

CHAPTER

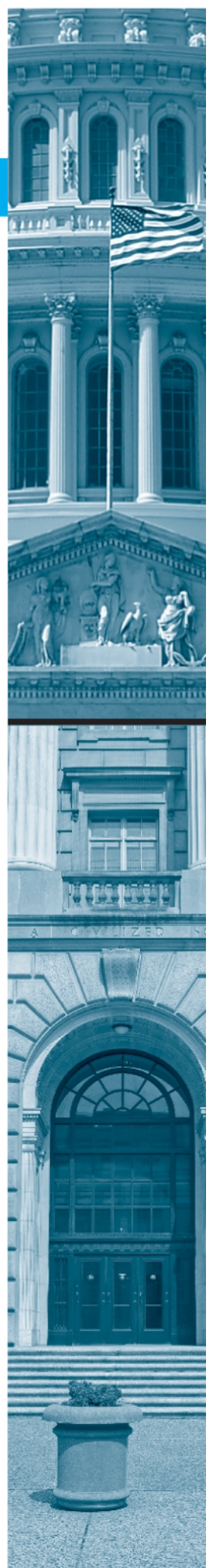
2

CORPORATE FORMATIONS AND CAPITAL STRUCTURE

LEARNING OBJECTIVES

After studying this chapter, you should be able to

- 1** Discuss the tax advantages and disadvantages of alternative business forms
- 2** Apply the check-the-box regulations to partnerships, corporations, and trusts
- 3** Recognize the legal requirements and tax considerations related to forming a corporation
- 4** Discuss the requirements for deferring gain or loss upon incorporation
- 5** Explain the tax implications of alternative capital structures
- 6** Determine the tax consequences of worthless stock or debt obligations
- 7** Identify tax planning opportunities in corporate formations
- 8** Comply with procedural rules for corporate formations



CHAPTER OUTLINE

Organization Forms Available...2-2
 Check-the-Box Regulations...2-8
 Legal Requirements and Tax Considerations Related to Forming a Corporation...2-9
 Section 351: Deferring Gain or Loss Upon Incorporation...2-12
 Choice of Capital Structure...2-27
 Worthlessness of Stock or Debt Obligations...2-32
 Tax Planning Considerations...2-34
 Compliance and Procedural Considerations...2-36

When starting a business, entrepreneurs must decide whether to organize it as a sole proprietorship, partnership, corporation, limited liability company, or limited liability partnership. This chapter discusses the advantages and disadvantages of each form of business association. Because many entrepreneurs find organizing their business as a corporation advantageous, the chapter looks at the definition of a corporation for federal income tax purposes. It also discusses the tax consequences of incorporating a business. The chapter closes by examining the tax implications of capitalizing a corporation with equity and/or debt and describing the advantages and disadvantages of alternative capital structures.

This textbook takes a life-cycle approach to corporate taxation. The corporate life cycle starts with corporate formation, discussed in this chapter. Once formed and operating, the corporation generates taxable income (or loss), incurs federal income tax and other liabilities, and makes distributions to its shareholders. Finally, at some point, the corporation might outlive its usefulness and be liquidated and dissolved. The corporate life cycle is too complex to discuss in one chapter. Therefore, additional coverage follows in Chapters C:3 through C:8.

ORGANIZATION FORMS AVAILABLE

OBJECTIVE 1

Discuss the tax advantages and disadvantages of alternative business forms

Businesses can be organized in several forms including

- Sole proprietorships
- Partnerships
- Corporations
- Limited liability companies
- Limited liability partnerships

A discussion of the tax implications of each form is presented below.

ADDITIONAL COMMENT

The income/loss of a sole proprietorship reported on Schedule C carries to page 1 of Form 1040 and is included in the computation of the individual's taxable income. Net income, if any, also carries to Schedule SE of Form 1040 for computation of the sole proprietor's self-employment tax.

ADDITIONAL COMMENT

The Tax Cuts and Jobs Act of 2017 added a deduction for qualified business income, effective for tax years beginning after 2017. The deduction is 20% of qualified business income from a partnership, S corporation, or sole proprietorship (also REIT dividends). See Chapter C:9 for additional details.

EXAMPLE C:2-1 ►

John, a single taxpayer, starts a new computer store, which he operates as a sole proprietorship. John reports a \$15,000 profit from the business in its first year of operation. In addition, John is allowed a \$3,000 ($0.20 \times \$15,000$) qualified business income deduction, so only \$12,000 of his profits is taxable. Assuming his marginal tax rate is 24%, John's tax on the \$12,000 of taxable profit from the business is \$2,880 ($0.24 \times \$12,000$).¹

If the business is unprofitable, the loss reduces the proprietor's total taxable income, thereby generating tax savings.

EXAMPLE C:2-2 ►

Assume the same facts as in Example C:2-1 except John reports a \$15,000 loss instead of a \$15,000 profit in the first year of operation. Assuming he still is taxed at a 24% marginal tax rate, the \$15,000 loss produces tax savings of \$3,600 ($0.24 \times \$15,000$).

¹ The \$15,000 Schedule C profit in Example C:2-1 will increase adjusted gross income (AGI). The qualified business income deduction, however, does not reduce AGI. The AGI level affects certain deduction calculations

(e.g., medical, charitable contributions, and miscellaneous itemized) and, because of limitations, may result in a taxable income increase different from the \$15,000 AGI increase.

ADDITIONAL COMMENT

Although this chapter emphasizes the tax consequences of selecting the entity in which a business will be conducted, other issues also are important in making such a decision. For example, the amount of legal liability assumed by an owner is important and can vary substantially among the different business entities.

Tax Advantages. The tax advantages of conducting business as a sole proprietorship are as follows:

- ▶ The sole proprietorship is not subject to taxation as a separate entity. Rather, the sole proprietor, as an individual, is taxed at his or her marginal rate on income earned by the business.
- ▶ Profits may qualify for the 20% qualified business income deduction.
- ▶ The proprietor's marginal tax rate may be lower than the marginal tax rate that would have applied had the business been organized as a corporation.
- ▶ The owner may contribute cash to, or withdraw profits from, the business without tax consequences.
- ▶ Although the owner usually maintains separate books, records, and bank accounts for the business, the money in these accounts belongs to the owner personally.
- ▶ The owner may contribute property to, or withdraw property from, the business without recognizing gain or loss.
- ▶ Business losses may offset nonbusiness income, such as interest, dividends, and any salary earned by the sole proprietor or his or her spouse, subject to the passive activity loss rules.

Tax Disadvantages. The tax disadvantages of conducting business as a sole proprietorship are as follows:

- ▶ The profits of a sole proprietorship are currently taxed to the individual owner, whether or not the profits are retained in the business or withdrawn for personal use. By contrast, the profits of a corporation are taxed to its shareholders only if and when the corporation distributes the earnings as dividends.
- ▶ At times, corporate tax rates have been lower than individual tax rates. In such times, businesses conducted as sole proprietorships have been taxed more heavily than businesses organized as corporations.
- ▶ A sole proprietor must pay the full amount of Social Security taxes because he or she is not considered to be an employee of the business. By contrast, shareholder-employees must pay only half their Social Security taxes; the corporate employer pays the other half. (The employer, however, might pass this half onto employees in the form of lower wages or fewer employees hired.)
- ▶ Sole proprietorships may not deduct compensation paid to owner-employees. By contrast, corporations may deduct compensation paid to shareholder-employees.
- ▶ Certain tax-exempt benefits (e.g., premiums for group term life insurance) available to shareholder-employees are not available to owner-employees.²
- ▶ A sole proprietor must use the same accounting period for business and personal purposes. Thus, he or she cannot defer income by choosing a business fiscal year that differs from the individual's calendar year. By contrast, a corporation may choose a fiscal year that differs from the shareholders' calendar years.

ADDITIONAL COMMENT

In 2017 and 2018, the employee's half of Social Security taxes is 6.2%, and the employee's half of the Medicare tax is 1.45%, for a total of 7.65%. The employer pays the same percentages for its half of these items. In addition, the employee (but not the employer) is subject to an additional 0.9% Medicare tax if the employee's wages exceed a threshold amount (\$200,000 unmarried; \$250,000 for married filing jointly; \$125,000 for married filing separately).

REAL-WORLD EXAMPLE

Entities filed the following number of tax returns in 2017:

Entity	Number
Partnership	4.01 million
C corporation	2.01 million
S corporation	4.84 million

PARTNERSHIPS

A **partnership** is an unincorporated business carried on by two or more individuals or entities for profit. The partnership form often is used by friends or relatives who engage in a business and by groups of investors who want to share the profits, losses, and expenses of an investment such as a real estate project.

A partnership is a tax reporting, but not taxpaying, entity. The partnership acts as a conduit for its owners. Its income, expenses, losses, credits, and other tax-related items pass through to the partners who report these items on their separate tax returns.

Each year a partnership must file a tax return (Form 1065—U.S. Partnership Return of Income) to report the results of its operations. When the partnership return is filed, the preparer must send each partner a statement (Schedule K-1, Form 1065) that reports the

² Section 162(l) permits self-employed individuals to deduct as a trade or business expense all of the health insurance costs incurred on behalf of themselves, their spouses, and their dependents.

partner's allocable share of partnership income, expenses, losses, credits, and other tax-related items. The partner then must report these items on his or her separate tax return. As with a sole proprietorship, the partner's allocable share of business profits is added to the partner's other income and taxed at that partner's marginal tax rate. A completed Form 1065 appears in Appendix B.

EXAMPLE C:2-3 ► Bob, a single taxpayer, owns a 50% interest in the BT Partnership, a calendar year entity. The BT Partnership reports a \$30,000 profit in its first year of operation. Bob's \$15,000 share passes through from the partnership level to Bob's individual tax return. In addition, Bob is allowed a \$3,000 ($0.20 \times \$15,000$) qualified business income deduction on his share of pass-through income, so only \$12,000 of it is taxable. Assuming Bob is taxed at a 24% marginal rate, his tax on the \$12,000 is \$2,880 ($0.24 \times \$12,000$). Bob must pay the \$2,880 tax whether or not the BT Partnership distributes any of its profits to him. ◀

If a partnership reports a loss, the partner's allocable share of the loss reduces that partner's other income and provides tax savings based on the partner's marginal tax rate. The passive activity loss rules, however, may limit the amount of any loss deduction available to the partner. (For a discussion of these rules, see Chapter C:9 of this textbook.)

EXAMPLE C:2-4 ► Assume the same facts as in Example C:2-3 except that, instead of a profit, the BT Partnership sustains a \$30,000 loss in its first year of operation. Assuming Bob is taxed at a 24% marginal rate, his \$15,000 share of the first year loss produces a tax savings of \$3,600 ($0.24 \times \$15,000$). ◀

TAX STRATEGY TIP

In a limited partnership, the general partner could be a corporation, thereby affording the general owners (shareholders) of the corporation added liability protection.

Organizationally, a partnership can be either general or limited. In a general partnership, the liability of each partner for partnership debts is unlimited. Thus, these partners are at risk for more than the amount of their capital investment in the partnership. In a limited partnership, at least one partner must be a general partner, and at least one partner must be a limited partner. As in a general partnership, the general partners are liable for all partnership debts, and the limited partners are liable only to the extent of their capital investment in the partnership, plus any amount they are obligated to contribute under their partnership agreement. Unless specified in that agreement, limited partners generally may not participate in the management of the partnership business.

Tax Advantages. The tax advantages of doing business as a partnership are as follows:

- The partnership as an entity pays no tax. Rather, the income of the partnership passes through to the separate returns of the partners and is taxed directly to them.
- Pass-through income may qualify for the 20% qualified business income deduction.
- A partner's tax rate may be lower than a corporation's tax rate for the same level of taxable income.
- Partnership income is not subject to double taxation. Although partnership profits are accounted for at the partnership level, they are taxed only at the partner level.
- Additional taxes generally are not imposed on distributions to the partners. With limited exceptions, partners can contribute money or property to, or withdraw money or property from, the partnership without recognizing gain or loss.
- Subject to limitations, partners can use losses to offset income from other sources.
- A partner's basis in a partnership interest is increased by his or her share of partnership income. This basis adjustment reduces the amount of gain recognized when the partner sells his or her partnership interest, thereby avoiding double taxation.

Tax Disadvantages. The tax disadvantages of doing business as a partnership are as follows:

- All the partnership's profits are taxed to the partners when earned, even if not distributed.
- A partner's tax rate could be higher than a corporation's tax rate for the same level of taxable income.
- A partner is not considered to be an employee of the partnership. Therefore, he or she must pay the full amount of self-employment taxes on his or her share of partnership

ADDITIONAL COMMENT

If two or more owners exist, a business cannot be conducted as a sole proprietorship. From a tax compliance and recordkeeping perspective, conducting a business as a partnership is more complicated than conducting the business as a sole proprietorship.

income. Some tax-exempt fringe benefits (e.g., premiums for group term life insurance) are not available to partners.³

- Partners generally cannot defer income by choosing a fiscal year for the partnership that differs from the tax year of the principal partner(s). However, if the partnership demonstrates a business purpose, or if it makes a special election, it may use a fiscal year in general.

Chapters C:9 and C:10 of this volume discuss partnerships in greater detail.

CORPORATIONS

Corporations fall into two categories: C corporations and S corporations. Both have limited liability. A C corporation is subject to double taxation. Its earnings are taxed first at the corporate level when earned, then again at the shareholder level when distributed as dividends. An S corporation, by contrast, is subject to single-level taxation, much like a partnership. Its earnings are accounted for at the corporate level but are taxed only at the shareholder level.

ADDITIONAL COMMENT

Unlike a sole proprietorship and a partnership, a C corporation is a separate taxpaying entity. This form can be advantageous because the corporate rate is 21%, which may be much lower than an individual shareholder's rate, which might be as high as 37%.

EXAMPLE C:2-5

TAX STRATEGY TIP

If a shareholder is also an employee of the corporation, the corporation can avoid double taxation by paying a deductible salary instead of a dividend. The salary, however, must be reasonable in amount. See Tax Planning Considerations in Chapter C:3 for further discussion of this technique along with an example demonstrating how the lower tax rate on dividends reduces the difference between salary and dividend payments.

EXAMPLE C:2-6

TAX STRATEGY TIP

By having a corporation retain earnings instead of paying dividends, the shareholder converts current ordinary income into deferred capital gains. The corporation, however, must avoid the accumulated earnings tax (see Chapter C:5).

C Corporations. A C corporation is a separate entity that, for tax years beginning after December 31, 2017, is taxed at 21% on taxable income. A C corporation must report all its income and expenses and compute its tax liability on Form 1120 (U.S. Corporation Income Tax Return). A completed Form 1120 appears in Appendix B. Shareholders are not taxed on the corporation's earnings unless these earnings are distributed as dividends, and qualified dividends are taxed at the shareholder's tax rate for long-term capital gains, which can be 0%, 15% or 20 % depending on the individual's tax status and level of taxable income.⁴ In addition, an incremental 3.8% tax rate applies to net investment income for taxpayers whose modified AGI exceeds \$200,000 (\$250,000 for married filing jointly). Net investment income includes, among other things, interest, dividends, annuities, royalties, rents, and net gains from the disposition of property not used in a trade or business, all reduced by deductions allocable to such income or gains. In contrast, a C corporation's capital gains are taxed at the same 21% tax rate as its other income.

Jane owns 100% of York Corporation stock. York reports taxable income of \$50,000 for the current year, so York pays a corporate income tax of \$10,500 ($0.21 \times \$50,000$). If the corporation distributes none of its earnings to Jane during the year, she pays no tax currently on York's earnings. However, if York distributes its after-tax earnings to Jane, she must pay tax on \$39,500 ($\$50,000 - \$10,500$) of dividend income. Assuming Jane's marginal tax rate on capital gains and qualified dividends is 15%, her tax on the dividend income is \$5,925 ($0.15 \times \$39,500$). The total tax on York's \$50,000 of profits, therefore, is \$16,425 (\$10,500 paid by York + \$5,925 paid by Jane). This total tax produces an effective tax rate of 32.85% ($\$16,425 \div \$50,000$) on the corporate profit.

Even when a corporation does not distribute its profits, double taxation may result. The profits are taxed to the corporation when they are earned. Then, effectively, they may be taxed a second time (as capital gains) when the shareholder sells appreciated stock or when the corporation liquidates.

On January 2 of the current year, Carl purchases 100% of York Corporation stock for \$60,000. In the same year, York reports taxable income of \$50,000, on which it pays tax of \$10,500. The corporation distributes none of the remaining \$39,500 to Carl. On January 3 of the next year, Carl sells his stock to Mary for \$99,500 (his initial investment plus the current year's accumulated earnings). Carl must report a capital gain of \$39,500 ($\$99,500 - \$60,000$). Thus, York's profit is effectively taxed twice—first at the corporate level when earned and again at the shareholder level when Carl sells the appreciated stock at a gain.

Tax Advantages. The tax advantages of doing business as a C corporation are as follows:

- A C corporation is an entity separate and distinct from its owners. Its tax rate may be lower than its owners' marginal tax rates. So long as these earnings are not distributed and taxed to both the shareholders and the corporation, aggregate tax savings may result. If retained in the business, the earnings may be used for reinvestment and the retirement of debt. This advantage, however, may be limited by the accumulated earnings tax and the personal holding company tax. (See Chapter C:5 for a discussion of these two taxes.)

³ Partners are eligible to deduct their health insurance costs in the same manner as a sole proprietor. See footnote 2 for details.

⁴ Taxable income breakpoints for tax rates for capital gains and qualified dividends are indexed using the Chained Consumer Price Index for All Urban Consumers (C-CPI-U) in tax years beginning after 2017. See the Quick Reference section of the text for these breakpoints.

- Shareholders employed by the corporation are considered to be employees for tax purposes. Consequently, they are liable for only half their Social Security taxes, while their corporate employer is liable for the other half.
- Shareholder-employees are entitled to nontaxable fringe benefits (e.g., premiums paid on group term life insurance and accident and health insurance). The corporation can provide these benefits with before-tax dollars (instead of after-tax dollars). By contrast, because sole proprietors and partners are not considered to be employees for tax purposes, they are ineligible for certain tax-free fringe benefits, although they are permitted to deduct their health insurance premiums.
- A corporation may deduct as an ordinary and necessary business expense compensation and certain benefits paid to shareholder-employees. Within reasonable limits, it may adjust this compensation and these benefits upward to shelter corporate taxable income.
- A C corporation can use a fiscal instead of a calendar year as its reporting period. A fiscal year could permit a corporation to defer income to a later reporting period. (A personal service corporation, however, generally must use a calendar year as its tax year.⁵)
- Special rules allow a shareholder to exclude 50% of the gain realized on the sale or exchange of stock held more than five years, provided the corporation meets certain requirements.

SELF-STUDY QUESTION

How are corporate earnings subject to double taxation?

ANSWER

Corporate earnings initially are taxed to the corporation. In addition, once these earnings are distributed to the shareholders as dividends, they are taxed again. Because the corporation does not receive a deduction for the distribution, these earnings have been taxed twice. Also, double taxation can occur when a shareholder sells his or her stock at a gain. In either case, the dividends or capital gains are taxed at the applicable capital gains rate.

Tax Disadvantages. The tax disadvantages of doing business as a C corporation are as follows:

- Double taxation of income results when the corporation distributes its earnings as dividends to shareholders or, effectively, when shareholders sell or exchange appreciated stock.
- Shareholders generally cannot withdraw money or property from the corporation without recognizing income. A distribution of cash or property to a shareholder generally is taxable as a dividend if the corporation has sufficient earnings and profits (E&P). (See Chapter C:4 for a discussion of E&P.)
- Net operating losses confer no tax benefit to the owners in the year the corporation incurs them. They can be carried back (if incurred before 2018) or carried over to offset the corporation's income in future years. For start-up corporations, these losses provide no tax benefit until the corporation earns a profit in a subsequent year. Shareholders cannot use these losses to offset income from other sources. (See Chapter C:3 for a discussion of corporate NOLs.)
- Capital losses confer no tax benefit to the owners in the year the corporation incurs them. They cannot offset the ordinary income of either the corporation or its shareholders. These losses must be carried back or carried over to offset corporate capital gains realized in other years. (See Chapter C:3 for a discussion of corporate capital gains and losses.)

