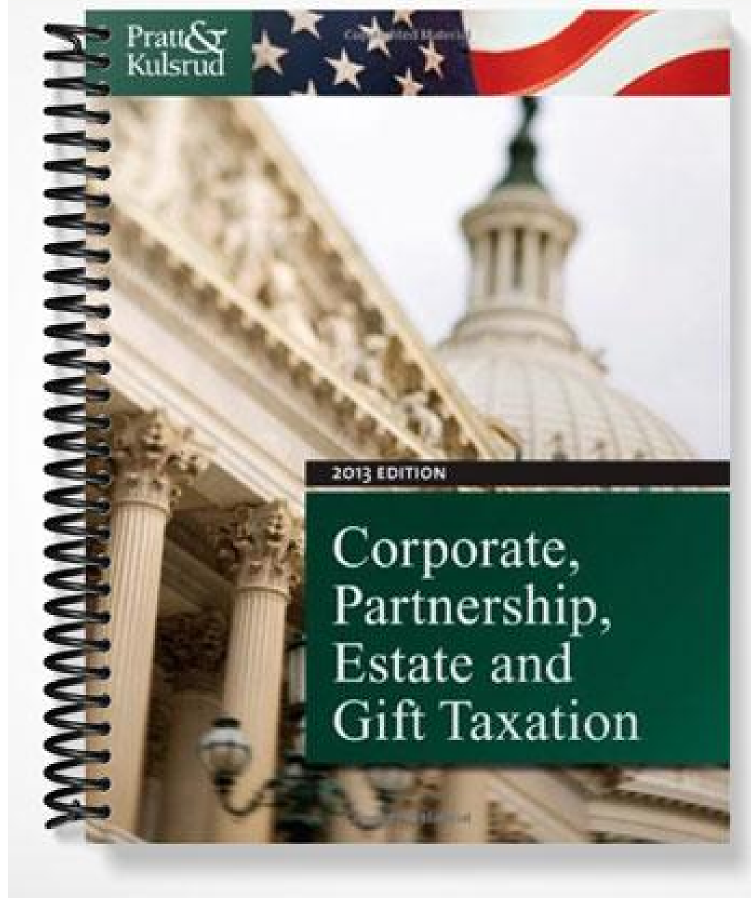
SOLUTIONS MANUAL
Pratt&
Kulsrud
2013 EDITION
Corporate,
Partnership,
Estate and
Gift Taxation

2

Corporate Formation and Capital Structure

Solutions to Problem Materials

DISCUSSION QUESTIONS

2-1 Some of the tax-related issues that should be considered are (See Example 1 and p. 2-3):

Double taxation. It is the responsibility of J's adviser to ensure that J realizes that incorporation may cause the income earned by the boutique to be taxed twice, once at the corporate level and once again when it is distributed. Although the double tax is avoided whenever the corporation is able to make a deductible distribution (e.g., salary, rents, or interest), these opportunities may not always exist (e.g., J is already receiving a reasonable salary). Double taxation problems can also occur if appreciated property is transferred to the corporation or is acquired by the corporation. If appreciated property is distributed as a dividend or in liquidation, the corporation must recognize gain on the distribution, which in turn yields a corporate level tax. When this tax is coupled with the tax at the shareholder level, double taxation results. As demonstrated in the Chapter 5 discussion of liquidations (see tax planning section), this phenomenon exacts a large penalty when the owner of a closely held corporation decides to sell his or her business. This double tax penalty on the sale of a business is a severe disadvantage of the C corporation form. For this reason alone, owners of closely held businesses often elect to operate as an S corporation. Here, it is assumed that J has made the decision to incorporate as a C corporation, so attention to specific aspects of the incorporation process are examined below.

Transfer of property. J should recognize that the tax law has important implications on the method employed by the corporation for obtaining use of business assets. Not all assets and liabilities currently associated with her boutique need to be transferred outright to the corporation in exchange for stock. Some of the assets could be retained and leased to the corporation (e.g., where the depreciation deduction would provide greater benefits to J than the corporation). Alternatively, some of the assets might be sold to the corporation. A different tax result occurs depending on which method is used. For example, the basis of the property that will be depreciated in future years may be altered, depending on the manner in which the property is obtained (e.g., if in exchange for stock, a carryover basis results, while a sale yields a step up in basis but at the cost of a tax).

