and a transferee can have a distribution interest in an LLC without being a member of an LLC. In short, there is a distinction between an equity interest and a distribution interest.

Here, Petitioner maintained throughout the period at issue—and at all other times—a 100% equity interest and a 100% distribution interest in JOTW. Petitioner received no ownership/membership interest in JOTW in exchange for his 2023 and 2024 contributions thereto because he, being the sole member of the LLC, already owned 100% of the equity interest in JOTW at the time of these additional contributions. As to Petitioner's distribution interest, for the reasons already discussed, the Court concludes that the increase in value of Petitioner's distribution interest does not create a new equity interest, just as it does not equate to the issuance of new shares.

[7] *See* Section 33-44-503(a).

<u>ORDER</u>

IT IS THEREFORE ORDERED that Petitioner's Motion is **DENIED**.

AND IT IS SO ORDERED.

Samuel L. Johnson
Administrative Law Judge

July 24, 2026
Columbia, South Carolina

CERTIFICATE OF SERVICE

I, Reynolds C. Rawls, hereby certify that I have this date served this Order upon all parties to this cause by depositing a copy hereof in the United States mail, postage paid, or by electronic mail, to the address provided by the party(ies) and/or their attorney(s).

Reynolds C. Rawls
Judicial Law Clerk

July 24, 2026
Columbia, South Carolina

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