S Corporations. An S corporation is so designated because special rules governing its tax treatment are found in Subchapter S of the IRC. Nevertheless, the general corporate tax rules apply unless overridden by the Subchapter S provisions. Like a partnership, an S corporation is a pass-through entity. Income, deductions, losses, and credits are accounted for by the S corporation, which generally is not subject to taxation. They pass through to the separate returns of its owners, who generally are subject to taxation. An S corporation offers its owners less planning flexibility than does a partnership. For example, the number and type of S corporation shareholders are limited, and the shareholders cannot allocate income, deductions, losses, and credits in a way that differs from their proportionate ownership. As mentioned before, like C corporation shareholders, S corporation shareholders enjoy limited liability.

To obtain S corporation status, a corporation must make a special election, and its shareholders must consent to that election. Each year, an S corporation files an information return, Form 1120S (U.S. Income Tax Return for an S Corporation), which reports the results of its operations and indicates the items of income, deduction, loss, and credit that pass through to the separate returns of its shareholders.

⁵ Sec. 441. See Chapter C:3 for the special tax year restrictions applying to personal service corporations.

TAX STRATEGY TIP

If a corporation anticipates losses in its early years, it might consider operating as an S corporation so that the losses pass through to the shareholders. When the corporation becomes profitable, it can revoke the S election if it wishes to accumulate earnings for growth.

Tax Advantages. The tax advantages of doing business as an S corporation are as follows:

- ▶ S corporations generally pay no tax. Instead, corporate income passes through and is taxed to the shareholders.
- ▶ Pass-through income may qualify for the 20% qualified business income deduction.
- ▶ The shareholders' marginal tax rates may be lower than a C corporation's tax rate, thereby producing overall tax savings.
- ▶ Corporate losses pass through to the separate returns of the shareholders and may be used to offset income earned from other sources. (Passive loss and basis rules, however, may limit loss deductions to shareholders. See Chapter C:11.) This treatment can be beneficial to owners of start-up corporations that generate losses in their early years of operation.
- ▶ Because capital gains, as well as other tax-related items, retain their character when they pass through to the separate returns of shareholders, the shareholders are taxed on these gains as though they directly realized them. Consequently, they can offset the gains against capital losses from other sources. Furthermore, they are taxed on these gains at their own capital gains rates.
- ▶ Shareholders generally can contribute money to or withdraw money from an S corporation without recognizing gain.
- ▶ Corporate profits are taxed only at the shareholder level in the year earned. Generally, the shareholders incur no additional tax liability when the corporation distributes the profits.
- ▶ A shareholder's basis in S corporation stock is increased by his or her share of corporate income. This basis adjustment reduces the shareholder's gain when he or she later sells the stock, thereby avoiding double taxation.

EXAMPLE C:2-7 ▶

Chuck owns 50% of the stock in Maine, an S corporation that uses the calendar year as its tax year. In its first year of operation, Maine reports \$30,000 of taxable income, all ordinary in character. Maine pays no corporate income tax. Chuck, however, must recognize his \$15,000 share of Maine's income whether or not the corporation distributes this income to him. However, Chuck is allowed a \$3,000 ($0.20 \times \$15,000$) qualified business income deduction on his share of pass-through income, so only \$12,000 of it is taxable. If his marginal rate is 24%, Chuck pays a tax of \$2,880 ($0.24 \times \$12,000$) on this share. If Maine instead reports a \$30,000 loss, Chuck's \$15,000 share of the loss reduces his tax liability by \$3,600 ($0.24 \times \$15,000$). ◀

TAX STRATEGY TIP

Relatively low individual tax rates may increase the attractiveness of an S corporation relative to the C corporation form of doing business.

Tax Disadvantages. The tax disadvantages of doing business as an S corporation are as follows:

- ▶ Shareholders are taxed on all of an S corporation's current year profits whether or not the corporation distributes these profits and whether or not the shareholders have the wherewithal to pay the tax on these profits.
- ▶ If the shareholders' marginal tax rates exceed that for a C corporation, the overall tax burden may be heavier, and the after-tax earnings available for reinvestment and debt retirement may be reduced.
- ▶ Nontaxable fringe benefits generally are not available to S corporation shareholder-employees.⁶ Ordinarily, fringe benefits provided by an S corporation are deductible by the corporation and taxable to the shareholder. On the other hand, S corporation shareholder-employees pay half of Social Security taxes while the S corporation employer pays the other half.
- ▶ S corporations generally cannot defer income by choosing a fiscal year other than a calendar year unless the S corporation can establish a legitimate business purpose for a fiscal year or unless it makes a special election.

Chapter C:11 discusses S corporations in greater detail. In addition, Appendix F compares the tax treatment of C corporations, partnerships, and S corporations.

⁶ S corporation shareholders may deduct their health insurance costs in the same manner as sole proprietors and partners. See footnotes 2 and 3 for details.

ADDITIONAL COMMENT

All 50 states have adopted statutes providing for LLCs.

LIMITED LIABILITY COMPANIES

A limited liability company (LLC) combines the best features of a partnership with those of a corporation even though, from a legal perspective, it is neither. While offering its owners the limited liability of a corporation, an LLC with more than one owner generally is treated as a partnership for tax purposes. This limited liability extends to all the LLC's owners. In this respect, the LLC is analogous to a limited partnership with no general partners. Unlike an S corporation, an LLC may have an unlimited number of owners who can be individuals, corporations, estates, and trusts. As discussed below, under the check-the-box regulations, the LLC may elect to be taxed as a corporation or be treated by default as a partnership. If treated as a partnership, the LLC files Form 1065 (U.S. Partnership Return of Income) with the IRS.

REAL-WORLD EXAMPLE

All the Big 4 accounting firms operate in some form of LLP.

LIMITED LIABILITY PARTNERSHIPS

The limited liability partnership (LLP) business form is attractive to owners of professional service organizations, such as public accounting firms, that adopt LLP status primarily to limit their legal liability. Under state LLP laws, partners are liable for their own acts and omissions as well as the acts and omissions of individuals under their direction. On the other hand, LLP partners are not liable for the negligence or misconduct of the other partners. Thus, from a legal liability perspective, an LLP partner is like a limited partner with respect to other partners' acts but like a general partner with respect to his or her own acts, as well as the acts of his or her agents. Like a general partnership or LLC with more than one owner, an LLP can elect to be taxed as a corporation under the check-the-box regulations. If treated as a partnership by default, the LLP files Form 1065 (U.S. Partnership Return of Income) with the IRS.

CHECK-THE-BOX REGULATIONS

OBJECTIVE 2

Apply the check-the-box regulations to partnerships, corporations, and trusts

Most unincorporated businesses may choose to be taxed as a partnership or a corporation under rules commonly referred to as the check-the-box regulations. According to these regulations, an unincorporated business with two or more owners is treated by default as a partnership for tax purposes unless it elects to be taxed as a corporation. An unincorporated business with one owner is disregarded as a separate entity and thus treated as a sole proprietorship by default unless it elects to be taxed as a corporation.⁷

An eligible entity (i.e., an unincorporated business) may elect its classification by filing Form 8832 (Entity Classification Election) with the IRS. The form must be signed by each owner of the entity, or any officer, manager, or owner of the entity authorized to make the election. The signatures must specify the date on which the election will be effective. The effective date cannot be more than 75 days before or 12 months after the date the entity files Form 8832. A copy of the form must be attached to the entity's tax return for the election year.

TAX STRATEGY TIP

When applying the federal check-the-box regulations, taxpayers also must check to see whether or not their state will treat the entity in a consistent manner for state tax purposes.

EXAMPLE C:2-8 ►

On January 10 of the current year, a group of ten individuals organizes an LLC to conduct a bookbinding business in Texas. In the current year, the LLC is an eligible entity under the check-the-box regulations and thus may elect (with the owners' consent) to be taxed as a corporation. If the LLC does not make the election, the LLC, for tax purposes, will be treated as a partnership by default. ◀

EXAMPLE C:2-9 ►

Assume the same facts as in Example C:2-8 except only one individual organized the LLC. Unless the LLC elects to be taxed as a corporation, the LLC, for tax purposes, will be disregarded by default. Consequently, its income will be taxed directly to the owner as if it were a sole proprietorship. ◀

⁷ This rule does not apply to corporations, trusts, or certain special entities such as real estate investment trusts, real estate mortgage investment conduits, or publicly traded partnerships. Reg. Sec. 301.7701-2(b)(8). Publicly traded

partnerships are discussed in Chapter C:10. Special check-the-box rules apply to foreign corporations. These rules are beyond the scope of this text.

If an entity elects to change its tax classification, it cannot make another election until 60 months after the effective date of the initial election. Following the election, certain tax consequences ensue. For example, following a partnership's election to be taxed as a corporation, the partnership is deemed to distribute its assets to the partners, who are then deemed to contribute the assets to a new corporation in a nontaxable exchange for stock. If an eligible entity that previously elected to be taxed as a corporation subsequently elects to be treated as a partnership or a disregarded entity, it is deemed to have distributed its assets and liabilities to its owner(s) in a liquidation as described in Chapter C:6. In the case of a partnership, the deemed distribution is followed by a deemed contribution of assets and liabilities to a newly formed partnership.⁸

LEGAL REQUIREMENTS AND TAX CONSIDERATIONS RELATED TO FORMING A CORPORATION

OBJECTIVE 3

Recognize the legal requirements and tax considerations related to forming a corporation

LEGAL REQUIREMENTS

State or jurisdictional laws dictate the legal requirements for forming a corporation. These requirements usually include

- ▶ Investing a minimum amount of capital
- ▶ Filing articles of incorporation
- ▶ Issuing stock
- ▶ Paying incorporation fees to the state or other jurisdiction

One of the first decisions an entrepreneur must make when organizing a corporation is choosing a state of incorporation. Although most entrepreneurs incorporate in the state where they conduct business, many incorporate in other states with more favorable corporation laws. Such laws might provide for little or no income, sales, or use taxes; low minimum capital requirements; and modest incorporation fees. Regardless of the state of incorporation, the entrepreneur must follow the incorporation procedure set forth in the applicable state statute. Typically, under this procedure, the entrepreneur must file articles of incorporation with the appropriate state agency. The articles must specify certain information, such as the formal name of the corporation; its purpose; the par value, number of shares, and classes of stock it is authorized to issue; and the names of the individuals who will initially serve on the corporation's board of directors. The state usually charges a fee for incorporation or filing. In addition, it periodically may assess a franchise tax for the privilege of doing business in the state. These fees and taxes could be substantial.

ADDITIONAL COMMENT

States are not consistent in how they tax corporations. Certain states have no state income taxes. Other states do not recognize an S corporation election, thereby taxing an S corporation as a C corporation.

TAX CONSIDERATIONS

Once the entrepreneur decides on the corporate form, he or she must transfer cash, property (e.g., equipment, furniture, inventory, and receivables), or services (e.g., accounting, legal, or architectural services) to the corporation in exchange for its debt or equity. These transfers may have tax consequences for both the transferor investor and the transferee corporation. For instance, the sale of property for stock usually is taxable to the transferor.⁹ However, if Sec. 351(a) (which treats an investor's interest in certain transferred business assets to be "changed in form" rather than "disposed of") applies, any gain or loss realized on the exchange may be deferred. In determining the tax consequences of incorporation, one must answer the following questions:

- ▶ What property should be transferred to the corporation?
- ▶ What services should the transferors or third parties provide for the corporation?

⁸ Reg. Sec. 301.7701-3(g). An alternative way for a corporation to be taxed as a pass-through entity is to make an election to be taxed as an S corporation. See Chapter C:11.

⁹ Sec. 1001.

- What liabilities, in addition to property, should be transferred?
- Do the transferor shareholders have control of the corporation after the transfers?

Example C:2-10 and Table C:2-1 compare the tax consequences of taxable and nontaxable property transfers.

EXAMPLE C:2-10 ► For several years Brad has operated a successful manufacturing business as a sole proprietorship. To limit his liability, he decides to incorporate his business as Block Corporation. Immediately preceding the incorporation, he reports the following balance sheet for his sole proprietorship, which uses the accrual method of accounting:

		<i>Adjusted Basis</i>	<i>Fair Market Value</i>
Assets:			
Cash		\$ 10,000	\$ 10,000
Accounts receivable		15,000	15,000
Inventory		20,000	25,000
Equipment	\$120,000		
Minus: Depreciation	(35,000)	85,000	100,000
Total		<u>\$ 130,000</u>	<u>\$ 150,000</u>
Liabilities and owner's equity:			
Accounts payable		\$ 30,000	\$ 30,000
Note payable on equipment		50,000	50,000
Owner's equity		50,000	70,000
Total		<u>\$ 130,000</u>	<u>\$ 150,000</u>

When Brad transfers the assets to Block in exchange for its stock, he realizes a gain because the value of the stock received exceeds his basis in the assets. If the exchange is taxable, Brad recognizes \$5,000 of ordinary income on the transfer of the inventory (\$25,000 FMV – \$20,000 basis) and, because of depreciation recapture, \$15,000 of ordinary income on the transfer of the equipment (\$100,000 FMV – \$85,000 basis). However, if the exchange meets the requirements of Sec. 351(a), it is nontaxable. In other words, Brad recognizes none of the income or gain realized on the transfer of assets and liabilities to Block. ◀

? STOP & THINK

Question: Joyce has conducted a business as a sole proprietorship for several years. She needs additional capital and wants to incorporate her business. The assets of her business (building, land, inventory, etc.) have a \$400,000 adjusted basis and a \$1.5 million FMV. Joyce is willing to exchange the assets for 1,500 shares of Ace Corporation stock, each having a \$1,000 fair market value. Bill and John each are willing to invest \$500,000 cash in Joyce's business for 500 shares of stock. Why is Sec. 351 relevant to Joyce? Does it matter to Bill and John?

Solution: If not for Sec. 351, Joyce would recognize gain on the incorporation of her business. She realizes a gain of \$1.1 million (\$1,500,000 – \$400,000) on her contribution of proprietorship assets to a new corporation in exchange for 60% of its outstanding shares ($1,500 \div [1,500 + 500 + 500] = 0.60$). However, she recognizes none of this gain because she meets the requirements of Sec. 351. Section 351 does not affect Bill or John because each is simply purchasing 20% of the new corporation's stock for \$500,000 cash. Nevertheless, their contribution of cash, which counts as property, allows the three shareholders to have 100% control after the transfer. They will not realize or recognize gain or loss unless they subsequently sell their stock at a price above or below the \$500,000 cost.

If all exchanges of property for corporate stock were taxable, many entrepreneurs would find the tax cost of incorporating their business prohibitively high. In Example C:2-10, for example, Brad would recognize a \$20,000 gain on the exchange of his assets for the corporate stock. Moreover, because losses also are realized in an exchange, without special rules, taxpayers could exchange loss property for stock and recognize the loss while maintaining an equity interest in the property transferred.

▼ TABLE C:2-1

Overview of Corporate Formation Rules

Tax Treatment for:	Taxable Property Transfer	Nontaxable Property Transfer
<i>Transferors:</i> 1. Gain realized	FMV of stock received Money received FMV of noncash boot property (including securities) received Amount of liabilities assumed by transferee corporation Minus: Adjusted basis of property transferred Realized gain (Sec. 1001(a))	Same as in a taxable transaction
2. Gain recognized	Transferors recognize the entire amount of realized gain (Sec. 1001(c)) Losses may be disallowed under related party rules (Sec. 267(a)(1)) Installment sale rules may apply to the realized gain (Sec. 453)	Transferors recognize none of the realized gain unless one of the following exceptions applies (Sec. 351(a)): a. Boot property is received (Sec. 351(b)) b. Liabilities are transferred to the corporation for a nonbusiness or tax avoidance purpose (Sec. 357(b)) c. Liabilities exceeding basis are transferred to the corporation (Sec. 357(c)) d. Services, certain corporate indebtedness, and interest claims are transferred to the corporation (Sec. 351(d)) The installment method may defer recognition of gain when a shareholder receives a corporate note as boot (Sec. 453)
3. Basis of qualified stock and other property received	FMV (Cost) (Sec. 1012)	Basis of property transferred to the corporation Plus: Gain recognized Minus: Money received (including liabilities treated as money) FMV of noncash boot property Total basis of qualified stock received (Sec. 358(a)) Allocation of total qualified stock basis is based on relative FMVs Basis of noncash boot property is its FMV (Sec. 358(a))
4. Holding period of property received	Day after the exchange date	Holding period of qualified stock received includes holding period of Sec. 1231 property or capital assets transferred; otherwise it begins the day after the exchange date
<i>Transferee Corporation:</i> 1. Gain recognized	The corporation recognizes no gain or loss on the receipt of money or other property in exchange for its stock (including treasury stock) (Sec. 1032)	Same as taxable transaction except the corporation may recognize gain under Sec. 311 if it transfers appreciated noncash boot property (Sec. 351(f))
2. Basis	FMV (Cost) (Sec. 1012)	Generally, same as in transferor's hands plus any gain recognized by transferor (Sec. 362) If the total adjusted basis of all transferred property exceeds the total FMV of the property, the total basis to the transferor is limited to the property's total FMV
3. Holding period	Day after the exchange date	Transferor's carryover holding period for the property transferred regardless of the property's character (Sec. 1223(2))

To allow taxpayers to incorporate without incurring a high tax cost and to prevent taxpayers from recognizing losses while maintaining an equity claim to the loss assets, Congress enacted Sec. 351.

SECTION 351: DEFERRING GAIN OR LOSS UPON INCORPORATION

OBJECTIVE 4

Discuss the requirements for deferring gain or loss upon incorporation

TAX STRATEGY TIP

A transferor who wishes to recognize gain or loss must take steps to avoid Sec. 351 by deliberately failing at least one of its requirements or by engaging in sales transactions. See Tax Planning Considerations at the end of this chapter for details.

Section 351(a) provides that transferors recognize no gain or loss when they transfer property to a corporation solely in exchange for the corporation's stock if immediately after the exchange, the transferors are in control of the corporation. Section 351 does not apply to a transfer of property to an investment company, nor does it apply in certain bankruptcy cases.

This rule is based on the premise that, when property is transferred to a controlled corporation, the transferors merely exchange direct ownership for indirect ownership through stock in the transferee corporation, which gives them an equity interest in the underlying assets. In other words, the transferors maintain a continuity of interest in the transferred property. Furthermore, if the only consideration the shareholders receive is stock, they have not generated cash with which to pay their taxes. If the transferors of property receive other consideration in addition to stock, such as cash or debt instruments, they will have the wherewithal to pay taxes and, under Sec. 351(b), may have to recognize some or all of their realized gain.

A transferor's realized gain or loss that is unrecognized for tax purposes is not exempt from taxation. It is only *deferred* until the shareholder sells or exchanges the stock received in the Sec. 351 exchange. Shareholders who receive stock in such an exchange take a stock basis that reflects the deferred gain or loss. For example, if a shareholder receives stock in exchange for property and recognizes no gain or loss, the stock basis equals the basis of property transferred less liabilities assumed by the corporation (see Table C:2-1). This tax treatment is discussed later in this chapter. Under an alternative approach, the stock basis can be calculated as follows: FMV of qualified stock received, minus any deferred gain (or plus any deferred loss). This latter approach highlights the deferral aspect of this type of transaction. If the shareholder later sells the stock, he or she will recognize the deferred gain or loss inherent in the basis adjustment.