Exchange for stock or debt. Consideration should be given to whether the property should be contributed in exchange for stock and/or debt as well as other property. In this regard, it should be noted that the tax consequences differ dramatically if the corporation should not succeed (e.g., § 1244 stock yields

ordinary loss, while a worthless security usually results in a capital loss).

Compensation of those performing services related to the incorporation. Professionals such as attorneys, accountants, and others who perform services related to the corporation may be willing to accept an equity interest (i.e., stock) for their services rather than cash. J should be aware of the tax consequences of paying for such services with stock.

2-2 The rationale for nonrecognition treatment for transfers to a controlled corporation lies in the continuity of interest principle. When the transfer or exchange property for stock in a corporation that the transferor control, there is only a change in the form of ownership of the property transferred. The transferor' economic position remains essentially the same, since the investment in the property continues, albeit indirectly through stock ownership. This continuity is ensured in the 80 percent ownership test. Moreover, to make transfers to a controlled corporation taxable would interfere with normal business practices; in effect, it would impose a tax on the choice of business form. In addition, if the transfer were taxable, shareholders could create artificial losses by transferring loss property to the corporation and recognizing the loss, notwithstanding the fact that the transferor still "owns" the property. [See p. 2-4 and Reg.§1.1002-1(c).]

2-3 Under § 351 (a), the general rule permitting nonrecognition on transfers to a controlled corporation, the following conditions must be satisfied for the transfer to be tax free.

Control. Those who transferred property to the corporation must own 80 percent of the stock of the corporation immediately after the exchange.

Property. Nonrecognition is granted only to transferor of property. In this regard, services are not considered property, and thus, a contribution of services is a taxable event.

Exchange solely for stock. The transferor must transfer property to the corporation and receive only stock of the corporation in exchange. Receipt of property other than stock (i.e., boot) causes realized gain to be recognized to the extent of the lesser of boot received or gain realized. (See pp. 2-5 through 2-12 and §351.)

2-4 This problem requires determination of whether § 351 applies when a transferor contributes (1) only services, (2) services and property, and (3) services and property that is nominal in value relative to that of the services.

a. Section 351 does not apply to either the exchange of R or S. Section 351 applies only to exchanges of property for stock when the transferor of property own 80 percent of the stock immediately after the exchange. With respect to S's contribution of services for stock, § 351 specifically provides that property does not include services. Therefore, § 351 does not apply to S's exchange, and S must recognize income equal to the value of the

services, $30,000. S's stock basis is also $30,000. In addition, the stock of S is not counted in determining whether the control test is satisfied. As a result, R is the only transferor of property, and he owns only 70 percent of the stock. Thus, § 351 does not apply to R's exchange and he must recognize gain of $20,000 ($70,000 – $50,000). His basis in the stock in this case would be its fair market value, $70,000. (See Example 10 and pp. 2-6 and 2-7.)

b. Section 351 applies to the exchanges of both R and S. However, the contribution of services by S is not covered by § 351. The Regulations provide that when a shareholder contributes both services *and* property (in contrast to only services as in a above), all of the stock received for services is counted toward the 80 percent threshold as long as the value of the property relative to the services is not nominal. The IRS has indicated that for ruling purposes, the value of the property must be at least 10 percent of the value of the services. In this case, the property represents 20% ($5,000/$25,000) of the value of the services and, therefore all of the stock issued for services is counted toward the control test. Because all of S's stock is counted, § 351 applies to R's exchange of property and S's exchange of property. S's exchange of services is not covered by § 351, and thus, S must report income equal to the value of stock received for services, $25,000. Note that all of S's stock, not just the proportion received for property, is counted. If only the 5 percent received for property were counted, the 80 percent test would not be satisfied since the total stock received for property would be only 75 percent. (See Examples 12 and 13 and pp. 2-8 and 2-9.)

