



C:2-60 Eric Wright conducts a dry cleaning business as a sole proprietorship. The business operates in a building that Eric owns. Last year, Eric mortgaged for \$150,000 the building and the land on which the building sits. He used the money for a down payment on his personal residence and college expenses for his two children. He now wants to incorporate his business and transfer the building and the mortgage to a new corporation, along with other assets and some accounts payable. The amount of the unpaid mortgage balance will not exceed Eric's adjusted basis in the land and building at the time he transfers them to the corporation. Eric is aware that Sec. 357(b) could impact the tax consequences of the transaction because no bona fide business purpose exists for the mortgage transfer, which the IRS might consider to have been for a tax avoidance purpose. However, Eric refuses to acknowledge this possibility when you confront him. He maintains that many taxpayers play the audit lottery and that, in the event of an audit, invoking this issue could be a bargaining ploy.

Required: What information about the transaction must be provided with the transferor and transferee's tax returns for the year in which the transfer takes place? Discuss the ethical issues raised by the AICPA's *Statements on Standards for Tax Services No. 1, Tax Return Positions* (which can be found in Appendix E) as it relates to this situation. Should the tax practitioner act as an advocate for the client? Should the practitioner sign the return?

TAX RESEARCH PROBLEMS

C:2-61 Anne and Michael own and operate a successful mattress business. They have decided to take the business public. They contribute all the assets of the business to newly formed Spring Corporation each in exchange for 20% of the stock. The remaining 60% is issued to an underwriting company that will sell the stock to the public and charge 10% of the sales proceeds as a commission. Prepare a memorandum for your tax manager explaining whether or not this transaction meets the tax-free requirements of Sec. 351.

C:2-62 Bob and Carl transfer property to Stone Corporation for 90% and 10% of Stone stock, respectively. Pursuant to a binding agreement concluded before the transfer, Bob sells half of his stock to Carl. Prepare a memorandum for your tax manager explaining why the exchange does or does not meet the Sec. 351 control requirement. Your manager has suggested that, at a minimum, you consult the following authorities:

- IRC Sec. 351
- Reg. Sec. 1.351-1

C:2-63 In an exchange qualifying for Sec. 351 tax-free treatment, Greta receives 100 shares of White Corporation stock plus a right to receive another 25 shares. The right is contingent on the valuation of a patent contributed by Greta. Because the patent license is pending, the patent cannot be valued for several months. Prepare a memorandum for your tax manager explaining whether the underlying 25 shares are considered "stock" for purposes of Sec. 351 and what tax consequences ensue from Greta's receipt of the 100 shares now and 25 shares later upon exercise of the right.

C:2-64 John plans to transfer the assets and liabilities of his business to Newco in exchange for all of Newco's stock. The assets have a \$250,000 basis and an \$800,000 FMV. John also plans to transfer \$475,000 of business related liabilities to Newco. Under Sec. 357(c), can John avoid recognizing a \$175,000 gain (the excess of liabilities over the basis of assets transferred) by transferring a \$175,000 personal promissory note along with the assets and liabilities?

C:2-65 Six years ago, Leticia, Monica, and Nathaniel organized Lemona Corporation to develop and sell computer software. Each individual contributed \$10,000 to Lemona in exchange for 1,000 shares of Lemona stock (for a total of 3,000 shares issued and outstanding). The corporation also borrowed \$250,000 from Venture Capital Associates to finance operating costs and capital expenditures.

Because of intense competition, Lemona struggled in its early years of operation and sustained chronic losses. This year, Leticia, who serves as Lemona's president, decided to seek additional funds to finance Lemona's working capital.

Venture Capital Associates declined Leticia's request for additional capital because of the firm's already high credit exposure to the software corporation. Hi-Tech Bank proposed to lend Lemona \$100,000, but at a 10% premium over the prime rate. (Other software manufacturers in the same market can borrow at a 3% premium.) Investment