EXAMPLE C:2-11 ►

Assume the same facts as in Example C:2-10. If Brad satisfies the conditions of Sec. 351, he will not recognize the \$20,000 realized gain (\$15,000 gain on equipment + \$5,000 gain on inventory) when he transfers the assets and liabilities of his sole proprietorship to Block Corporation. Under the alternative approach, Brad's basis in the Block stock is its FMV decreased to reflect the deferred gain. Thus, Brad's basis in the Block stock is \$50,000 (\$70,000 FMV – \$20,000 deferred gain). If Brad later sells his stock for its \$70,000 FMV, he will recognize the \$20,000 gain at the time of sale. ◀

ADDITIONAL COMMENT

As will be discussed later in this chapter, the statutory method for arriving at Brad's stock basis is the adjusted basis of property transferred (\$130,000) minus liabilities assumed by the corporation (\$80,000), again \$50,000.

The specific requirements for deferral of gain and loss under Sec. 351(a) are

- The transferors must transfer property to the corporation.
- They must receive stock of the transferee corporation in exchange for their property.
- They must be in control of the corporation immediately after the exchange.

Each of these requirements is explained below.

THE PROPERTY REQUIREMENT

The rule of gain or loss nonrecognition applies only to transfers of property to a corporation in exchange for the corporation's stock. Section 351 does not define the term *property*. However, the courts and the IRS have defined *property* to include cash and almost any other asset, including installment obligations, accounts receivable, inventory,

equipment, patents and other intangibles representing know-how, trademarks, trade names, and computer software.¹⁰

Excluded from the statutory definition of property are¹¹

- ▶ Services (such as legal or accounting services) rendered to the corporation in exchange for its stock
- ▶ Indebtedness of the transferee corporation not evidenced by a security
- ▶ Interest on transferee corporation debt that accrued on or after the beginning of the transferor's holding period for the debt

The first of these exclusions perhaps is the most important. A person receiving stock in compensation for services must recognize the stock's FMV as ordinary income for tax purposes. In other words, an exchange of services for stock is a taxable transaction even where concurrent transfers of property for stock are nontaxable under Sec. 351.¹² A shareholder's basis in the stock received in compensation for services is the stock's FMV (not necessarily the FMV of the services).

EXAMPLE C:2-12 ▶ Amy and Bill form West Corporation. Amy exchanges property for 90 shares (90% of the outstanding shares) of West stock. Amy's exchange is nontaxable because Amy has exchanged property for stock and controls West immediately after the exchange. Bill performs accounting services that he normally bills for \$12,000 in exchange for ten shares of West stock worth \$10,000. Bill's exchange is taxable because he has provided services in exchange for stock. Thus, Bill recognizes \$10,000 of ordinary income—the FMV of the stock—as compensation for his services. Bill's basis in the stock is its \$10,000 FMV. ◀

THE CONTROL REQUIREMENT

Section 351 requires the transferors, as a group, to be in control of the transferee corporation immediately after the exchange. A transferor may be an individual or any type of entity (such as a partnership, another corporation, or a trust). Section 368(c) defines *control* as ownership of at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock (e.g., nonvoting preferred stock).¹³ The minimum ownership levels for nonvoting stock apply to each class of stock rather than to the nonvoting stock in total.¹⁴

EXAMPLE C:2-13 ▶ Dan exchanges property having a \$22,000 adjusted basis and a \$30,000 FMV for 60% of newly created Sun Corporation's single class of stock. Ed exchanges \$20,000 cash for the remaining 40% of Sun stock. The transaction qualifies as a nontaxable exchange under Sec. 351 because the transferors, Dan and Ed, together own at least 80% of the Sun stock immediately after the exchange. Therefore, Dan defers recognition of his \$8,000 (\$30,000 – \$22,000) realized gain. (Ed realizes no gain because he contributes cash.) ◀

Because services do not qualify as property, stock received by a person who exclusively provides services does not count toward the 80% control threshold. Unless transferors of property own at least 80% of the corporation's stock immediately after the exchange, the control requirement will not be met, and the entire transaction will be taxable.

EXAMPLE C:2-14 ▶ Dana transfers property having an \$18,000 adjusted basis and a \$35,000 FMV to newly created York Corporation for 70 shares of York stock. Ellen provides legal services for the remaining 30 York shares valued at \$15,000. Because Ellen does not transfer property to York, her stock is not counted toward the 80% ownership threshold. On the other hand, because Dana transfers property to York, his stock is counted toward this threshold. However, Dana is not in control of York immediately after the exchange because he owns only 70% of York stock. Therefore, Dana recognizes all \$17,000 (\$35,000 – \$18,000) of his gain realized on the exchange. Dana's basis in his York stock is its \$35,000 FMV. Ellen recognizes \$15,000 of ordinary income, the FMV of stock received for her services. Ellen's basis in her York stock is \$15,000. The tax consequences to Ellen are the same whether or not Dana meets the control requirement. ◀

¹⁰ For an excellent discussion of the definition of *property*, see footnote 6 of *D.N. Stafford v. U.S.*, 45 AFTR 2d 80-785, 80-1 USTC ¶9218 (5th Cir., 1980).

¹¹ Sec. 351(d).

¹² Secs. 61 and 83.

¹³ In determining whether the 80% requirements are satisfied, the constructive ownership rules of Sec. 318 do not apply (see Rev. Rul. 56-613, 1956-2 C.B. 212). See Chapter C:4 for an explanation of Sec. 318.

¹⁴ Rev. Rul. 59-259, 1959-2 C.B. 115, as modified by Rev. Rul. 81-17, 1981-1 C.B. 75.

If the property transferors own at least 80% of the stock immediately after the exchange, they, but not the provider of services, will be in control of the transferee corporation.

EXAMPLE C:2-15 ► Assume the same facts as in Example C:2-14, except a third individual, Fred, contributes \$35,000 in cash for 70 shares of York stock. Now Dana and Fred together own more than 80% of the York stock ($140 \div 170 = 0.82$) immediately after the exchange. Therefore, the transaction meets the Sec. 351 control requirement, and neither Dana nor Fred recognizes gain on the exchange. Ellen still must recognize \$15,000 of ordinary income, the FMV of the stock she receives for her services. ◀

Transferors of Both Property and Services. If a person transfers both services *and* property to a corporation in exchange for the corporation's stock, all the stock received by that person, including stock received in exchange for services, is counted toward the 80% control threshold.¹⁵

EXAMPLE C:2-16 ► Assume the same facts as in Example C:2-14 except that, in addition to providing legal services in exchange for stock worth \$15,000, Ellen contributes property worth at least \$1,500. In this case, all of Ellen's stock counts toward the 80% ownership threshold. Because Dana and Ellen together own 100% of the York stock, the exchange meets the Sec. 351 control requirement. Therefore, Dana recognizes no gain on his property exchange. However, Ellen still must recognize \$15,000 of ordinary income, the FMV of the stock received as compensation for services. ◀

When a person transfers both property and services in exchange for a corporation's stock, the property must have more than nominal value for that person's stock to count toward the 80% control threshold.¹⁶ The IRS generally requires that the FMV of the stock received for transferred property be at least 10% of the value of the stock received for services provided. If the value of the stock received for the property is less than 10% of the value of the stock received for the services, the IRS will not issue an advance ruling to the effect that the transaction meets the requirements of Sec. 351.¹⁷

EXAMPLE C:2-17 ► Assume the same facts as in Example C:2-16 except that Ellen contributes only \$1,000 worth of property in addition to the legal services. In this case, the IRS will not issue an advance ruling that the transaction meets the Sec. 351 requirements because the FMV of stock received for the property (\$1,000) is less than 10% of the value of the stock received for the services ($\$1,500 = 0.10 \times \$15,000$). Consequently, if the IRS audits Ellen's tax return for the year of transfer, it probably will challenge Dana's and Ellen's position that the transfer is nontaxable under Sec. 351. ◀

Transfers to Existing Corporations. Section 351 applies to transfers to an existing corporation as well as transfers to a newly created corporation. The same requirements must be met in both cases. Property must be transferred in exchange for stock, and the property transferors must be in control of the corporation immediately after the exchange.

EXAMPLE C:2-18 ► Jack and Karen own 75 and 25 shares, respectively, of Texas Corporation stock. Jack transfers property with a \$15,000 adjusted basis and a \$25,000 FMV to the corporation in exchange for an additional 25 shares of Texas stock. The transaction meets the Sec. 351 control requirement because, immediately after the exchange, Jack owns 80% ($100 \div 125 = 0.80$) of Texas stock. Therefore, Jack recognizes no gain. ◀

If a shareholder transfers property to an existing corporation for additional stock but does not own at least 80% of the stock immediately after the exchange, the control requirement is not met. Thus, Sec. 351 denies tax-free treatment for many transfers of property to an existing corporation by a new shareholder. A new shareholder's transfer of property to an existing corporation is nontaxable only if that shareholder acquires at least 80% of the corporation's stock, or if enough existing shareholders also transfer additional property so that the transferors as a group, including the new shareholder, control the corporation immediately after the exchange.

¹⁵ Reg. Sec. 1.351-1(a)(2), Ex. (3).

¹⁶ Reg. Sec. 1.351-1(a)(1)(ii).

¹⁷ Rev. Proc. 77-37, 1977-2 C.B. 568, Sec. 3.07, as modified by T.D. 8761, 1998-1 C.B. 812.

EXAMPLE C:2-19 ▶ Alice owns all 100 shares of Local Corporation stock, valued at \$100,000. Beth owns property with a \$15,000 adjusted basis and a \$100,000 FMV. Beth contributes the property to Local in exchange for 100 shares of newly issued Local stock. The transaction does not meet the Sec. 351 control requirement because Beth owns only 50% of Local stock immediately after the exchange. Consequently, Beth recognizes an \$85,000 (\$100,000 – \$15,000) gain. ◀

If an existing shareholder exchanges property for additional stock to enable another shareholder to qualify for tax-free treatment under Sec. 351, the stock received must be of more than nominal value.¹⁸ For advance ruling purposes, the IRS requires that this value be at least 10% of the value of the stock already owned.¹⁹

EXAMPLE C:2-20 ▶ Assume the same facts as in Example C:2-19 except that Alice transfers additional property worth \$10,000 for an additional ten shares of Local stock. Now both Alice and Beth are transferors, thereby satisfying the Sec. 351 control requirement. Consequently, neither Alice nor Beth recognizes gain on the exchange. If Alice receives fewer than ten shares, the IRS will not issue an advance ruling that the exchange is tax-free under Sec. 351. ◀

? STOP & THINK

Question: Matthew and Michael each own 50 shares of Main Corporation stock having a \$250,000 FMV. Matthew wants to transfer property with a \$40,000 adjusted basis and a \$100,000 FMV to Main in exchange for an additional 20 shares. Can Matthew avoid recognizing \$60,000 (\$100,000 – \$40,000) of the gain realized on the transfer?

Solution: If Matthew simply exchanges the property for additional stock, he must recognize the gain. The Sec. 351 control requirement will not have been met because Matthew will own only 70 of the 120 outstanding shares (or 58.33%) immediately after the exchange.

Gain recognition can be avoided in two ways:

1. Matthew can transfer sufficient property (i.e., \$750,000 worth) to Main to receive 150 additional shares so that, immediately after the exchange, he will own 80% (200 out of 250 shares) of Main stock.
2. Alternatively, Michael also can contribute additional property to qualify as a transferor. Specifically, he can contribute to the corporation at least \$25,000, or 10% of the \$250,000 value of the Main stock that he already owns so that together the two transferors will own 100% of Main stock immediately after the exchange.

Disproportionate Exchanges of Property and Stock. Section 351 does not require that the value of the stock received by the transferors be proportionate to the value of the property transferred. However, if the value of the stock received is *not* proportionate to the value of the property transferred, the exchange may be treated in accordance with its economic effect, that is, a proportional exchange followed by a constructive gift, compensation payment, or extinguishment of a liability owed by one shareholder to another.²⁰ If the deemed effect of the transaction is a gift from one transferor to another, for example, the “donor” will be treated as though he or she received stock equal in value to that of the property contributed and then gave some of the stock to the “donee.”

EXAMPLE C:2-21 ▶ Don and his son John transfer property worth \$75,000 (adjusted basis of \$42,000 to Don) and \$25,000 (adjusted basis of \$20,000 to John), respectively, to newly formed Star Corporation in exchange for all 100 shares of Star stock. Don and John receive 25 and 75 Star shares, respectively. Because Don and John are in control of Star immediately after the exchange, they recognize no gain or loss. However, because Don and John did not receive the stock in proportion to the FMV of their respective property contributions, Don might be deemed to have received 75 shares (worth \$75,000), then to have given 50 shares (worth \$50,000) to John. If the IRS deems such a gift, it might require Don to pay gift taxes. Don’s basis in his remaining 25 shares is \$14,000 $[(25 \div 75) \times \$42,000 \text{ basis in the property transferred}]$. John’s basis in the 75 shares is \$48,000 $[\$20,000 \text{ basis in the property transferred by John} + (\$42,000 - \$14,000) \text{ basis in the shares deemed to have been gifted by Don}]$. ◀

¹⁸ Reg. Sec. 1.351-1(a)(1)(ii).

¹⁹ Rev. Proc. 77-37, 1977-2 C.B. 568, Sec. 3.07, as modified by T.D. 8761, 1998-1 C.B. 812.

²⁰ Reg. Sec. 1.351-1(b)(1).

Immediately After the Exchange. Section 351 requires that the transferors be in control of the transferee corporation “immediately after the exchange.” This requirement does not mean that all transferors must simultaneously exchange their property for stock. It does mean, however, that all the exchanges must be agreed to beforehand, and the agreement must be executed in an expeditious and orderly manner.²¹

EXAMPLE C:2-22 ►

TAX STRATEGY TIP

If one shareholder has a prearranged plan to dispose of his or her stock, and the disposition reduces the ownership of the transferor shareholders below the required 80% control, such disposition can disqualify the Sec. 351 transaction for all the shareholders. As a precaution, all shareholders should provide a written representation that they do not currently have a plan to dispose of their stock.

Art, Beth, and Carlos form New Corporation. Art and Beth each transfer noncash property worth \$25,000 in exchange for one-third of the New stock. Carlos contributes \$25,000 cash for another one-third of the New stock. On January 10, Art and Carlos transfer their property and cash, respectively. Beth transfers her property on March 3. Because all three transfers are part of the same prearranged transaction, the transferors are deemed to be in control of the corporation immediately after the exchange. ◀

Section 351 does not require the transferors to retain control of the transferee corporation for any specific length of time after the exchange. Control is required only “immediately after the exchange.” The IRS has interpreted this phrase to mean that the transferors must not have a prearranged plan to dispose of their stock outside the control group. If they do have such a plan, they are not considered to be in control immediately after the exchange.²²

EXAMPLE C:2-23 ►

Amir, Bill, and Carl form White Corporation. Each contributes to White appreciated property worth \$25,000 in exchange for one-third of White stock. Before the exchange, Amir arranges to sell his stock to Dana as soon as he receives it. This prearranged plan implies that Amir, Bill, and Carl do *not* have control immediately after the exchange because Bill and Carl own only 66.7% of the stock while Amir has disposed of his interest. Therefore, each must recognize gain on the exchange. ◀

THE STOCK REQUIREMENT

Under Sec. 351, transferors who exchange property solely for transferee corporation qualified stock recognize no gain or loss if they control the corporation immediately after the exchange. For this purpose, qualified stock may be voting or nonvoting and may be common stock or qualified preferred stock. On the other hand, *nonqualified* preferred stock is treated as boot. Preferred stock generally has a preferred claim to dividends and liquidating distributions. Such stock, however, is nonqualified if

- The shareholder can require the corporation to redeem it,
- The corporation either is required to redeem the stock or is likely to exercise a right to redeem it, or
- The dividend rate on the stock varies with interest rates, commodity prices, or other similar indices.

These features render the preferred stock more like cash or debt than like equity. Thus, it is treated as boot subject to the rules discussed below. In addition, stock rights or stock warrants are not considered stock for purposes of Sec. 351.²³

Topic Review C:2-1 summarizes the major requirements for a nontaxable exchange under Sec. 351.

EFFECT OF SEC. 351 ON THE TRANSFERORS

If all Sec. 351 requirements are met, the transferors recognize no gain or loss on the exchange of their property for stock in the transferee corporation. The receipt of property other than stock does not necessarily render the entire transaction taxable. Rather, it could result in the recognition of all or part of the transferors' realized gain.

Receipt of Boot. If a transferor receives any money or property other than stock in the transferee corporation, the additional money or property is considered to be boot. Boot may include cash, notes, securities, nonqualified preferred stock, or stock in another corporation. Upon receiving boot, the transferor recognizes gain to the extent of the lesser of the transferor's

²¹ Reg. Sec. 1.351-1(a)(1).

²² Rev. Rul. 79-70, 1979-1 C.B. 144.

²³ Reg. Sec. 1.351-1(a)(1)(ii).

TOPIC REVIEW C:2-1

Major Requirements of Sec. 351

1. The nonrecognition of gain or loss rule applies only to transfers of property in exchange for a corporation's qualified stock. It does not apply to an exchange of services for stock.
2. The property transferors must be in control of the transferee corporation immediately after the exchange. Control means ownership of at least 80% of the voting power and at least 80% of the total number of shares of all other classes of stock. Stock disposed of after the exchange pursuant to a prearranged plan does not meet the "immediately after the exchange" requirement.
3. The nonrecognition rule applies only to the gain realized in an exchange of property for qualified stock. If the transferor receives property other than qualified stock, such property is considered to be boot. The transferor recognizes gain to the extent of the lesser of the FMV of any boot received or the realized gain.

realized gain or the FMV of the boot property received.²⁴ A transferor never recognizes a loss in an exchange qualifying under Sec. 351 whether or not he or she receives boot.

The character of the recognized gain depends on the type of property transferred. For example, if the shareholder transfers a capital asset such as stock in another corporation, the recognized gain is capital in character. If the shareholder transfers Sec. 1231 property, such as equipment or a building, the recognized gain is ordinary in character to the extent of any depreciation recaptured under Sec. 1245 or 1250.²⁵ Thus, depreciation is not recaptured unless the transferor receives boot and recognizes a gain on the depreciated property transferred.²⁶ If the shareholder transfers inventory, the recognized gain is entirely ordinary in character.

EXAMPLE C:2-24 ▶ Pam, Rob, and Sam form East Corporation and transfer the following property:

<i>Transferor</i>	<i>Asset</i>	<i>Transferor's Adj. Basis</i>	<i>FMV</i>	<i>Consideration Received</i>
Pam	Machinery	\$ 10,000	\$ 12,500	25 shares East stock
Rob	Land	18,000	25,000	40 shares East stock and \$5,000 East note
Sam	Cash	17,500	17,500	35 shares East stock

The machinery is Sec. 1231 property, and the land is a capital asset. The exchange meets the requirements of Sec. 351 except that, in addition to East stock, Rob receives boot of \$5,000 (the FMV of the note). Rob realizes a \$7,000 (\$25,000 – \$18,000) gain, of which he recognizes \$5,000—the lesser of the \$7,000 realized gain or the \$5,000 boot received. The gain is capital in character because the property transferred was a capital asset in Rob's hands. Pam realizes a \$2,500 gain on her exchange of machinery. However, even though Pam would have been required to recapture depreciation had she sold or exchanged the machinery, she recognizes no gain because she received no boot. Sam neither realizes nor recognizes gain on his cash purchase of East stock.

ADDITIONAL COMMENT

If multiple assets were aggregated into one computation, any built-in losses would be netted against the gains. Such a result is inappropriate because losses cannot be recognized in a Sec. 351 transaction.

Computing Gain When Several Assets Are Transferred. Revenue Ruling 68-55 adopts a "separate properties approach" for computing gain or loss when a shareholder transfers more than one asset to a corporation.²⁷ Under this approach, the gain or loss realized and recognized is computed separately for each property transferred. The transferor is deemed to have received a proportionate share of stock, securities, and boot in exchange for each property transferred, based on the assets' relative FMVs.