c. Whether § 351 applies to either exchange of property depends on whether the stock of S is counted toward control. In this case, it appears that S is contributing property with the hope that the stock exchanged for services can be counted toward the 80 percent test. However, the Regulations provide that contributions of property that are nominal in value may be disregarded. The IRS has indicated that the value of stock received for property must be at least 10 percent of the value of the stock received for services before an advance ruling concerning the application of § 351 will be issued. In this case, the stock received for property represents only 3.45 percent ($1,000 property value/$29,000 services value) of the value of the stock received for services. Therefore, it appears that § 351 would not apply to either of the exchanges. Therefore, R would recognize a gain of $20,000 ($70,000 – $50,000) and have a basis in his stock of $70,000. S would report income of $29,000 and have a $29,000 basis in his stock received for services. The additional share of stock received for property will have a $1,000 basis and S will have a recognized gain or loss, depending on the difference between the property's basis and its $1,000 fair market value. (See Example 13 and pp. 2-8 and 2-9.)

2-5 This problem requires an understanding of how a contribution by a service shareholder is treated for purposes of the control test.

a. Section 351 applies only to exchanges of property for stock when the transferor of property own 80 percent of the stock immediately after the exchange. Section 351 specifically provides that property does not include services. Consequently, assuming a shareholder contributes *solely* services to a corporation, the most that could be received without disqualifying P's exchange is 20 percent. If Q receives more than 20 percent (e.g., 21%) of the stock solely for services, P's transfer of property would be fully taxable. (See Example 10 and pp. 2-7.)

b. When a shareholder couples a contribution of property with that of services, all of the stock received, not just the amount received for the property, is counted toward the control test. For example, if Q wanted 40 percent of the stock, he could contribute services for 30 percent and property for 10 percent, and all of the stock would be counted toward the control test. The Regulations caution, however, that nominal contributions of property may be disregarded. The IRS requires that the value of the contributed property be at least 10 percent of the value of the services provided in order for the transfer to be considered a transfer of property and thereby counted towards control. (See pp. 2-8 and 2-9.)

2-6 This problem addresses the fundamental aspects of the control test.

a. Section 351 applies to exchanges of property for stock when the transferor of property own 80 percent of the stock immediately after the exchange. In this case, the transferor of property, M, N, and O, *as a group,* own 100 percent of the stock immediately after the exchange. Thus, the exchanges satisfy the requirements and § 351 applies. (See Example 6 and p. 2-6.)

b. Section 351 applies. This provision applies to transfers to existing corporations (as well as newly formed corporations) as long as the various tests are satisfied. In this case, M owns 80 percent (160/200) of the stock outstanding immediately after the transfer. Note that M's ownership prior to the transfer (100 shares) is included in determining control. Section 351 does not require the transferor to obtain 80 percent control on the exchange, but merely to have 80 percent control immediately thereafter. (See Example 7 and pp. 2-6, 2-7.)

2-7 The major difference between § 721 and § 351 concerns the control test. Section 351 permits nonrecognition treatment only if the transferor owns 80% of the stock immediately after the exchange. In contrast, § 721 does not contain such a requirement. Consequently, if owners wish to admit new investors subsequent to the original formation of the entity, the partnership or LLC is far more flexible. New investors in a C or S corporation must own 80% of the stock immediately after the exchange for nonrecognition. However, existing owners probably are unwilling to relinquish their position of control so this may not be an option. Alternatively, the existing investors must accommodate the new investor by simultaneously contributing property so that their stock ownership would be

considered for purposes of the 80% ownership test. While this is an option, for the existing transferor's stock to be considered, the value of the property transferred to accommodate the new investor must be equal to at least 10% of the value of the existing stock ownership. Meeting this test may prove difficult in many situations. On the other hand, a partnership or LLC can admit owners generally without tax consequences regardless of their interests (See p. 2-6).

2-8

a. The exchanges of property for stock by S and T qualify for treatment under § 351. However, because T receives boot (i.e., securities) in addition to stock, T must recognize any gain realized to the extent of the value of the boot received. (See pp. 2-10 through 2-12.)

b. T may report the gain using the installment method, recognizing income as payments on the debt are received. (See p. 2-12.)