EXAMPLE C:2-25 ▶ Joan transfers two assets to newly formed North Corporation in a transaction qualifying in part for tax-free treatment under Sec. 351. The total FMV of the assets is \$100,000. The consideration

²⁴ Sec. 351(b).

²⁵ Section 1239 also may require some gain to be characterized as ordinary income. Section 1250 ordinary depreciation recapture will not apply to real property placed in service after 1986 because MACRS mandates straight-line depreciation.

²⁶ Secs. 1245(b)(3) and 1250(c)(3).

²⁷ 1968-1 C.B. 140, as amplified by Rev. Rul. 85-164, 1985-2 C.B. 117.

received by Joan consists of \$90,000 of North stock and \$10,000 of North notes. The following data illustrate how Joan determines her realized and recognized gain under the procedure set forth in Rev. Rul. 68-55.

	<u>Asset 1</u>	<u>Asset 2</u>	<u>Total</u>
Asset's FMV	\$40,000	\$60,000	\$100,000
Percent of total FMV	40%	60%	100%
Consideration received in exchange for asset:			
Stock (Stock × percent of total FMV)	\$36,000	\$54,000	\$ 90,000
Notes (Notes × percent of total FMV)	<u>4,000</u>	<u>6,000</u>	<u>10,000</u>
Total proceeds	\$40,000	\$60,000	\$100,000
Minus: Adjusted basis	(65,000)	(25,000)	(90,000)
Realized gain (loss)	<u>(\$25,000)</u>	<u>\$ 35,000</u>	<u>\$ 10,000</u>
Boot received	\$ 4,000	\$ 6,000	\$ 10,000
Recognized gain (loss)	None	\$ 6,000	\$ 6,000

Under the separate properties approach, the loss realized on the transfer of Asset 1 does not offset the gain realized on the transfer of Asset 2. Therefore, Joan recognizes \$6,000 of the total \$10,000 realized gain, even though she receives \$10,000 of boot. Joan's selling Asset 1 to North so as to recognize the loss might be advisable. However, the Sec. 267 loss limitation rules may apply to Joan if she is a controlling shareholder (see page C:2-35). ◀

Computing a Shareholder's Basis.

Boot Property. A transferor's basis in any boot property received is the property's FMV.²⁸

Stock. A shareholder computes his or her adjusted basis in stock received in a Sec. 351 exchange as follows:²⁹

Adjusted basis of property transferred to the corporation	
Plus: Any gain recognized by the transferor	
Minus: FMV of boot received from the corporation	
Money received from the corporation	
Liabilities assumed by the corporation	
<u>Adjusted basis of stock received</u>	

EXAMPLE C:2-26 ►

ADDITIONAL COMMENT

Because Sec. 351 is a deferral provision, any unrecognized gain must be reflected in the basis of the stock received by the transferor shareholder and is accomplished by substituting the shareholder's basis in the property transferred for the basis of the stock received. This substituted (exchanged) basis may be further adjusted by gain recognized and boot received.

Bob transfers a capital asset having a \$50,000 adjusted basis and an \$80,000 FMV to South Corporation. He acquired the property two years ago. Bob receives all 100 shares of South stock, having a \$70,000 FMV, plus a \$10,000 90-day South note (boot property). Bob realizes a \$30,000 gain on the exchange, computed as follows:

FMV of stock received	\$70,000
Plus: FMV of 90-day note	<u>10,000</u>
Amount realized	\$80,000
Minus: Adjusted basis of property transferred	<u>(50,000)</u>
Realized gain	<u>\$30,000</u>

Bob's recognized gain is \$10,000, i.e., the lesser of the \$30,000 realized gain or the \$10,000 FMV of the boot property. This gain is long-term and capital in character. The Sec. 351 rules effectively require Bob to defer \$20,000 (\$30,000 – \$10,000) of his realized gain. Bob's basis in the South stock is \$50,000, computed as follows:

Adjusted basis of property transferred	\$50,000
Plus: Gain recognized by Bob	10,000
Minus: FMV of boot received	<u>(10,000)</u>
Adjusted basis of Bob's stock	<u>\$50,000</u> ◀

²⁸ Sec. 358(a)(2).

²⁹ Sec. 358(a)(1).

If a transferor receives more than one class of qualified stock, his or her basis must be allocated among the classes according to their relative FMVs.³⁰

EXAMPLE C:2-27 ▶

SELF-STUDY QUESTION

What is an alternative method for determining the basis of the assets received by the transferor shareholder? How is this method applied to Bob in Example C:2-26?

ANSWER

The basis of all boot property is its FMV, and the basis of qualified stock received is the stock's FMV minus any deferred gain or plus any deferred loss. Bob's stock basis under the alternative method is \$50,000 (\$70,000 FMV of stock – \$20,000 deferred gain).

Assume the same facts as in Example C:2-26 except Bob receives 100 shares of South common stock with a \$45,000 FMV, 50 shares of South qualified preferred stock with a \$25,000 FMV, and a 90-day South note with a \$10,000 FMV. The total adjusted basis of the stock is \$50,000 (\$50,000 basis of property transferred + \$10,000 gain recognized – \$10,000 FMV of boot received). This basis must be allocated between the common and qualified preferred stock according to their relative FMVs, as follows:

$$\text{Basis of common stock} = \frac{\$45,000}{\$45,000 + \$25,000} \times \$50,000 = \$32,143$$

$$\text{Basis of preferred stock} = \frac{\$25,000}{\$45,000 + \$25,000} \times \$50,000 = \$17,857$$

Bob's basis in the note is its \$10,000 FMV. ▶

Transferor's Holding Period. The transferor's holding period for any stock received in exchange for a capital asset or Sec. 1231 property includes the holding period of the property transferred.³¹ If the transferor exchanged any other kind of property (e.g., inventory) for the stock, the transferor's holding period for the stock begins on the day after the exchange. Likewise, the holding period for boot property begins on the day after the exchange.

EXAMPLE C:2-28 ▶

Assume the same facts as in Example C:2-26. Bob's holding period for the stock includes the holding period of the capital asset transferred. His holding period for the note starts on the day after the exchange. ▶



STOP & THINK

Question: The holding period for stock received in exchange for a capital asset or Sec. 1231 property includes the holding period of the transferred item. The holding period for inventory or other assets begins on the day after the exchange. Why the difference?

Solution: Because stock received in a Sec. 351 exchange represents a "continuity of interest" in the property transferred, logically the stock should not only be valued and characterized in the same manner as the asset exchanged for the equity claim, but also accorded the same tax attributes. Because the holding period of a capital asset is relevant in determining the character of gain or loss realized (i.e., long-term or short-term) on the asset's subsequent sale, stock received in a tax-free exchange of the asset should be accorded the same holding period for the purpose of determining the character of gain or loss realized on the stock's subsequent sale. By the same token, because the holding period of a noncapital asset is less relevant in determining the character of gain or loss realized on the asset's subsequent sale, stock received in a tax-free exchange of the asset need not be accorded the same holding period for the purpose of determining the character of gain or loss realized on the stock's subsequent sale. Given the very nature of a noncapital asset, this gain or loss generally is ordinary in character, in any event. Moreover, if stock received in exchange for a noncapital asset were accorded a holding period that includes that of the transferred property, a transferor could sell the stock in a short time to realize a long-term capital gain, thereby converting ordinary income (potentially from the sale of the noncapital asset) into capital gain from the sale of stock.

Topic Review C:2-2 summarizes the tax consequences of a Sec. 351 exchange to the transferor(s) and the transferee corporation.

³⁰ Sec. 358(b)(1) and Reg. Sec. 1.358-2(b)(2).

³¹ Sec. 1223(1). Revenue Ruling 85-164 (1985-2 C.B. 117) provides that a single share of stock may have two holding periods: a carryover holding period for the portion of such share received in exchange for a capital asset or

Sec. 1231 property and a holding period that begins on the day after the exchange for the portion of such share received for inventory or other property. The split holding period is relevant only if the transferor sells the stock received within one year of the transfer date.

TOPIC REVIEW C:2-2

Tax Consequences of a Sec. 351 Exchange

TO TRANSFEROR(S):

1. Transferors recognize no gain or loss when they exchange property for qualified stock. Exception: A transferor recognizes gain equal to the lesser of the realized gain or the sum of any money received plus the FMV of any non-cash property received. The character of the gain depends on the type of property transferred.
2. The basis of the qualified stock received equals the adjusted basis of the property transferred plus any gain recognized by the transferor minus the FMV of any boot property received minus any money received (including liabilities assumed or acquired by the transferee corporation).
3. The holding period of qualified stock received in exchange for capital assets or Sec. 1231 property includes the holding period of the transferred property. The holding period of stock received in exchange for any other property begins on the day after the exchange.

TO TRANSFEEE CORPORATION:

1. A corporation recognizes no gain or loss when it exchanges its own stock for property or services.
2. The corporation's basis in property received is the transferor's basis plus any gain recognized by the transferor. However, if the total adjusted basis of all transferred property exceeds the total FMV of the property, the total basis to the transferee is limited to the property's total FMV.
3. The corporation's holding period for property received includes the transferor's holding period.

ADDITIONAL COMMENT

The nonrecognition rule for corporations that issue stock for property applies whether or not the transaction qualifies the transferor shareholder for Sec. 351 treatment.

TAX CONSEQUENCES TO TRANSFEEE CORPORATION

A corporation that issues stock or debt for property or services is subject to various IRC rules for determining the tax consequences of that exchange.

Gain or Loss Recognized by the Transferee Corporation. Corporations recognize no gain or loss when they issue their own stock in exchange for property or services.³² This result ensues whether or not Sec. 351 governs the exchange and whether or not the corporation issues new stock or treasury stock.

EXAMPLE C:2-29 ► West Corporation pays \$10,000 to acquire 100 shares of its own stock from existing shareholders. The next year, West reissues these 100 treasury shares in exchange for land having a \$15,000 FMV. West realizes a \$5,000 (\$15,000 – \$10,000) gain on the exchange but recognizes none of this gain. ◀

Corporations also recognize no gain or loss when they exchange their own debt instruments for property or services. On the other hand, a corporation recognizes gain (but not loss) if it transfers appreciated property to a transferor as part of a Sec. 351 exchange. The amount and character of the gain are determined as though the property had been sold by the corporation immediately before the transfer.

EXAMPLE C:2-30 ► Alice, who owns 100% of Ace Corporation stock, transfers to Ace land having a \$100,000 FMV and a \$60,000 adjusted basis. In exchange, Alice receives 75 additional shares of Ace common stock having a \$75,000 FMV, and Zero Corporation common stock having a \$25,000 FMV. Ace's basis in the Zero stock, a capital asset, is \$10,000. Alice realizes a \$40,000 gain [(\$75,000 + \$25,000) – \$60,000] on the land transfer, of which she recognizes \$25,000 (i.e., the FMV of the boot property received). In addition, Ace recognizes a \$15,000 capital gain (\$25,000 – \$10,000) upon transferring the Zero stock to Alice. ◀

Transferee Corporation's Basis for Property Received. A corporation that acquires property in exchange for its stock in a transaction that is taxable to the transferor takes a current cost (i.e., its FMV) basis in the property. On the other hand, if

³² Sec. 1032.

ADDITIONAL COMMENT

If a shareholder transfers built-in gain property in a Sec. 351 transaction, the built-in gain actually is duplicated. This duplication occurs because the transferee corporation assumes the potential gain through its carryover basis in the assets it receives, and the transferor shareholder assumes the potential gain through its substituted basis in the transferee corporation stock. A similar duplication occurs for built-in loss property. This result reflects the double taxation characteristic of C corporations.

the exchange qualifies for nonrecognition treatment under Sec. 351 and is wholly or partially tax-free to the transferor, the corporation's basis in the property is computed under Sec. 362 as follows:

Transferor's adjusted basis in property transferred to the corporation
Plus: Gain (if any) recognized by transferor
Minus: Reduction for loss property (if applicable)
<u>Transferee corporation's basis in property</u>

The transferee corporation's holding period for property acquired in a transaction satisfying the Sec. 351 requirements includes the period during which the property was held by the transferor.³³ This general rule applies to all types of property without regard to their character in the transferor's hands or the amount of gain recognized by the transferor. This rule also applies if the corporation reduces a property's basis under the loss property limitation discussed below.³⁴

EXAMPLE C:2-31

Top Corporation issues 100 shares of its stock for land having a \$15,000 FMV. Tina, who transferred the land, had a \$12,000 basis in the property. If the exchange satisfies the Sec. 351 requirements, Tina recognizes no gain on the exchange. Top's basis in the land is \$12,000, the same as Tina's. Top's holding period includes Tina's holding period. However, if the exchange does *not* satisfy the Sec. 351 requirements, Tina recognizes \$3,000 of gain. Top's basis in the land is its \$15,000 acquisition cost, and its holding period begins on the day after the exchange date.

Reduction for Loss Property. Section 362(e)(2) prevents shareholders from generating double losses by transferring loss property to a corporation. The double loss potential exists because the corporation would hold property with a built-in loss, and the shareholders would hold stock with a built-in loss. Accordingly, if a corporation's total adjusted basis (including any increase for gain recognized by the shareholder) for all properties transferred by the shareholder exceeds the properties' total FMV, the basis to the corporation of the properties must be reduced by this excess. The reduction in basis is allocated among the properties in proportion to their respective built-in losses. The limitation applies on a shareholder-by-shareholder basis. In other words, the property values and built-in losses of all shareholders are not aggregated.

EXAMPLE C:2-32

John transfers the following assets to Pecan Corporation in exchange for all of Pecan's stock worth \$26,000.

<u>Assets</u>	<u>Adjusted Basis to John</u>	<u>FMV</u>
Inventory	\$ 5,000	\$ 8,000
Equipment	15,000	11,000
Furniture	9,000	7,000
Total	<u>\$ 29,000</u>	<u>\$ 26,000</u>

Although the transaction meets the requirements of Sec. 351, the total basis of the assets transferred (\$29,000) exceeds their total FMV. Consequently, the total basis to Pecan is limited to the assets' FMV (\$26,000). The \$3,000 (\$29,000 – \$26,000) reduction in basis must be allocated among the assets in proportion to their respective built-in losses as follows:

<u>Assets</u>	<u>Built-in Losses</u>	<u>Allocated Reduction</u>
Equipment	\$4,000	\$2,000
Furniture	2,000	1,000
Total	<u>\$ 6,000</u>	<u>\$ 3,000</u>

³³ Sec. 1223(2).

³⁴ Reg. Sec. 1.362-4(c)(3)(i).

Thus, Pecan's bases for the assets transferred by John are:

Inventory	\$ 5,000
Equipment (\$15,000 – \$2,000)	13,000
Furniture (\$9,000 – \$1,000)	8,000
Total	<u>\$ 26,000</u>

The holding period of each property includes the transferor's holding period. ◀

A corporation subject to the basis reduction rules described above can avoid this result if the corporation and all its shareholders so elect. Under the election, the corporation need not reduce the bases of the assets received, but the affected shareholder's basis in stock received for the property is reduced by the amount by which the corporation would have reduced its basis absent the election.

EXAMPLE C:2-33 ► Assume the same facts as in Example C:2-32 except John and Pecan elect not to reduce the bases of the assets Pecan received. Under the election, John's basis in his Pecan stock is reduced to \$26,000 (\$29,000 – \$3,000). ◀

A corporation and its shareholders can avoid the basis reduction rules altogether if each shareholder transfers enough appreciated property to offset any built-in losses of other property transferred. This avoidance opportunity exists because in making the comparison, each shareholder aggregates the adjusted bases and FMVs of his or her property transferred.

EXAMPLE C:2-34 ► Assume the same facts as in Example C:2-32 except the inventory's FMV is \$12,000. In this case, total basis equals \$29,000 and total FMV equals \$30,000. Because total basis does not exceed total FMV, the limitation does not apply. Consequently, the corporation takes a carryover basis in each asset even though some assets have built-in losses. ◀

ASSUMPTION OF THE TRANSFEROR'S LIABILITIES

When a shareholder transfers property to a controlled corporation, the corporation often assumes the transferor's liabilities. The question arises as to whether the transferee corporation's assumption of liabilities is equivalent to a cash (boot) payment to the transferor. In certain types of transactions, the transferee's assumption of a transferor's liability is treated as a payment of cash to the transferor. For example, in a like-kind exchange, if a transferee assumes a transferor's liability, the transferor is treated as though he or she received a cash payment equal to the amount of the liability assumed. By contrast, if a transaction satisfies the Sec. 351 requirements, Sec. 357 provides relief from such treatment.

General Rule—Sec. 357(a). For the purpose of determining gain recognition, the transferee corporation's assumption of liabilities in a property transfer qualifying under Sec. 351 is *not* considered equivalent to the transferor's receipt of money. Consequently, the transferee corporation's assumption of liabilities does not result in the transferor's recognizing part or all of his or her realized gain. For the purpose of calculating the transferor's stock basis, however, the transferee corporation's assumption of liabilities is treated as money received and thus decreases the transferor's stock basis. Moreover, for the purpose of calculating the transferor's *realized* gain, the transferee corporation's assumption of liabilities is treated as part of the transferor's amount realized.³⁵

EXAMPLE C:2-35 ► Roy and Eduardo transfer the following assets and liabilities to newly formed Palm Corporation:

³⁵ Sec. 358(d)(1).

<u>Transferor</u>	<u>Asset/ Liability</u>	<u>Transferor's Adj. Basis</u>	<u>FMV</u>	<u>Consideration Received</u>
Roy	Machinery	\$15,000	\$32,000	50 shares Palm stock
	Mortgage	8,000	—	Assumed by Palm
Eduardo	Cash	24,000	24,000	50 shares Palm stock

The transaction meets the requirements of Sec. 351. Roy's recognized gain is determined as follows:

FMV of stock received	\$24,000
Plus: Palm's assumption of the mortgage liability	8,000
Amount realized	\$32,000
Minus: Basis of machinery	(15,000)
Realized gain	\$17,000
Boot received	\$ -0-
Recognized gain	\$ -0-

Although Palm's assumption of the mortgage liability increases Roy's amount realized, Roy recognizes none of his realized gain because the mortgage assumption is not considered to be boot (i.e., a cash equivalent). Eduardo recognizes no gain because he transferred only cash. Roy's stock basis is \$7,000 (\$15,000 basis of property transferred – \$8,000 liability assumed by Palm). Eduardo's stock basis is \$24,000. ▶

ADDITIONAL COMMENT

If any of the assumed liabilities are created for tax avoidance purposes, *all* the assumed liabilities are tainted.



ETHICAL POINT

Information about any transferor liabilities assumed by the transferee corporation must be reported with the transferee and transferor's tax returns for the year of transfer (see page C:2-36). Where a client asks a tax practitioner to ignore the fact that tax avoidance is the primary purpose for transferring a liability to a corporation, the tax practitioner must examine the ethical considerations of continuing to prepare returns and provide tax advice for the client.

The general rule of Sec. 357(a), however, has two exceptions. These exceptions, discussed below, relate to (1) transfers for the purpose of tax avoidance or without a bona fide business purpose and (2) transfers where the liabilities assumed by the corporation exceed the total basis of the property transferred.

Tax Avoidance or No Bona Fide Business Purpose—Sec. 357(b). All liabilities assumed by a controlled corporation *are* considered to be money received by the transferor, and therefore boot, if the principal purpose of the transfer of any portion of such liabilities is tax avoidance or if the liability transfer has no bona fide business purpose.

The transfer of liabilities might be considered to be motivated principally by tax avoidance where the transferor incurred the liabilities shortly before the transfer. Thus, the most important factor in determining whether a tax avoidance purpose exists may be the length of time between the incurrence of the liability and its transfer to, or assumption by, the corporation.

The assumption of liabilities normally is considered to have a business purpose if the transferor incurred the liabilities in the normal course of business or in the course of acquiring business property. Examples of liabilities without a bona fide business purpose and whose transfer would cause *all* liabilities transferred to be considered boot are personal obligations of the transferor, including a home mortgage or any other loans of a personal nature.

EXAMPLE C:2-36 ▶

David owns land having a \$100,000 FMV and a \$60,000 adjusted basis. The land is not encumbered by any liabilities. To obtain cash for his personal use, David transfers the land to his wholly owned corporation in exchange for additional stock and \$25,000 cash. Because the cash is considered to be boot, David must recognize \$25,000 of gain. Assume instead that David mortgages the land for \$25,000 to obtain the needed cash. If shortly thereafter David transfers the land and the mortgage to his corporation for additional stock, the \$25,000 mortgage assumed by the corporation will be considered to be boot because the transfer of the mortgage appears to have no bona fide business purpose. David's recognized gain will be \$25,000, i.e., the lesser of the boot received (\$25,000) or his realized gain (\$40,000). This special liability rule prevents David from obtaining cash without boot recognition. ▶

Liabilities in Excess of Basis—Sec. 357(c). Under Sec. 357(c), if the total amount of liabilities transferred to a controlled corporation exceeds the total adjusted basis of all property transferred, the excess liability is taxed as a gain to the transferor. This rule applies

regardless of whether the transferor realizes any gain or loss. The rationale for the rule is that the transferor has received a benefit (in the form of a release from liabilities) that exceeds his or her original investment in the transferred property. Therefore, the transferor should be taxed on this benefit. The character of the recognized gain depends on the type of property transferred to the corporation. The transferor's basis in any stock received is zero.

EXAMPLE C:2-37 ► Judy transfers \$10,000 cash and land, a capital asset, to Duke Corporation in exchange for all its stock. At the time of the exchange, the land has a \$70,000 adjusted basis and a \$125,000 FMV. Duke assumes a \$100,000 mortgage on the land for a bona fide business purpose. Although Judy receives no boot, Judy must recognize a \$20,000 (\$100,000 – \$80,000) capital gain, the amount by which the liabilities assumed by Duke exceed the basis of the land and the cash. Judy's basis in the Duke stock is zero, computed as follows:

Judy's basis in the land transferred	\$ 70,000
Plus: Cash transferred	10,000
Gain recognized	20,000
Minus: Liabilities assumed by Duke	(100,000)
Judy's basis in the Duke stock	<u>\$ –0–</u>

Note that, without the recognition of the \$20,000 gain, Judy's basis in the Duke stock would be a negative \$20,000 (\$80,000 – \$100,000). ◀

? STOP & THINK

Question: What are the fundamental differences between the liability exceptions of Sec. 357(b) and Sec. 357(c)?

Solution: Section 357(b) treats all “tainted” liabilities as boot so that gain recognition is the lesser of gain realized or the amount of boot. Excess liabilities under Sec. 357(c) are not treated as boot; they require gain recognition whether or not the transferor realizes any gain. Section 357(b) tends to be punitive in that the “tax avoidance” liabilities cause all the “offending” shareholder's transferred liabilities to be treated as boot even if the transfer of some liabilities do not have a tax avoidance purpose. Section 357(c) is not intended to be punitive. It recognizes that the shareholder has received an economic benefit to the extent of excess liabilities, and it prevents the occurrence of a negative stock basis. In short, Section 357(b) deters or punishes tax avoidance while Sec. 357(c) taxes an economic gain.

KEY POINT

Because of the “liabilities in excess of basis” exception, many cash basis transferor shareholders might inadvertently create recognized gain in a Sec. 351 transaction. However, a special exception exists that protects cash basis taxpayers. This exception provides that liabilities that would give rise to a deduction when paid are not treated as liabilities for purposes of Sec. 357(c).

Liabilities of a Cash Method Taxpayer—Sec. 357(c)(3). In a Sec. 351 tax-free exchange, special problems arise when a taxpayer using the cash or hybrid method of accounting transfers property and liabilities of an ongoing business to a corporation.³⁶ Often, the principal assets transferred are accounts receivable having a zero basis. Liabilities usually are transferred as well. Consequently, the amount of liabilities transferred may exceed the total basis (but not the FMV) of the property transferred.

Under the general rule of Sec. 357(c), the transferor recognizes gain equal to the amount by which the liabilities assumed exceed the total basis of the property transferred. Section 357(c)(3), however, provides that, in applying the general rule, the term *liabilities* does *not* include any amount that would give rise to a deduction when paid (e.g., accounts payable of a cash basis taxpayer). These amounts also are not considered liabilities for the purpose of determining the shareholder's basis in stock received.³⁷ Therefore, they generally do not reduce this basis. However, if after all other adjustments the stock's basis exceeds its FMV, these liabilities could reduce stock basis, but not below the stock's FMV.³⁸

EXAMPLE C:2-38 ► Tracy operates a cash basis accounting practice as a sole proprietorship. She transfers the assets of her practice to Prime Corporation in exchange for all the Prime stock. The balance sheet for the transferred practice is as follows:

³⁶ Sec. 357(c)(3).

³⁷ Sec. 358(d)(2).

³⁸ Sec. 358(h)(1).

<u>Assets and Liabilities</u>	<u>Adjusted Basis</u>	<u>FMV</u>
Cash	\$ 5,000	\$ 5,000
Furniture	5,000	8,000
Accounts receivable	—0—	50,000
Total	<u>\$10,000</u>	<u>\$63,000</u>
Accounts payable (deductible expenses)	\$ —0—	\$25,000
Note payable (on office furniture)	2,000	2,000
Owner's equity	8,000	36,000
Total	<u>\$10,000</u>	<u>\$63,000</u>

If, for purposes of Sec. 357(c), the accounts payable were considered liabilities, the \$27,000 of liabilities transferred (i.e., the \$25,000 of accounts payable and the \$2,000 note payable) would exceed the \$10,000 total basis of assets transferred, and Troy would recognize a \$17,000 gain. Because paying the \$25,000 of accounts payable gives rise to a deduction, however, they are not considered liabilities for purposes of Sec. 357(c). On the other hand, the \$2,000 note payable *is* considered a liability for this purpose because paying it would not give rise to a deduction. Thus, the total liabilities transferred to Prime amount to only \$2,000. Because that amount does not exceed the \$10,000 total basis of the assets transferred, Tracy recognizes no gain. Moreover, the accounts payable are not considered liabilities for purposes of computing Tracy's basis in her stock because the stock's basis (\$8,000) does not exceed its FMV (\$36,000). Thus, her basis in the Prime stock is \$8,000 (\$10,000 — \$2,000). ◀

Topic Review C:2-3 summarizes the liability assumption and acquisition rules of Sec. 357.

OTHER CONSIDERATIONS IN A SEC. 351 EXCHANGE

Recapture of Depreciation. If a Sec. 351 exchange is completely nontaxable (i.e., the transferor receives no boot), no depreciation is recaptured. Instead, the corporation inherits the entire amount of the transferor's recapture potential. Where the transferor recognizes some depreciation recapture as ordinary income (e.g., because of boot recognition), the transferee inherits the remaining recapture potential. If the transferee corporation subsequently disposes of the depreciated property, the corporation is subject to recapture rules on depreciation it claimed subsequent to the transfer, plus the recapture potential it inherited from the transferor.

EXAMPLE C:2-39 ▶ Azeem transfers machinery having a \$25,000 original cost, an \$18,000 adjusted basis, and a \$35,000 FMV for all 100 shares of Wheel Corporation stock. Before the transfer, Azeem used the machinery in his business and claimed \$7,000 of depreciation. In the transfer, Azeem recaptures no depreciation, and Wheel inherits the \$7,000 recapture potential. After claiming an additional \$2,000 of depreciation, Wheel has a \$16,000 adjusted basis in the machinery. If Wheel

TOPIC REVIEW C:2-3

Liability Assumption and Acquisition Rules of Sec. 357

1. *General Rule (Sec. 357(a)):* A transferee corporation's assumption of liabilities in a Sec. 351 exchange is not treated as boot by the shareholder for gain recognition purposes. On the other hand, the assumption of liabilities is treated as the receipt of money for purposes of determining the transferor's stock basis and amount realized.
2. *Exception 1 (Sec. 357(b)):* All liabilities assumed by a transferee corporation are considered to be money/boot received by the transferor if the principal purpose of the transfer of any of the liabilities is tax avoidance or if no bona fide business purpose exists for the transfer.
3. *Exception 2 (Sec. 357(c)):* If the total amount of liabilities assumed by a transferee corporation exceeds the total basis of property transferred, the transferor recognizes the excess as gain.
4. *Special Rule (Sec. 357(c)(3)):* For purposes of Exception 2, the term liabilities for a transferor using a cash or hybrid method of accounting does not include any amount that would give rise to a deduction when paid.

now sells the machinery for \$33,000, it must recognize a \$17,000 (\$33,000 – \$16,000) gain. Of this gain, \$9,000 is ordinary income recaptured under Sec. 1245. The remaining \$8,000 is a Sec. 1231 gain. ◀

Computing Depreciation. When a shareholder transfers depreciable property to a corporation in a nontaxable Sec. 351 exchange and the shareholder has not fully depreciated the property, the corporation must use the depreciation method and recovery period used by the transferor.³⁹ For the year of the transfer, the depreciation must be allocated between the transferor and the transferee corporation according to the number of months each party held the property. The transferee corporation is assumed to have held the property for the entire month in which the property was transferred.⁴⁰

EXAMPLE C:2-40 ► On June 10 of Year 1, Carla paid \$6,000 for a computer (five-year property for MACRS purposes), which she used in her sole proprietorship business. In Year 1, she claimed \$1,200 ($0.20 \times \$6,000$) of depreciation. She did not elect Sec. 179 expensing and did not claim any bonus depreciation. On February 10 of Year 2, she transfers the computer and other sole proprietorship assets to King Corporation in exchange for King stock. Because Sec. 351 applies, she recognizes no gain or loss. King must use the same MACRS recovery period and method that Carla used. Depreciation for Year 2 is \$1,920 ($0.32 \times \$6,000$). That amount must be allocated between Carla and King. The computer is considered to have been held by Carla for one month and by King for 11 months (including the month of transfer). The Year 2 depreciation amounts claimed by Carla and King are calculated as follows:

Carla	$\$6,000 \times 0.32 \times 1/12 = \160
King Corporation	$\$6,000 \times 0.32 \times 11/12 = \$1,760$

King's basis in the computer is calculated as follows:

Original cost	\$6,000
Minus: Year 1 depreciation claimed by Carla	(1,200)
Year 2 depreciation claimed by Carla	(160)
Adjusted basis on transfer date	<u>\$4,640</u>

King's depreciation for Year 2 and subsequent years is as follows:

Year 2 (as computed above)	\$1,760
Year 3 ($\$6,000 \times 0.1920$)	1,152
Year 4 ($\$6,000 \times 0.1152$)	691
Year 5 ($\$6,000 \times 0.1152$)	691
Year 6 ($\$6,000 \times 0.0576$)	346
Total	<u>\$4,640</u> ◀

If the transferee corporation's basis in the depreciable property exceeds the transferor's basis (e.g., as a result of an upward adjustment to reflect gain recognized by the transferor), the corporation treats the excess amount as newly purchased MACRS property and uses the recovery period and method applicable to the class of property transferred.⁴¹

EXAMPLE C:2-41 ► Assume the same facts as in Example C:2-40 except that, in addition to King stock, Carla receives a King note. Consequently, she must recognize \$1,000 of gain on the transfer of the computer. King's basis in the computer is calculated as follows:

Original cost	\$6,000
Depreciation claimed by Carla	(1,360)
Adjusted basis on transfer date	<u>\$4,640</u>
Plus: Gain recognized by Carla	1,000
Basis to King on transfer date	<u>\$5,640</u>

The additional \$1,000 of basis is depreciated as though it were separate, newly purchased five-year MACRS property. Thus, King claims depreciation of \$200 ($0.20 \times \$1,000$) on this

³⁹ Sec. 168(i)(7).

⁴⁰ Prop. Reg. Secs. 1.168-5(b)(2)(i)(B), 1.168-5(b)(4)(i), and 1.168-5(b)(8).

⁴¹ Prop. Reg. Sec. 1.168-5(b)(7).

ADDITIONAL COMMENT

Currently, we have no clear guidance on how the corporation depreciates transferred property that has a reduced basis under the loss property limitation rule discussed on page C:2-21. For now, taxpayers probably should rely on Prop. Reg. 1.168-2(d)(3), which provides a method for calculating depreciation when the transferee's basis is less than the transferor's basis.

portion of the basis in addition to the \$1,760 of depreciation on the \$4,640 carryover basis. Alternatively, King could elect to expense the \$1,000 "new" basis under Sec. 179. ◀

Assignment of Income Doctrine. The assignment of income doctrine holds that income is taxable to the person who earned it and that it may not be assigned to another person for tax purposes.⁴² The question arises as to whether the assignment of income doctrine applies where a cash method taxpayer transfers uncollected accounts receivable to a corporation in a Sec. 351 exchange. Specifically, who must recognize the income when it is collected—the taxpayer who transferred the receivable or the corporation that now owns and collects on the receivable? The IRS has ruled that the doctrine does *not* apply in a Sec. 351 exchange if the taxpayer transfers substantially all the business assets and liabilities, and a bona fide business purpose exists for the transfer. Instead, the accounts receivable take a zero basis in the corporation's hands, and the corporation includes their value in its income when it collects on the receivables.⁴³

EXAMPLE C:2-42 ▶

For a bona fide business purpose, Ruth, a cash basis taxpayer, transfers all the assets and liabilities of her legal practice to Legal Services Corporation in exchange for all of Legal Services stock. The assets include \$30,000 of accounts receivable that will generate earnings that Ruth has not included in her gross income. Because Ruth transfers substantially all the business assets and liabilities for a bona fide business purpose, the assignment of income doctrine does not apply to the receivables transferred, and Legal Services takes a zero basis in the receivables. Subsequently, Legal Services includes the value of the receivables in its income as it collects on them. ◀

The question of whether a transferee corporation can deduct the accounts payable transferred to it in a nontaxable transfer has frequently been litigated.⁴⁴ Most courts have held that ordinarily expenses are deductible only by the party that incurred those liabilities in the course of its trade or business. However, the IRS has ruled that in a nontaxable exchange the transferee corporation may deduct the payments it makes to satisfy the transferred accounts payable even though they arose in the transferor's business.⁴⁵

CHOICE OF CAPITAL STRUCTURE

OBJECTIVE 5

Explain the tax implications of alternative capital structures

When a corporation is formed, the way it is financed will determine its capital structure. The corporation may obtain capital from shareholders, nonshareholders, and creditors. In exchange for their capital, shareholders may receive common or preferred stock; nonshareholders may receive benefits such as employment or special rates on products sold by the corporation; and creditors may receive long- or short-term debt. As explained below, each of these alternatives has tax advantages and disadvantages for the shareholders, creditors, and corporation.

CHARACTERIZATION OF OBLIGATIONS AS DEBT OR EQUITY

The deductibility of interest payments creates an incentive for corporations to incur sufficient debt to maximize the amount of allowable interest deductions. Because debt financing often resembles equity financing (e.g., preferred stock), the IRS and the courts have refused to accept the form of the security as controlling.⁴⁶ In some cases, debt obligations that possess equity characteristics have been treated as common or preferred stock for tax purposes. In determining the appropriate tax treatment, the courts have relied on a number of factors.

⁴² See, for example, *Lucas v. Guy C. Earl*, 8 AFTR 10287, 2 USTC ¶496 (USSC, 1930).

⁴³ Rev. Rul. 80-198, 1980-2 C.B. 113.

⁴⁴ See, for example, *Wilford E. Thatcher v. CIR*, 37 AFTR 2d 76-1068, 76-1 USTC ¶9324 (9th Cir., 1976), and *John P. Bongiovanni v. CIR*, 31 AFTR 2d 73-409, 73-1 USTC ¶9133 (2nd Cir., 1972).

⁴⁵ Rev. Rul. 80-198, 1980-2 C.B. 113.

⁴⁶ See, for example, *Aqualane Shores, Inc. v. CIR*, 4 AFTR 2d 5346, 59-2 USTC ¶9632 (5th Cir., 1959) and *Sun Properties, Inc. v. U.S.*, 47 AFTR 273, 55-1 USTC ¶9261 (5th Cir., 1955).

HISTORICAL NOTE

The Treasury Department at one time issued proposed and final regulations covering Sec. 385. These regulations were the subject of so much criticism that the Treasury Department eventually withdrew them. Section 385, however, makes it clear that Congress wants the Treasury Department to make further attempts at clarifying the debt-equity issue. So far, the Treasury Department has issued no "new" proposed or final regulations.

Congress enacted Sec. 385 to establish a standard for determining whether a security is debt or equity. Section 385 provides that the following factors be considered in the determination:

- Whether there is a written unconditional promise to pay on demand or on a specified date a certain sum of money in return for adequate consideration in the form of money or money's worth, in addition to an unconditional promise to pay a fixed rate of interest
- Whether the debt is subordinate to, or preferred over, other indebtedness of the corporation
- The ratio of corporate debt to equity
- Whether the debt is convertible into stock of the corporation
- The relationship between holdings of stock in the corporation and holdings of the interest in question⁴⁷

DEBT CAPITAL

Various provisions govern the tax treatment of (1) the issuance of debt; (2) the payment of interest on debt; and (3) the extinguishment, retirement, or worthlessness of debt. The tax implications of each of these events are examined below.

SELF-STUDY QUESTION

From a tax perspective, why is the distinction between debt and equity important?

ANSWER

Subject to limitations, interest paid with respect to a debt instrument is deductible by the payor corporation. Dividends paid with respect to an equity instrument are not deductible by the payor corporation. Thus, the determination of whether an instrument is debt or equity can provide different results to the payor corporation. Different results apply to the payee as well. Qualified dividends are subject to the applicable capital gains tax rate while interest is taxed as ordinary income.

Issuance of Debt. If a transferor transfers appreciated property in exchange for stock, the transfer will be nontaxable, provided the Sec. 351 requirements have been met. On the other hand, if the transferor transfers appreciated property in exchange for corporate debt as part of a Sec. 351 exchange, the FMV of the debt received will be treated as boot, possibly leading to gain recognition.

Payment of Interest. For tax years beginning after December 31, 2017, C corporations with average gross receipts for the previous three years exceeding \$26 million (in 2019) are limited in their interest deduction to the sum of (1) business interest income; (2) 30% of adjusted taxable income, and (3) floor plan financing interest for corporate taxpayers who sell motor vehicles. Interest expense greater than the sum of these three items carries over to the next tax year, subject to the limitation in that year. The carryover period is indefinite. To arrive at adjusted taxable income, a C Corporation calculates its taxable income without regard to (1) any item of income, gain, deduction, or loss not properly allocable to a trade or business; (2) any business interest or business interest income; (3) any net operating loss deduction; and (4) any deduction allowable for depreciation, amortization, or depletion taken in years before 2022. C corporations with average gross receipts of \$26 million or less are not limited in their business interest deduction. In contrast to business interest expenses, the corporation cannot deduct dividends paid on equity securities.

If a corporation issues a debt instrument at a discount, Sec. 1272 requires the holder to amortize the original issue discount over the term of the obligation and treat the accrual as interest income. The debtor corporation amortizes the original issue discount over the term of the obligation and treats the accrual as an additional cost of borrowing.⁴⁸ If the corporation repurchases the debt instrument for more than the issue price (plus any original issue discount deducted as interest), the corporation deducts the excess of the purchase price over the issue price (adjusted for any amortization of original issue discount) as interest expense.⁴⁹

Under Sec. 171, if a corporation issues a debt instrument at a premium, the holder may elect to amortize the premium over the term of the obligation and treat the accrual as a reduction in interest income earned on the obligation. For the debtor corporation, the premium reduces the amount of deductible interest.⁵⁰ If the corporation repurchases the debt instrument at a price greater than the issue price (minus any premium treated as income), the corporation deducts the excess of the purchase price over the issue price (adjusted for any amortization of premium) as interest expense.⁵¹

⁴⁷ See also *O.H. Kruse Grain & Milling v. CIR*, 5 AFTR 2d 1544, 60-2 USTC ¶9490 (9th Cir., 1960), which lists additional factors that the courts might consider.