2-9

a. To qualify for § 351 treatment, the transferor of property must own at least 80 percent of the stock immediately after the exchange. If T's transfer is considered a part of a prearranged plan that calls for her contribution, the transfers of R, S, and T qualify for § 351 treatment because the three own 100 percent of the stock immediately after the plan is completed. On the other hand, if T's transfer is not treated as part of a plan but as a separate contribution, T's transfer does not qualify for § 351 treatment since T does not own 80 percent of the stock immediately after the exchange (she would own only 33% of the stock after her transfer). Consequently, T's transfer would be treated as a sale and any gain or loss would be recognized (§ 267 would not apply to disallow any loss since T does not own more than 50% of the stock). Even if T's transfer is considered to be separate, the transfers of R and S continue to qualify since they own 100 percent of the stock immediately after their exchanges. (See Example 15 and p. 2-9.)

b. If T desires taxable treatment (e.g., to recognize a loss), delaying the contribution of property may be desirable. (See Example 44 and pp. 2-10 and 2-35.)

2-10 All of the items except (d) (services) constitute property under § 351. Item (e), the patent, may be viewed to embody services and arguably is not property. However, the courts have generally treated patents as property. Item (f), a note receivable from a third party, qualifies as property without question. However, the treatment of a note receivable from a shareholder is more controversial. There is little doubt that it constitutes property, but whether it creates basis for purpose of determining whether liabilities exceed basis under § 357(c) is not clear. A research case at the end of this chapter deals with this problem. (See p. 2-5.)

2-11

a. Receipt of preferred stock is permissible and would not result in recognition, assuming the transferor of property otherwise satisfy the 80 percent test. To obtain nonrecognition, the transferor(s) must own 80 percent of the total combined voting power of all stock entitled to vote and 80 percent of the total number of shares of each class of nonvoting stock. This latter requirement can operate to cause what normally would be considered a nontaxable exchange into a wholly taxable transaction. For example, if one transferor contributed services solely for preferred stock and the other transferor contributed property solely for common stock, the transaction would not meet the control test since the transferor of *property* does not own 80% of the preferred stock. A research case dealing with this issue appears at the end of the chapter. (See p. 2-6.)

b. Receipt of rights to purchase stock is not the equivalent of receiving stock; thus gain would be recognized. (See p. 2-6.)

c. Securities may not be received tax-free. If a transferor receives both stock and securities in an exchange that otherwise qualifies as a § 351 transaction, the securities are treated as boot and the transferor must recognize any realized gain to the extent of the value of the securities received. Any gain to be recognized may be postponed until payments on the securities are received. If the transferor received only securities, the transfer would be considered a sale of the property to the corporation. (See p. 2-11.)

d. Convertible bonds are considered securities and *not* stock. Consequently, they are treated as boot. Thus any gain realized must be recognized to the extent of the "boot" received.

e. Receipt of money triggers recognition of realized gain to the extent of boot received. (See p. 2-10.)

2-12 A transferor may find nonrecognition undesirable when the transferor will realize a loss on the exchange. (See p. 2-11.) In addition, the transferor may attempt to step-up the basis of the property transferred to the corporation at the cost of a deferred tax (e.g., the installment sales method is used). (See Examples 44 and 45 and p. 2-35.)

2-13

a. True. Although the relief of a liability is the economic equivalent to receiving cash and paying off the debt, Congress has provided otherwise. [See Example 18, p. 2-12, and § 357(a).]

b. False. Although liabilities transferred by the transferor are normally not considered boot for purposes of determining gain or loss recognized on the exchange, they are treated as boot in determining the transferor's basis except those liabilities relating to routine deductible expenditures, which are exempted from liability status under § 357(c)(3). (See Examples 27 and 28

and pp. 2-17 and 2-18.)

c. False. Note that the gain realized is irrelevant. Gain must be recognized to the extent liabilities exceed basis regardless of the amount of gain realized. The gain realized is irrelevant since in this case it will always equal or exceed the excess of the liabilities over basis. [See Examples 21 and 22, p. 2-14 and § 357(c).]

d. True. If any of the liabilities are tainted, all liabilities are treated as boot, not just those that have no business purpose. [See p. 2-13 and § 357(b).]