⁴⁸ Sec. 163(e).

⁴⁹ Reg. Sec. 1.163-7(c).

⁵⁰ Reg. Sec. 1.163-12.

⁵¹ Reg. Sec. 1.163-7(c).

Extinguishment of Debt. Generally, the retirement of debt is not a taxable event. Thus, a debtor corporation's extinguishing an obligation at face value does not result in the creditor's recognizing gain or loss. However, amounts received by the holder of a debt instrument (e.g., note, bond, or debenture) at the time of its retirement are deemed to be "in exchange for" the obligation. Thus, if the obligation is a capital asset in the holder's hands, the holder must recognize a capital gain or loss if the amount received differs from its face value or adjusted basis, unless the difference is due to original issue or market discount.

EXAMPLE C:2-43 ▶

ADDITIONAL COMMENT

Even though debt often is thought of as a preferred instrument because of the deductibility of the interest paid, the debt must be repaid at its maturity, whereas stock has no specified maturity date. Also, interest usually must be paid at regular intervals, whereas dividends do not have to be declared if sufficient funds are not available to pay them or if the corporation needs to retain funds for operations or growth.

SELF-STUDY QUESTION

Does the transferee corporation recognize gain on the receipt of appreciated property from a shareholder?

ANSWER

No. A corporation does not recognize gain when it receives property from its shareholders, whether or not it exchanges its own stock. However, the transfer must qualify as a Sec. 351 exchange or the transaction will be taxable to the shareholders.

Titan Corporation issues a ten-year note at its \$1,000 face amount. On the date of issuance, Rick purchases the note for \$1,000. Because of a decline in interest rates, Titan calls the note at a price of \$1,050 payable to each note holder. Rick reports the premium as a \$50 capital gain, and Titan deducts as interest expense total premiums paid to all its note holders. ◀

Table C:2-2 presents a comparison of the tax advantages and disadvantages of a corporation's using debt in its capital structure.

EQUITY CAPITAL

Corporations can raise equity capital through the issuance of various types of stock. Some corporations issue only a single class of stock, whereas others issue numerous classes of stock. Reasons for the use of multiple classes of stock include

- ▶ Permitting nonfamily employees of family owned corporations to obtain an equity interest in the business while keeping voting control in the hands of family members.
- ▶ Financing a closely held corporation through the issuance of preferred stock to an outside investor, while leaving voting control in the hands of existing common stockholders.

Table C:2-3 lists some of the major tax advantages and disadvantages of using common and preferred stock in a corporation's capital structure.

CAPITAL CONTRIBUTIONS BY SHAREHOLDERS

A corporation recognizes no income when it receives cash or noncash property as a capital contribution from a shareholder.⁵² If the shareholders make voluntary pro rata payments to a corporation but do not receive any additional stock, the payments are treated as additional consideration for the stock already owned.⁵³ The shareholders' respective bases in their stock are increased by the amount of cash contributed, plus the basis of any noncash property contributed, plus any gain recognized by the shareholders. The

▼ TABLE C:2-2

Tax Advantages and Disadvantages of Using Debt in a Corporation's Capital Structure

Advantages:

1. A corporation can deduct interest paid on a debt obligation, subject to limitation.
2. Shareholders do not recognize income in a debt retirement as they would in a stock redemption.

Disadvantages:

1. If at the time the corporation is formed or later when a shareholder makes a capital contribution, the shareholder receives a debt instrument in exchange for property, the debt is treated as boot, and the shareholder recognizes gain to the extent of the lesser of the boot's FMV or the realized gain.
2. If debt becomes worthless or is sold at less than its face value, the loss generally is a nonbusiness bad debt (treated as a short-term capital loss) or a capital loss. Section 1244 ordinary loss treatment applies only to stock (see pages C:2-32 and C:2-33).
3. In some circumstances, business interest deductions are limited.

⁵² Sec. 118(a).

⁵³ Reg. Sec. 1.118-1.

▼ **TABLE C:2-3****Tax Advantages and Disadvantages of Using Equity in a Corporation's Capital Structure****Advantages:**

1. A 50%, 65%, or 100% dividends-received deduction is available to a corporate shareholder who receives dividends. A similar deduction is not available for the receipt of interest (see Chapter C:3).
2. A shareholder can receive common and preferred stock in a tax-free corporate formation under Sec. 351 or a nontaxable reorganization under Sec. 368 without recognizing gain (see Chapters C:2 and C:7, respectively). Receipt of debt securities in each of these two types of transactions generally results in the shareholder's recognizing gain.
3. Common and preferred stock can be distributed tax-free to the corporation's shareholders as a stock dividend. Some common and preferred stock distributions, however, may be taxable as dividends under Sec. 305(b). Distributions of debt obligations generally are taxable as a dividend (see Chapter C:4).
4. Under Sec. 1244, common or preferred stock that the shareholder sells or exchanges or that becomes worthless is eligible for ordinary loss treatment, subject to limitations (see pages C:2-32 and C:2-33). The loss recognized on similar transactions involving debt securities generally is treated as capital in character.
5. Section 1202 excludes 50% of capital gains realized on the sale or exchange of qualified small business (C) corporation stock that has been held for more than five years. For qualified stock acquired after February 17, 2009 and before September 28, 2010, the exclusion is 75%, and for qualified stock acquired after September 27, 2010, the exclusion is 100%.
6. Qualified dividends are taxed at the applicable capital gains rate.

Disadvantages:

1. Dividends are not deductible in determining a corporation's taxable income.
2. Redemption of common or preferred stock generally is taxable to the shareholders as a dividend. Under the general rule, none of the redemption distribution offsets the shareholder's basis for the stock investment. Redemption of common and preferred stock is eligible for exchange treatment only in situations specified in Secs. 302 and 303 (see Chapter C:4).
3. Preferred stock issued to a shareholder as a dividend might meet the definition of Sec. 306 stock. Sale, exchange, or redemption of such stock can result in the recognition of ordinary income instead of capital gain (see Chapter C:4). This ordinary income is taxed as a "deemed dividend" at the applicable capital gains rate.

TYPICAL MISCONCEPTION

The characteristics of preferred stock can be similar to those of a debt security. Often, a regular dividend is required at a stated rate, much like what would be required with respect to a debt obligation. The holder of preferred stock, like a debt holder, may have preferred liquidation rights over holders of common stock. Also, preferred stock is not required to possess voting rights. However, differences remain. A corporation can deduct its interest expense but not dividends. Interest income is ordinary income to shareholders, but qualified dividends are subject to the applicable capital gains tax rate.

corporation's basis in any property received as a capital contribution from a shareholder equals the shareholder's basis, plus any gain recognized by the shareholder.⁵⁴ Normally, the shareholders recognize no gain when they transfer property to a controlled corporation as a capital contribution.

EXAMPLE C:2-44 ►

Dot and Fred each own 50% of the stock in Trail Corporation, and each has a \$50,000 basis in that stock. Later, as a voluntary contribution to Trail's capital, Dot contributes \$40,000 in cash and Fred contributes property having a \$25,000 basis and a \$40,000 FMV. As a result of the contributions, Trail recognizes no income. Dot's basis in her stock is increased to \$90,000 (\$50,000 + \$40,000), and Fred's basis in his stock is increased to \$75,000 (\$50,000 + \$25,000). Trail's basis in the property contributed by Fred is \$25,000—the same as Fred's basis in the property. ◀

If a shareholder-lender gratuitously forgives corporate debt, the debt forgiveness might be treated as a capital contribution equal to the principal amount of the forgiven debt. A determination of whether debt forgiveness is a capital contribution is based on the facts and circumstances surrounding the event.

⁵⁴ Sec. 362(a).

WHAT WOULD YOU DO IN THIS SITUATION?



Your corporate client wants to issue 100-year bonds. The corporation's CEO reads *The Wall Street Journal* regularly and has observed that similar bonds have been issued by several companies, including several Fortune 500 companies. He touts the fact that the interest rate on these bonds is slightly more than that for 30-year U.S. Treasury bonds. In addition, he expresses the belief that interest on the bonds would be deductible, whereas dividends on preferred or common

stock would be nondeductible. You are concerned that the IRS might treat the bonds as equity because of their extraordinarily long term. If the IRS does treat the bonds as such, it might recharacterize the "interest" as dividends and deny your client an interest deduction.

What advice would you give the client now regarding the bond issue? What advice would you give it when it prepares its tax return after the new bonds have been issued?

BOOK-TO-TAX ACCOUNTING COMPARISON

The IRC requires capital contributions of property other than money made by a nonshareholder to be reported at a zero basis. Financial accounting rules, however, require donated capital to be reported at the FMV of the asset on the financial accounting books. Neither set of rules requires the property's value to be included in income.

CAPITAL CONTRIBUTIONS BY NONSHAREHOLDERS

Nonshareholders sometimes contribute capital to a corporation in the form of cash or other property. For example, a city government might make a "contribution to capital" to a corporation in the form of undeveloped land to induce the corporation to locate within the city and provide jobs for citizens of the municipality. For transfers before December 23, 2017, such "contributions to capital" were excluded from the corporation's gross income if the money or property contributed was neither a payment for goods or services nor a subsidy to induce the corporation to limit production. However, for transfers after December 22, 2017, the term "contribution of capital" no longer includes contributions to the corporation by nonshareholders who are customers, potential customers, governmental entities, or civic groups. Instead, contributions to a corporation made after December 22, 2017 by nonshareholders who fall into any of these categories will be taxable income to the corporation to the extent of the fair market value of the property contributed. The corporation will then take a fair market value basis in the property received. All other "contributions to capital" by nonshareholders who are not customers, potential customers, governmental entities, or civic groups will continue to be nontaxable. In this case, the corporation will continue to take a zero basis in the property received, which precludes the corporation from claiming depreciation deductions or other capital recovery offsets with respect to the contributed property.

If a nonshareholder, who is not a customer, potential customer, governmental entity, or civic group, contributes cash, the basis of any property acquired with the cash during a 12-month period beginning on the day the corporation received the contribution is reduced by the cash amount used to acquire the property. The amount of any cash received from nonshareholders that the corporation does not use to purchase property during the 12-month period reduces the basis of another noncash property held by the corporation on the last day of the 12-month period. This basis reduction applies to the corporation's other property in the following order:

1. Depreciable property
2. Amortizable property
3. Depletable property
4. All other property

In the sequence of these downward adjustments, however, a property's basis may not be reduced below zero.

EXAMPLE C:2-45 ▶ To induce the company to locate in the municipality, on March 1, 2019, the City of San Antonio contributes to Circle Corporation \$100,000 in cash and a tract of land having a \$500,000 FMV. Because the City of San Antonio is a governmental entity, Circle recognizes \$600,000 of ordinary income as a result of the contribution and takes a \$500,000 basis in the land. ◀

EXAMPLE C:2-46 ▶ To induce the company to locate in the municipality, on March 1, 2019, Mr. X, who is not a customer, potential customer, representative of the City of San Antonio, or a representative of a civic organization contributes to Circle Corporation \$100,000 in cash and a tract of land having a \$500,000 FMV. Because of a downturn in Circle's business, the company invests only \$70,000 of

the contributed cash over a 12-month period. Because Mr. X is not a customer, potential customer, a governmental entity, or a civic organization, Circle recognizes no income as a result of the contribution. Circle's basis in the land is zero. Also, the basis of the property purchased with \$70,000 of the contributed cash also is zero (\$70,000 cost – \$70,000 contributed cash used to purchase the property). The basis of Circle's remaining assets, starting with its depreciable property, must be reduced by the \$30,000 (\$100,000 – \$70,000) cash contributed but not invested in property. ◀

WORTHLESSNESS OF STOCK OR DEBT OBLIGATIONS

OBJECTIVE 6

Determine the tax consequences of worthless stock or debt obligations

Investors who purchase stock in, or lend money to, a corporation usually want to earn a profit and recover their investment. Some investments, however, do not offer an adequate return on capital, and an investor may lose part or all of the investment. In this event, the securities evidencing the investment become worthless. This section examines the tax consequences of stock or debt securities becoming worthless.

SECURITIES

A debt or equity security that becomes worthless results in a capital loss for the investor as of the last day of the tax year in which the security becomes worthless. For purposes of this rule, the term *security* includes (1) a share of stock in a corporation; (2) a right to subscribe for, or the right to receive, a share of stock in a corporation; or (3) a bond, debenture, note, or other evidence of indebtedness with interest coupons or in registered form issued by a corporation.⁵⁵

In some situations, investors recognize an ordinary loss when a security becomes worthless. Investors who contribute capital, either in the form of equity or debt to a corporation that later fails, generally prefer ordinary losses because such losses are deductible against ordinary income. Ordinary losses that generate a pre-2018 NOL can be carried back two years or carried over up to 20 years. Post-2017 NOLs, on the other hand, do not carry back but carry over indefinitely subject to an 80% of taxable income limitation in the carryover year. (See Chapter C:3 for further discussion.) In general, ordinary loss treatment is available in the following circumstances:

- *Securities that are noncapital assets.* An ordinary loss occurs when a security that is a noncapital asset in the hands of the taxpayer is sold or exchanged or becomes totally worthless. Securities in this category include those held as inventory by a securities dealer.
- *Affiliated corporations.* A domestic corporation can claim an ordinary loss for any affiliated corporation's security that becomes worthless during the tax year. The domestic corporation must own at least 80% of the total voting power of all classes of stock entitled to vote, and at least 80% of each class of nonvoting stock (other than stock limited and preferred as to dividends). At least 90% of the aggregate gross receipts of the loss corporation for all tax years must have been derived from nonpassive income sources.
- *Section 1244 stock.* Section 1244 permits a shareholder to claim an ordinary loss if qualifying stock issued by a small business corporation is sold or exchanged or becomes worthless. This treatment is available only to an individual who was issued the qualifying stock or who was a partner in a partnership at the time the partnership acquired the qualifying stock. In the latter case, the partner's distributive share of partnership losses includes the loss sustained by the partnership on such stock. Ordinary loss treatment is not available for stock inherited, received as a gift, or purchased from another shareholder. The ordinary loss is limited to \$50,000 per year (or \$100,000 if the taxpayer is married and files a joint return). Losses exceeding the dollar ceiling in any given year are considered capital in character.

TYPICAL MISCONCEPTION

Probably the most difficult aspect of deducting a loss on a worthless security is establishing that the security is actually worthless. A mere decline in value is not sufficient to create a loss. The burden of proof of establishing total worthlessness rests with the taxpayer.

SELF-STUDY QUESTION

Why would a shareholder want his or her stock to qualify as Sec. 1244 stock?

ANSWER

Section 1244 is a provision that may help the taxpayer but that can never hurt. If the Sec. 1244 requirements are satisfied, the individual shareholders of a small business corporation may treat losses from the sale or worthlessness of their stock as ordinary rather than capital in character. If the Sec. 1244 requirements are not satisfied, such losses generally are treated as capital in character.

EXAMPLE C:2-47 ►

For \$175,000, Tammy and her husband Cole purchased 25% of Minor Corporation's initial offering of a single class of stock. Minor is a small business corporation, and the Minor stock satisfies all Sec. 1244 requirements. On September 1 of the current year, Minor filed for bankruptcy. Two years later, the bankruptcy court notifies shareholders that the Minor stock is worthless. In that year, Tammy and Cole can deduct \$100,000 of their initial investment as an ordinary loss. The remaining \$75,000 loss is treated as capital in character. ◀

⁵⁵ Sec. 165(g).

If a corporation issues Sec. 1244 stock for property whose adjusted basis exceeds its FMV immediately before the exchange, the stock's basis is reduced to the property's FMV for the purpose of determining the ordinary loss amount.

EXAMPLE C:2-48

▶ In a Sec. 351 nontaxable exchange, Penny transfers to Small Corporation property having a \$40,000 adjusted basis and a \$32,000 FMV for 100 shares of Sec. 1244 stock. Ordinarily, Penny's basis in the stock would be \$40,000. However, for Sec. 1244 purposes, her stock basis is the property's FMV, or \$32,000. If Penny sells the stock for \$10,000, her recognized loss is \$30,000 (\$10,000 – \$40,000). Her ordinary loss under Sec. 1244 is \$22,000 (\$10,000 – \$32,000 Sec. 1244 basis). The remaining \$8,000 loss is treated as capital in character. (Note also that, under Sec. 362(e)(2), Small would reduce its basis in the transferred property to its \$32,000 FMV.) ▶

Section 1244 loss treatment requires no special election. Investors, however, should be aware that, if they fail to satisfy certain requirements, ordinary loss treatment will be unavailable, and their loss will be treated as capital in character. The requirements are as follows:

- ▶ The issuing corporation must be a small business corporation at the time it issues the stock. A small business corporation is a corporation that receives in the aggregate \$1 million or less in money or noncash property (other than stock and securities) in exchange for its stock.⁵⁶
- ▶ The issuing corporation must have derived more than 50% of its aggregate gross receipts from “active” sources (i.e., other than royalties, rents, dividends, interest, annuities, and gains on sales of stock and securities) during the five most recent tax years ending before the date on which the shareholder sells or exchanges the stock or the stock becomes worthless.

If a shareholder contributes additional cash or property to a corporation after acquiring Sec. 1244 stock, the amount of ordinary loss recognized on the sale, exchange, or worthlessness of the Sec. 1244 stock is limited to the shareholder's capital contribution at the time the corporation issued the stock.

TAX STRATEGY TIP

If a shareholder contributes additional money or property to an existing corporation, he or she should be sure to receive additional stock in the exchange so that it will qualify for Sec. 1244 treatment if all requirements are met. If the shareholder does not receive additional stock, the increased basis of existing stock resulting from the capital contribution will not qualify for Sec. 1244 treatment.

UNSECURED DEBT OBLIGATIONS

In addition to holding an equity interest, shareholders may lend funds to the corporation. The type of loss allowed if the corporation does not repay the borrowed funds depends on the nature of the loan or advance.

If the unpaid loan was not evidenced by a security (i.e., an unsecured debt obligation), it is considered to be either business or nonbusiness bad debt. Nonbusiness bad debts are treated less favorably than business bad debts. Under Sec. 166, nonbusiness bad debts are deductible as short-term capital losses (to the extent of capital gains plus up to the \$3,000 annual limit for net capital losses) when they become totally worthless. Business bad debts are deductible as ordinary losses without limitation when they become either partially or totally worthless. The IRS generally treats a loan made by a shareholder to a corporation in connection with his or her stock investment as nonbusiness in character.⁵⁷ It is understandable why a shareholder might attempt to rebut this presumption with the argument that a business purpose exists for the loan.

An advance in connection with the shareholder's trade or business, such as a loan to protect the shareholder's employment at the corporation, may be treated as an ordinary loss under the business bad debt rules. Regulation Sec. 1.166-5(b) states that whether a bad debt is business or nonbusiness related depends on the taxpayer's motive for making the advance. The debt is business related if the necessary relationship between the loss and the conduct of the taxpayer's trade or business exists at the time the debt was incurred, acquired, or became worthless.

In *U.S. v. Edna Generes*, the U.S. Supreme Court held that where multiple motives exist for advancing funds to a corporation, such as where a shareholder-employee advances funds to protect his or her employment, determining whether the advance is business or nonbusiness

⁵⁶ Regulation Sec. 1.1244(c)-2 provides special rules for designating which shares of stock are eligible for Sec. 1244 treatment when the corporation has issued more than \$1 million of stock.

⁵⁷ Here, it is assumed that the loan is not considered to be an additional capital contribution. In such a case, the Sec. 165 worthless security rules apply instead of the Sec. 166 bad debt rules.

KEY POINT

In many closely held corporations, the shareholders are also employees. Thus, when a shareholder-employee makes a loan to the corporation, a question arises as to whether the loan is being made in the individual's capacity as an employee or a shareholder. The distinction is important because an employee loan that is worthless is entitled to ordinary loss treatment, whereas a shareholder loan that is worthless is treated as a nonbusiness bad debt (short-term capital loss).

related must be based on the "dominant motivation" for the advance.⁵⁸ If the advance is only "significantly motivated" by considerations relating to the taxpayer's trade or business, such motivation will not establish a proximate relationship between the bad debt and the taxpayer's trade or business. Therefore, it may result in a nonbusiness bad debt characterization. On the other hand, if the advance is "dominantly motivated" by considerations relating to the taxpayer's trade or business, such motivation usually is sufficient to establish such a proximate relationship. Therefore, it may result in a business bad debt characterization.

Factors deemed important in determining the character of bad debt include the taxpayer's equity in the corporation relative to compensation paid by the corporation. For example, a modest salary paid by the corporation relative to substantial stockholdings in the corporation suggests an investment motive for the advance. Conversely, a substantial salary paid by the corporation relative to modest stockholdings suggests a business motive for the advance. The business motive at issue is the protection of the employee-lender's employment because the advance may help save the business from failing. Reasonable minds may differ on what is substantial and what is modest, and monetary stakes often are high in these cases. Consequently, the determination frequently involves litigation.

EXAMPLE C:2-49 ►

Top Corporation employs Mary as its legal counsel. It pays Mary an annual salary of \$100,000. In March of the current year, Mary advances the corporation \$50,000 to assist it financially. In October of the current year, Top declares bankruptcy and liquidates. In the liquidation, Mary and other investors receive 10 cents on every dollar advanced. If Mary can show that her advance was dominantly motivated by a desire to preserve her employment, her \$45,000 ($\$50,000 \times 0.90$) loss will be treated as business bad debt, ordinary in character, and fully deductible in the current year. On the other hand, if Mary shows that the advance was only significantly motivated by a desire to preserve her employment, her \$45,000 loss will be treated as nonbusiness bad debt, capital in character, and deductible in this year and in subsequent years only to the extent of \$3,000 in excess of any capital gains she recognizes. ◀

ADDITIONAL COMMENT

For the act of lending money to a corporation to be considered the taxpayer's trade or business, the taxpayer must show that he or she was individually in the business of seeking out, promoting, organizing, and financing business ventures. *Ronald L. Farrington v. CIR*, 65 AFTR 2d 90-616, 90-1 USTC ¶150,125 (DC Okla., 1990).

A loss sustained by a shareholder who guarantees a loan made by a third party to the corporation generally is treated as a nonbusiness bad debt. The loss can be claimed only to the extent the shareholder actually pays the third party and is unable to recover the payment from the debtor corporation.⁵⁹ Occasionally, the IRS treats the amount of a shareholder advance as additional paid-in capital. In such circumstances, any worthless security loss the shareholder claims for his or her equity investment may be increased by this amount.

TAX PLANNING CONSIDERATIONS

OBJECTIVE 7

Identify tax planning opportunities in corporate formations

AVOIDING SEC. 351

Section 351 is not an elective provision. If its conditions are met, a corporate formation is tax-free, even if the taxpayer does not want it to be. Most often, taxpayers desire Sec. 351 treatment because it allows them to defer gains when transferring appreciated property to a corporation. In some cases, however, shareholders find such treatment disadvantageous because they would like to recognize gain or loss on the property transferred.

Avoiding Nonrecognition of Losses Under Sec. 351. If a shareholder transfers to a corporation property that has declined in value, the shareholder may want to recognize the loss so it can offset income from other sources. The shareholder can recognize the loss only if the Sec. 351 nonrecognition rules and the Sec. 267 related party rules do not apply to the exchange.

Avoiding Sec. 351 treatment requires that one or more of its requirements not be met. The simplest way to accomplish this objective is to ensure that the transferors of property do not receive 80% of the voting stock.

⁵⁸ 29 AFTR 2d 72-609, 72-1 USTC ¶9259 (USSC, 1972).

⁵⁹ Reg. Sec. 1.166-8(a).

Even if a shareholder avoids Sec. 351 treatment, he or she still may not be able to recognize the losses because of the Sec. 267 related party loss rules. Under Sec. 267(a)(1), if the shareholder owns more than 50% of the corporation's stock, directly or indirectly, he or she is a related party and therefore cannot recognize loss on an exchange of property for the corporation's stock or other property. If the transferors of property receive less than 80% of the corporation's voting stock and if the transferor of loss property does not own more than 50% of the stock, the transferor of loss property may recognize the loss.

EXAMPLE C:2-50 ▶

SELF-STUDY QUESTION

Which tax provisions may potentially limit a transferor shareholder from recognizing a loss on the transfer of property to a corporation?

ANSWER

Such transfer cannot be to a controlled corporation, or Sec. 351 will defer the loss. Even if Sec. 351 can be avoided, losses on sales between a corporation and a more-than-50% shareholder are disallowed under Sec. 267. Thus, to recognize a loss on the sale of property, such shareholder must, directly or indirectly, own 50% or less of the transferee corporation's stock.

ADDITIONAL COMMENT

Any potential built-in gain on property transferred to the transferee corporation is duplicated because such gain may be recognized at the corporate level and at the shareholder level. This double taxation may be another reason for avoiding the nonrecognition of gain under Sec. 351.

Lynn owns property having a \$100,000 basis and a \$60,000 FMV. If Lynn transfers the property to White Corporation in a nontaxable exchange under Sec. 351, she will not recognize a loss, which will be deferred until she sells her White stock. If the Sec. 351 requirements are not met, she will recognize a \$40,000 loss in the year she transfers the property. If Lynn receives 50% of the White stock in exchange for her property, Cathy, an unrelated individual, receives 25% of the stock in exchange for \$30,000 cash, and John, another unrelated individual, receives the remaining 25% for services performed, the Sec. 351 control requirement will not be met because the transferors of property acquire less than 80% of the White stock. Moreover, Lynn will not be a related party under Sec. 267 because she will not own more than 50% of the stock either directly or indirectly. Therefore, Lynn will recognize a \$40,000 loss on the exchange. ◀

Avoiding Nonrecognition of Gain Under Sec. 351. Sometimes a transferor would like to recognize gain when he or she transfers appreciated property to a corporation so the transferee corporation can get a stepped-up basis in the transferred property. Some other reasons for recognizing gain are as follows:

- ▶ If the transferor's gain is capital in character, he or she can offset this gain with capital losses from other transactions.
- ▶ Individual long-term capital gains are taxed at the applicable capital gains rate, which may be lower than the 21% top tax rate applicable to corporate-level capital gains.
- ▶ The corporation's tax rate may be higher than a noncorporate transferor's marginal tax rate. In such case, it might be beneficial for the transferor to recognize gain so the corporation can get a stepped-up basis in the property. A stepped-up basis would either reduce the corporation's gain when it later sells the property or allow the corporation to claim greater depreciation deductions when it uses the property.

A transferor who wishes to recognize gain on the transfer of appreciated property to a corporation can avoid Sec. 351 treatment through one of the following planning techniques:

- ▶ The transferor can sell the property to the controlled corporation for cash.
- ▶ The transferor can sell the property to the controlled corporation for cash and debt. This transaction involves relatively less cash than the previous transaction. However, the sale may be treated as a nontaxable exchange if the IRS recharacterizes the debt as equity.⁶⁰
- ▶ The transferor can sell the property to a third party for cash and have the third party contribute the property to the corporation for stock.
- ▶ The transferor can have the corporation distribute sufficient boot property so that, even if Sec. 351 applies to the transaction, he or she will recognize gain.
- ▶ The transferors can fail one or more of the Sec. 351 tests. For example, if the transferors do not own 80% of the voting stock immediately after the exchange, the Sec. 351 control requirement will not have been met, and they will recognize gain.
- ▶ To trigger gain recognition under Sec. 357(c), the transferors may transfer to the corporation debt that exceeds the basis of all property transferred.

⁶⁰ See, for example, *Aqualane Shores, Inc. v. CIR*, 4 AFTR 2d 5346, 59-2 USTC ¶9632 (5th Cir., 1959) and *Sun Properties, Inc. v. U.S.*, 47 AFTR 273, 55-1 USTC ¶9261 (5th Cir., 1955).

EXAMPLE C:2-51 ► Ten years ago, James purchased land as an investment for \$100,000. The land is now worth \$500,000. James plans to transfer the land to Bell Corporation in exchange for all its stock. Bell will subdivide the land and sell individual tracts. Because the land is inventory, Bell's gain on the land sales will be ordinary income. James has realized a large capital loss in the current year and would like to recognize capital gain on the transfer of the land to Bell. One way for James to accomplish this objective is to transfer the land to Bell in exchange for all the Bell stock plus a note for \$400,000. Because the note is boot, James will recognize \$400,000 of gain even though Sec. 351 applies to the exchange. However, if the note is due in a subsequent year, James's gain will be deferred until collection unless he elects out of the installment method. ◀

COMPLIANCE AND PROCEDURAL CONSIDERATIONS

OBJECTIVE 8

Comply with procedural rules for corporate formations

ADDITIONAL COMMENT

The required information provided to the IRS by both the transferor-shareholders and the transferee corporation should be consistent. For example, the FMVs assigned to the stock and other properties included in the exchange should be the same for all parties to the transaction.

REPORTING REQUIREMENTS UNDER SEC. 351

A taxpayer who receives stock or other property in a Sec. 351 exchange must attach a statement to his or her tax return for the period encompassing the date of the exchange.⁶¹ The statement must include all facts pertinent to the exchange, including:

- A description of the property transferred and its adjusted basis to the transferor
- A description of the stock received in the exchange, including its type, number of shares, and FMV
- A description of any other securities received in the exchange, including principal amount, terms, and FMV
- The amount of money received
- A description of any other property received, including its FMV
- A statement of the liabilities transferred to the corporation, including the nature of the liabilities, when and why they were incurred, and the business reason for their transfer

The transferee corporation must attach a statement to its tax return for the year in which the exchange took place. The statement must include

- A complete description of all property received from the transferors
- The transferors' adjusted bases in the property
- A description of the stock issued to the transferors
- A description of any other securities issued to the transferors
- The amount of money distributed to the transferors
- A description of any other property distributed to the transferors
- Information regarding the transferor's liabilities assumed by the corporation

⁶¹ Reg. Sec. 1.351-3.

PROBLEM MATERIALS

DISCUSSION QUESTIONS

- C:2-1** What entities or business forms are available for a new enterprise? Explain the advantages and disadvantages of each.
- C:2-2** Alice and Bill plan to go into business together. For the first two or three years of operations, they anticipate losses, which they would like to use to offset income from other sources. They also are concerned about exposing their personal assets to business liabilities. Advise Alice and Bill as to what business form would best meet their needs.
- C:2-3** Bruce and Bob organize Black LLC on May 10 of the current year. What is the entity's default tax classification? Are any alternative classification(s) available? If so, (1) how do Bruce and Bob elect the alternative classification(s) and (2) what are the tax consequences of doing so?
- C:2-4** John and Wilbur form White Corporation on May 3 of the current year. What is the entity's default tax classification? Are any alternative classification(s) available? If so, (1) how do John and Wilbur elect the alternative classification(s) and (2) what are the tax consequences of doing so?
- C:2-5** Barbara organizes Blue LLC on May 17 of the current year. What is the entity's default tax classification? Are any alternative classification(s) available? If so, (1) how does Barbara elect the alternative classification(s) and (2) what are the tax consequences of doing so?
- C:2-6** Debate the following proposition: All corporate formation transactions should be taxable events.
- C:2-7** What are the tax consequences for the transferor and transferee when property is transferred to a newly created corporation in an exchange qualifying as nontaxable under Sec. 351?
- C:2-8** What items are considered to be property for purposes of Sec. 351(a)? What items are not considered to be property?
- C:2-9** How is "control" defined for purposes of Sec. 351(a)?
- C:2-10** Explain how the IRS has interpreted the phrase "in control immediately after the exchange" for purposes of a Sec. 351 exchange.
- C:2-11** John and Mary each exchange property worth \$50,000 for 100 shares of New Corporation stock. Peter exchanges services for 98 shares of New stock and \$1,000 in cash for two shares of New stock. Are the Sec. 351 requirements met? Explain why or why not. What advice would you give the shareholders?
- C:2-12** Does Sec. 351 require shareholders to receive stock equal in value to the property transferred? Suppose Fred and Susan each transfer property worth \$50,000 to Spade Corporation. In exchange, Fred receives 25 shares of Spade stock and Susan receives 75 shares. Are the Sec. 351 requirements met? Explain the tax consequences of the exchange.
- C:2-13** Does Sec. 351 apply to property transfers to an existing corporation? Suppose Carl and Lynn each own 50 shares of North Corporation stock. Carl transfers property worth \$50,000 to North for an additional 25 shares. Does Sec. 351 apply? Explain why or why not. If not, what can be done to qualify the transaction for Sec. 351 treatment?
- C:2-14** How are a transferor's basis and holding period determined for stock and other property (boot) received in a Sec. 351 exchange? How does the transferee corporation's assumption of liabilities affect the transferor's basis in the stock?
- C:2-15** Under what circumstances is a corporation's assumption of liabilities considered boot in a Sec. 351 exchange?
- C:2-16** What factor(s) would the IRS likely consider to determine whether the transfer of a liability to a corporation in a Sec. 351 exchange was motivated by a business purpose?
- C:2-17** Mark transfers all the property of his sole proprietorship to newly formed Utah Corporation in exchange for all the Utah stock. Mark has claimed depreciation on some of the property. Under what circumstances is Mark required to recapture previously claimed depreciation deductions? How is the depreciation deduction for the year of transfer calculated? What are the tax consequences if Utah sells the depreciable property?
- C:2-18** How does the assignment of income doctrine apply to a Sec. 351 exchange?
- C:2-19** What factors did Congress mandate to be considered in determining whether indebtedness is classified as debt or equity for tax purposes?
- C:2-20** What are the advantages and disadvantages of using debt in a firm's capital structure?
- C:2-21** What are the advantages of Sec. 1244 loss treatment when a stock investment becomes worthless? What conditions must be met to qualify for this treatment?

C:2-22 What are the advantages of business bad debt treatment when a shareholder's loan or advance to a corporation cannot be repaid? What must the debtholder show to claim a business bad debt deduction?

C:2-23 Why might shareholders avoid Sec. 351 treatment? Explain three ways they can accomplish this end.

C:2-24 What are the Sec. 351 reporting requirements?

ISSUE IDENTIFICATION QUESTIONS

C:2-25 Peter Jones has owned all 100 shares of Trenton Corporation stock for the past five years. This year, Mary Smith contributes property with a \$50,000 basis and an \$80,000 FMV for 80 newly issued Trenton shares. At the same time, Peter contributes \$15,000 in cash for 15 newly issued Trenton shares. What tax issues regarding the exchanges should Mary and Peter consider?

C:2-26 Carl contributes equipment with a \$50,000 adjusted basis and an \$80,000 FMV to Cook Corporation for 50 of its 100 shares of stock. His son, Carl Jr., contributes \$20,000 cash for the remaining 50 Cook shares. What tax issues regarding the exchanges should Carl and his son consider?

C:2-27 Several years ago, Bill acquired 100 shares of Bold Corporation stock directly from the corporation for \$100,000 in cash. This year, he sold the stock to Sam for \$35,000. What tax issues regarding the stock sale should Bill consider?

PROBLEMS

C:2-28 *Organizational Forms Available.* Lucia, a single taxpayer, operates a florist business. She is considering either continuing the business as a sole proprietorship or reorganizing it as either a C corporation or an S corporation. Her goal is to withdraw \$20,000 of profits from the business annually while minimizing her total tax liability. She expects the business to generate annually \$50,000 of taxable income, all of which qualifies as pass-through income, before considering a deductible salary expense (see below). Which business form(s) can best achieve Lucia's goals? Remember that a shareholder is taxed on S corporation income whether withdrawn or not and is not taxed on the actual withdrawals or distributions. Assume the C corporation is taxed at 21%, Lucia is in the 22% individual tax bracket for ordinary income, and Lucia is taxed at 15% on dividend income. When considering either corporate option, perform the analysis first by treating any withdrawals as deductible salary payments of the corporation. Then do the analysis by treating them as nondeductible dividends or distributions. Ignore employment taxes.

C:2-29 *Transfer of Property and Services to a Controlled Corporation.* In the current year, Dick, Evan, and Fran form Triton Corporation. Dick contributes land (a capital asset) having a \$50,000 FMV in exchange for 50 shares of Triton stock. He purchased the land three years ago for \$60,000. Evan contributes machinery (Sec. 1231 property purchased four years ago) having a \$45,000 adjusted basis and a \$30,000 FMV in exchange for 30 shares of Triton stock. Fran contributes services worth \$20,000 in exchange for 20 shares of Triton stock.

- What is the amount of Dick's recognized gain or loss?
- What is Dick's basis in his Triton shares? When does his holding period begin?
- What is the amount of Evan's recognized gain or loss?
- What is Evan's basis in his Triton shares? When does his holding period begin?
- How much income, if any, does Fran recognize?
- What is Fran's basis in her Triton shares? When does her holding period begin?
- What is Triton's basis in the land and the machinery? When does its holding period begin? How does Triton treat the amount paid to Fran for her services?

C:2-30 *Transfer of Property and Services to a Controlled Corporation.* In the current year, Ed, Fran, and George form Jet Corporation. Ed contributes land (a capital asset) having a \$35,000 FMV purchased as an investment four years ago for \$15,000 in exchange for 35 shares of Jet stock. Fran contributes machinery (Sec. 1231 property) purchased four years ago and used in her business in exchange for 35 shares of Jet stock. Immediately before

the exchange, the machinery had a \$45,000 adjusted basis and a \$35,000 FMV. George contributes services worth \$30,000 in exchange for 30 shares of Jet stock.

- What is the amount of Ed's recognized gain or loss?
- What is Ed's basis in his Jet shares? When does his holding period begin?
- What is the amount of Fran's recognized gain or loss?
- What is Fran's basis in her Jet shares? When does her holding period begin?
- How much income, if any, does George recognize?
- What is George's basis in his Jet shares? When does his holding period begin?
- What is Jet's basis in the land and the machinery? When does its holding period begin? How does Jet treat the amount paid to George for his services?
- How would your answers to Parts a through g change if George instead contributed \$5,000 in cash and services worth \$25,000 for his 30 shares of Jet stock?

C:2-31 *Control Requirement.* In which of the following independent situations is the Sec. 351 control requirement met?

- Olive transfers property to Quick Corporation for 75% of Quick stock, and Mary provides services to Quick for the remaining 25% of Quick stock.
- Pete transfers property to Target Corporation for 60% of Target stock, and Robert transfers property worth \$15,000 and performs services worth \$25,000 for the remaining 40% of Target stock.
- Herb and his wife, Wilma, each have owned 50 of the 100 outstanding shares of Vast Corporation stock since it was formed three years ago. In the current year, their son, Sam, transfers property to Vast for 50 newly issued shares of Vast stock.
- Charles and Ruth develop a plan to form Tiny Corporation. On June 3 of this year, Charles transfers property worth \$50,000 for 50 shares of Tiny stock. On August 1, Ruth transfers \$50,000 cash for 50 shares of Tiny stock.
- Assume the same facts as in Part d except that Charles has a prearranged plan to sell 30 of his shares to Sam on October 1.

C:2-32 *Control Requirement.* In which of the following unrelated exchanges is the Sec. 351 control requirement met? If the transaction does not meet the Sec. 351 requirements, suggest ways in which the transaction can be structured so as to meet these requirements.

- Fred exchanges property worth \$50,000 and services worth \$50,000 for 100 shares of New Corporation stock. Greta exchanges \$100,000 cash for the remaining 100 shares of New stock.
- Maureen exchanges property worth \$2,000 and services worth \$48,000 for 100 shares of Gemini Corporation stock. Norman exchanges property worth \$50,000 for the remaining 100 shares of Gemini stock.

C:2-33 *Control Requirement.* Sam and Veronica own 300 and 200 shares, respectively, of Poly-Electron Corporation stock, which represent all the shares outstanding. The current market value per share is \$25. Poly-Electron needs capital to expand its operations, and Veronica is willing to contribute to Poly-Electron silver bullion against which the corporation can borrow operating funds. Veronica purchased the bullion 12 years ago, when its cost was a fraction of its current market value. If Veronica wants to avoid recognizing a gain upon transferring the bullion to the corporation, how many additional shares must she receive in exchange for the bullion, and what value of silver bullion should she contribute to Poly-Electron in exchange for additional shares? Hint: Veronica needs to achieve 80% control of the corporation.

C:2-34 *Sec. 351 Requirements.* Al, Bob, and Carl form West Corporation and transfer the following items to West:

<u>Transferor</u>	<u>Item</u>	<u>Item Transferred</u>		<u>Shares Received by Transferor</u>
		<u>Transferor's Basis</u>	<u>FMV</u>	
Al	Patent	—0—	\$25,000	1,000 common
Bob	Cash	\$25,000	25,000	250 preferred
Carl	Services	—0—	7,500	300 common

The common stock has voting rights. The preferred stock does not.

- Is the exchange nontaxable under Sec. 351? Explain the tax consequences of the exchange to Al, Bob, Carl, and West.

- b. How would your answer to Part a change if Bob instead had received 200 shares of common stock and 200 shares of preferred stock?
- c. How would your answer to Part a change if Carl instead had contributed \$800 cash as well as services worth \$6,700?

C:2-35

Incorporating a Sole Proprietorship. Tom incorporates his sole proprietorship as Total Corporation and transfers its assets to Total in exchange for all 100 shares of Total stock and four \$10,000 interest-bearing notes. The stock has a \$125,000 FMV. The notes mature consecutively on the first four anniversaries of the incorporation date. The assets transferred are as follows:

<u>Assets</u>		<u>Adjusted Basis</u>	<u>FMV</u>
Cash		\$ 5,000	\$ 5,000
Equipment	\$130,000		
Minus: Accumulated depreciation	(70,000)	60,000	90,000
Building	\$100,000		
Minus: Accumulated depreciation	(49,000)	51,000	40,000
Land		24,000	30,000
Total		<u>\$140,000</u>	<u>\$165,000</u>

- a. What are the amounts and character of Tom's recognized gains or losses?
- b. What is Tom's basis in the Total stock and notes?
- c. What is Total's basis in the property received from Tom?

C:2-36

Transfer to an Existing Corporation. For the last five years, Ann and Fred each have owned 50 of the 100 outstanding shares of Zero Corporation stock. Ann transfers land having a \$10,000 basis and a \$25,000 FMV to Zero for an additional 25 shares of Zero stock. Fred transfers \$1,000 cash to Zero for one additional share of Zero stock. What amount of the gain or loss must Ann recognize on the exchange? If the transaction does not meet the Sec. 351 requirements, suggest ways in which it can be structured so as to meet these requirements.

C:2-37

Transfer to an Existing Corporation. For the last three years, Lucy and Marvin each have owned 50 of the 100 outstanding shares of Lucky Corporation stock. Lucy transfers property having an \$8,000 basis and a \$12,000 FMV to Lucky for an additional ten shares of Lucky stock. How much gain or loss must Lucy recognize on the exchange? If the transaction does not meet the Sec. 351 requirements, suggest ways in which it can be structured so as to meet these requirements.

C:2-38

Disproportionate Receipt of Stock. Jerry transfers property with a \$28,000 adjusted basis and a \$50,000 FMV to Texas Corporation for 75 shares of Texas stock. Frank, Jerry's father, transfers property with a \$32,000 adjusted basis and a \$50,000 FMV to Texas for the remaining 25 shares of Texas stock.

- a. What is the amount of each transferor's recognized gain or loss?
- b. What is Jerry's basis in his Texas stock?
- c. What is Frank's basis in his Texas stock?

C:2-39

Sec. 351: Boot Property Received. Sara transfers land (a capital asset) having a \$30,000 adjusted basis to Temple Corporation in a Sec. 351 exchange. In return, Sara receives the following consideration:

<u>Consideration</u>	<u>FMV</u>
100 shares of Temple common stock	\$100,000
50 shares of Temple qualified preferred stock	50,000
Temple note due in three years	20,000
Total	<u>\$170,000</u>

- a. What are the amount and character of Sara's recognized gain or loss?
- b. What is Sara's basis in her common stock, preferred stock, and note?
- c. What is Temple's basis in the land?

- C:2-40** *Receipt of Bonds for Property.* Joe, Karen, and Larry form Gray Corporation. Joe contributes land (a capital asset) having an \$8,000 adjusted basis and a \$15,000 FMV to Gray in exchange for Gray ten-year notes having a \$15,000 face value. Karen contributes equipment (Sec. 1231 property) having an \$18,000 adjusted basis and a \$25,000 FMV for 50 shares of Gray stock. She previously claimed \$10,000 of depreciation on the equipment. Larry contributes \$25,000 cash for 50 shares of Gray stock.
- What are the amount and character of Joe's, Karen's, and Larry's recognized gains or losses?
 - What basis do Joe, Karen, and Larry take in the stock or notes they receive?
 - What basis does Gray take in the land and equipment? What happens to the \$10,000 of depreciation recapture potential on the equipment?
- C:2-41** *Transfer of Depreciable Property.* Nora transfers to Needle Corporation depreciable machinery originally costing \$18,000 and now having a \$15,000 adjusted basis. In exchange, Nora receives all 100 shares of Needle stock having an \$18,000 FMV and a three-year Needle note having a \$4,000 FMV.
- What are the amount and character of Nora's recognized gain or loss?
 - What are Nora's bases in the Needle stock and note?
 - What is Needle's basis in the machinery?
- C:2-42** *Transfer of Personal Liabilities.* Jim owns 80% of Gold Corporation stock. He transfers a business automobile to Gold in exchange for additional Gold stock worth \$5,000 and Gold's assumption of both his \$1,000 automobile debt and his \$2,000 education loan. The automobile originally cost Jim \$12,000 and, on the transfer date, has a \$4,500 adjusted basis and an \$8,000 FMV.
- What are the amount and character of Jim's recognized gain or loss?
 - What is Jim's basis in his additional Gold shares?
 - When does Jim's holding period for the additional shares begin?
 - What basis does Gold take in the automobile?
- C:2-43** *Liabilities in Excess of Basis.* Barbara transfers to Moore Corporation \$10,000 cash and machinery having a \$15,000 basis and a \$35,000 FMV in exchange for 50 shares of Moore stock. The machinery was used in Barbara's business, originally cost Barbara \$50,000, and is subject to a \$28,000 liability, which Moore assumes. Sam exchanges \$17,000 cash for the remaining 50 shares of Moore stock.
- What are the amount and character of Barbara's recognized gain or loss?
 - What is Barbara's basis in the Moore stock?
 - What is Moore's basis in the machinery?
 - What are the amount and character of Sam's recognized gain or loss?
 - What is Sam's basis in the Moore stock?
 - When do Barbara and Sam's holding periods for their stock begin?
 - How would your answers to Parts a through f change if Sam received \$17,000 of Moore stock for legal services (instead of cash)?
- C:2-44** *Transfer of Business Properties.* Jerry transfers to Emerald Corporation property having a \$32,000 adjusted basis and a \$50,000 FMV in exchange for all of Emerald's stock worth \$15,000 and Emerald's assumption of a \$35,000 mortgage on the property.
- What is the amount of Jerry's recognized gain or loss?
 - What is Jerry's basis in the Emerald stock?
 - What is Emerald's basis in the property?
 - How would your answers to Parts a through c change if the mortgage assumed by Emerald were \$15,000 and the Emerald stock were worth \$35,000?
- C:2-45** *Incorporating a Cash Basis Proprietorship.* Ted decides to incorporate his medical practice. He uses the cash method of accounting. On the date of incorporation, the practice reports the following balance sheet:

	<u>Basis</u>	<u>FMV</u>
Assets:		
Cash	\$ 5,000	\$ 5,000
Accounts receivable	—0—	65,000
Equipment (net of \$15,000 depreciation)	35,000	40,000
Total	<u>\$40,000</u>	<u>\$110,000</u>

Liabilities and Owner's Equity:

Current liabilities	\$ -0-	\$ 35,000
Note payable on equipment	15,000	15,000
Owner's equity	25,000	60,000
Total	<u>\$40,000</u>	<u>\$110,000</u>

All the current liabilities would be deductible by Ted if he paid them. Ted transfers all the assets and liabilities to a professional corporation in exchange for all of its stock.

- What are the amount and character of Ted's recognized gain or loss?
- What is Ted's basis in the stock?
- What is the corporation's basis in the property?
- Who recognizes income on the receivables upon their collection? Can the corporation obtain a deduction for the liabilities when it pays them?

C:2-46 *Transfer of Depreciable Property.* On January 10 of the current year, Mary transfers to Green Corporation a machine purchased three years ago for \$100,000. On the transfer date, the machine has a \$60,000 adjusted basis and a \$110,000 FMV. Mary receives all 100 shares of Green stock, worth \$100,000, and a two-year Green note worth \$10,000.

- What are the amount and character of Mary's recognized gain or loss?
- What is Mary's basis in the stock and note? When does her holding period begin?
- What are the amount and character of Green's gain or loss?
- What is Green's basis in the machine? When does Green's holding period begin?

C:2-47 *Contribution to Capital by a Nonshareholder.* In 2019, the City of Omaha donates land worth \$500,000 to Ace Corporation to induce it to locate in Omaha and create an estimated 2,000 jobs for its citizens.

- How much income, if any, must Ace report on the land contribution?
- What basis does Ace take in the land?
- Assume the same facts except the City of Omaha also donated to Ace \$100,000 cash, which the corporation used to pay a portion of the \$250,000 cost of equipment that it purchased six months later. How much income, if any, must Ace report on the cash contribution? What basis does Ace take in the equipment?
- How would your answers to Parts a–c change if the contribution is made by a nonshareholder who is not a customer, potential customer, governmental entity, or civic group?

C:2-48 *Choice of Capital Structure.* Kobe transfers \$500,000 in cash to newly formed Bryant Corporation for 100% of Bryant's stock. In the first year of operations, Bryant's taxable income before any payments to Kobe is \$120,000. What total amount of taxable income must Kobe and Bryant each report in the following two scenarios?

- Bryant pays a \$70,000 dividend to Kobe.
- Assume that when Bryant was formed, Kobe transferred his \$500,000 to the corporation for \$250,000 of Bryant stock and \$250,000 in Bryant notes. The notes are repayable in five annual installments of \$50,000 plus 8% annual interest on the unpaid balance. During the current year, Bryant gives Kobe \$50,000 in repayment of the first note plus \$20,000 interest.

C:2-49 *Worthless Stock or Securities.* Tom and Vicki are married and file a joint income tax return. They each purchase 50% of the stock in Guest Corporation from Al for \$75,000. Tom is employed full-time by Guest and earns \$100,000 in annual salary. Because of Guest's financial difficulties, Tom and Vicki each lend Guest an additional \$25,000. The \$25,000 is secured by bonds and is repayable in five years, with interest accruing at the prevailing market rate. Guest's financial difficulties escalate, and it eventually declares bankruptcy. Tom and Vicki receive nothing for their Guest stock or Guest bonds.

- What are the amount and character of each shareholder's loss on the worthless stock and bonds?
- How would your answer to Part a change if the liability were not secured by bonds?
- How would your answer to Part a change if Tom and Vicki had purchased their stock for \$75,000 each at the time Guest was formed?

C:2-50 *Worthless Stock.* Duck Corporation is owned equally by Harry, Susan, and Big Corporation. Harry and Susan are single. Eight years ago, Harry, Tom, and Big, the original investors in Duck, each paid \$125,000 for their Duck stock. Susan purchased her stock from Tom five years ago for \$175,000. No adjustments to basis occur after the stock acquisition date. Duck encounters financial difficulties as a result of a lawsuit brought by a customer who suffered personal injuries from using a defective product. Duck files for

bankruptcy, and uses all its assets to pay its creditors in the current year. What are the amount and character of each shareholder's loss?

- C:2-51** *Sale of Sec. 1244 Stock.* Lois, who is single, transfers property with an \$80,000 basis and a \$120,000 FMV to Water Corporation in exchange for all 100 shares of Water stock. The shares qualify as Sec. 1244 stock. Two years later, Lois sells the shares for \$28,000.
- What are the amount and character of Lois's recognized gain or loss?
 - How would your answer to Part a change if the FMV of the property were \$70,000?
- C:2-52** *Transfer of Sec. 1244 Stock.* Assume the same facts as in Problem C:2-51 except that Lois gave the Water stock to her daughter, Sue, six months after she received it. The stock had a \$120,000 FMV when Lois acquired it and when she made the gift. Sue sold the stock two years later for \$28,000. How is the loss treated for tax purposes?
- C:2-53** *Avoiding Sec. 351 Treatment.* Six years ago, Donna purchased land as an investment. The land cost \$150,000 and is now worth \$480,000. Donna plans to transfer the land to Development Corporation, which will subdivide it and sell individual tracts. Development's income on the land sales will be ordinary in character.
- What are the tax consequences of the asset transfer and land sales if Donna contributes the land to Development in exchange for all its stock?
 - In what alternative ways can the transaction be structured to achieve more favorable tax results? Assume Donna's marginal tax rate for capital gains is 23.8% (20% + 3.8% on net investment income), and Development's tax rate is 21%.

COMPREHENSIVE PROBLEMS

- C:2-54** On March 1 of the current year, Alice, Bob, Carla, and Dick form Bear Corporation and transfer the following items:

<u>Transferor</u>	<u>Asset</u>	<u>Property Transferred</u>		<u>Number of Common Shares Issued</u>
		<u>Basis to Transferor</u>	<u>FMV</u>	
Alice	Land	\$12,000	\$30,000	400
	Building	38,000	70,000	
	Mortgage on the land and building	60,000	60,000	
Bob	Equipment	25,000	40,000	300
Carla	Van	15,000	10,000	50
Dick	Accounting services	—0—	10,000	100

Alice purchased the land and building several years ago for \$12,000 and \$50,000, respectively. Alice has claimed straight-line depreciation on the building. Bob also receives a Bear note for \$10,000 due in three years. The note bears interest at the prevailing market rate. Bob purchased the equipment three years ago for \$50,000. Carla also receives \$5,000 cash. Carla purchased the van two years ago for \$20,000.

- Does the transaction satisfy the requirements of Sec. 351?
 - What are the amount and character of the gains or losses recognized by Alice, Bob, Carla, Dick, and Bear?
 - What is each shareholder's basis in his or her Bear stock? When does the holding period for the stock begin?
 - What is Bear's basis in its property and services? When does the holding period for each property begin?
- C:2-55** Ed and Fay together own 100% of the common stock of an existing corporation. On January 2 of the current year, they made the following additional transfers to the corporation, which qualify under Sec. 351. Ed transferred equipment (having a \$55,000 FMV and \$36,000 adjusted basis) in exchange for additional common stock worth \$40,000, qualified preferred stock worth \$9,000, and nonqualified preferred stock worth \$6,000. Ed acquired the equipment on March 14 three years ago and claimed \$46,000 of depreciation before contributing it to the corporation. Fay transferred inventory (having a \$40,000 FMV and \$14,000 adjusted basis) and land (a capital asset having a \$20,000 FMV and \$50,000 adjusted basis) in exchange for additional common stock worth \$33,000 and \$24,000 cash. Fay acquired the land

on February 3 eight years ago. In addition, the corporation assumed \$3,000 of Fay's liabilities, which were bona fide business debts with no tax avoidance purpose. These liabilities are general liabilities not associated with any particular asset. For each transferor shareholder, determine the amount realized, gain or loss realized, gain or loss recognized (if any), character of gain or loss recognized, basis of stock received, and holding period of stock received. For the corporation, determine the gain or loss recognized (if any), basis of each property received, and holding period of each property received.

TAX STRATEGY AND CRITICAL THINKING PROBLEMS

C:2-56 Assume the same facts as in Problem C:2-55.

- Under what circumstances is the tax result in Problem C:2-55 beneficial, and for which shareholders? Are the shareholders likely to be pleased with the result?
- If the shareholders decide that meeting the Sec. 351 requirements would generate a greater tax benefit, how might they proceed?

C:2-57 Paula Green owns and operates the Green Thumb Nursery as a sole proprietorship. The business has total assets with a \$260,000 adjusted basis and a \$500,000 FMV. Paula wants to expand into the landscaping business. She views this expansion as risky and therefore wants to incorporate so as not to put her personal assets at risk. Her friend, Mary Brown, is willing to invest \$250,000 in the enterprise.

Although Green Thumb has earned approximately \$55,000 per year, Paula and Mary expect that, when the landscaping business is launched, the new corporation will incur annual losses of \$50,000 for the next two years. They expect profits of at least \$80,000 annually, beginning in the third year. Paula and Mary earn approximately \$50,000 from other sources. They are considering the following alternative capital structures and elections:

- Green Thumb issues 50 shares of common stock to Paula and 25 shares of common stock to Mary.
- Green Thumb issues 50 shares of common stock to Paula and a \$250,000 ten-year note bearing interest at 8% to Mary.
- Green Thumb issues 40 shares of common stock to Paula plus a \$100,000 ten-year note bearing interest at 6% and 15 shares of common stock to Mary, plus a \$100,000 ten-year note bearing interest at 6%.
- Green Thumb issues 50 shares of common stock to Paula and 25 shares of preferred stock to Mary. The preferred stock is nonparticipating but pays a cumulative preferred dividend at 8% of its \$250,000 stated value.

What are the advantages and disadvantages of each of these alternatives? What considerations are relevant for determining the best alternative?

C:2-58 Assume the same facts as in Problem C:2-57.

- Given the nursery's operating prospects, what business forms might Paula and Mary consider and why?
- In light of their proposed use of debt and equity, how might Paula and Mary structure a partnership to achieve their various business and investment objectives?

CASE STUDY PROBLEMS

C:2-59 Bob Jones has a small repair shop that he has run for several years as a sole proprietorship. The proprietorship uses the cash method of accounting and the calendar year as its tax year. Bob needs additional capital for expansion and knows two people who might be interested in investing in the business. One would like to work for the business. The other would only invest.

Bob wants to know the tax consequences of incorporating the business. His business assets include a building, equipment, accounts receivable, and cash. Liabilities include a mortgage on the building and a few accounts payable, which are deductible when paid.

Required: Write a memorandum to Bob explaining the tax consequences of the incorporation. As part of your memorandum examine the possibility of having the corporation issue common and preferred stock and debt for the shareholders' property and money.



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

Managers LLC proposed to inject \$50,000 of equity capital into Lemona, but on the condition that the investment firm be granted the right to elect five members to Lemona's board of directors. Discouraged by the "high cost" of external borrowing, Leticia turned to Monica and Nathaniel.

She proposed to Monica and Nathaniel that each of the three original investors contribute an additional \$25,000 to Lemona, each in exchange for five 20-year debentures. The debentures would be unsecured and subordinated to Venture Capital Associates debt. Annual interest on the debentures would accrue at a floating 5% premium over the prime rate. The right to receive interest payments would be cumulative; that is, each debenture holder would be entitled to past and current interest payments before Lemona's board could declare a common stock dividend. The debentures would be both nontransferable and noncallable.

Leticia, Monica, and Nathaniel have asked you, their tax accountant, to advise them on the tax implications of the proposed financing arrangement. After researching the issue, set forth your advice in a client letter. At a minimum, you should consult the following authorities:

- IRC Sec. 385
- *Rudolph A. Hardman*, 60 AFTR 2d 87-5651, 87-2 USTC ¶9523 (9th Cir., 1987)
- *Tomlinson v. The 1661 Corporation*, 19 AFTR 2d 1413, 67-1 USTC ¶9438 (5th Cir., 1967)