e. True. Normally, when total liabilities transferred exceed total basis transferred, gain is recognized only to the extent that the liabilities exceed basis [§ 357(c)]. However, if any of the liabilities are tainted (i.e., their transfer has no business purpose or is for tax avoidance purposes), all liabilities—not just the tainted liabilities—are treated as boot and any gain realized is recognized to the extent of the boot received [§ 357(b)]. This treatment is far more severe, causing the taxpayer to recognize more gain. [See footnote 28, p. 2-13, and § 357(c)(2)(A).] If both § 357(b) (liability bailouts) and § 357(c) (liabilities in excess of basis) apply, § 357(b) controls, causing all liabilities to be treated as boot. [See p. 2-14.]

f. True. Only liabilities that create a capital asset are considered liabilities. [See Examples 23 and 24, pp. 2-15 and 2-16, and § 357(c)(3)(A)(I).]

2-14 F might consider becoming a transferor also so that his ownership interest can be counted in determining whether the control requirement is satisfied. F would have to contribute an amount of property or cash equal to at least 10 percent of the value of the stock already owned to meet IRS guidelines. [See Example 14, p. 2-9, Reg. § 1.351-1(a)(1), and Rev. Proc. 72-22, 1976-1 C.B. 562.]

2-15 G may not be able to utilize the nonrecognition provision of § 351 because of the plan to dispose of more than 20 percent of the stock after the incorporation and related exchange. This plan ultimately would leave G with less than 80 percent ownership of the corporation required by § 351. Momentary control is sufficient as long as no prearranged plan to dispose of the stock exists as it does in this situation. (See Example 16 and p. 2-10.)

2-16 When depreciable property is transferred to a corporation in a tax-free exchange, recapture of depreciation already deducted by the transferor is not triggered. Instead, the recapture potential shifts to the transferee-corporation. In this case, the $1,000 of potential depreciation recapture (i.e., the amount of depreciation claimed by the transferor) carries over to the corporation. Upon subsequent sale of the computer at a $2,500 gain (a highly unlikely result), the corporation must recapture the $1,000 of depreciation claimed by D plus any depreciation it has claimed. In this case, at least $1,000 of the gain is ordinary income and the balance is § 1231 gain. [See Example 32 and p. 2-21 and §§ 1245(b)(3) and

1250(d)(3).]

2-17

a. No effect. The corporation recognizes no gain or loss when it receives money, property or services in exchange for its stock. (See p. 2-18 and § 1032.)

b. No effect. Under 1032, a corporation recognizes no gain or loss on the issuance of its stock. Whether the transaction qualifies under § 351 for nonrecognition is irrelevant. (See p. 2-18 and § 1032.)

c. No effect. The corporation can use either newly issued or treasury stock. (See p. 2-18.)

d. The corporation may treat the issuance of stock for services as if it had paid cash to the person who provided (or will provide) the services and that person purchased the stock for the cash received. The corporation still recognizes no gain or loss on the issuance of stock. Instead, it will treat the payment as an organization expense. Consequently, the corporation's taxable income would be reduced. (See Example 5 and pp. 2-6 and 2-18 and Rev. Rul. 62-217, 1962-2 C.B. 59.)

2-18 The transferor uses a substituted basis for the stock received computed as follows (see example 25 and p. 16.):

	Adjusted basis of property transferred
+	Gain recognized
–	Boot received
–	Liabilities transferred
=	Adjusted basis of stock received

In contrast, the basis of any boot received is the boot's fair market value. The holding period for the stock received begins on the same day as that for the assets transferred when the assets transferred are capital assets or § 1231 property. The holding period for stock received for assets other than capital assets or § 1231 property (e.g., inventory), as well as any boot received, begins on the date of the exchange. (See Exhibit 2.1 and p. 2-16.)

The corporation uses a carryover basis for the contributed property, computed as follows:

Adjusted basis of property transferred

+ Gain recognized by the transferor

= Adjusted basis of property transferred

The holding period of the property received by the corporation includes the period held by the transferor. (See Example 29 and Exhibit 2.2 and pp. 2-18 and 2-19).

a. Transferor's basis is a substituted basis and the holding period begins on December 3, 2009 since the machine is § 1231 property.

   Corporation's basis is a carryover basis and the holding period begins on December 3, 2009.

b. The provider of services (note that the term *transferor* as applied to a service shareholder is somewhat of a misnomer) has a basis in the stock received equal to its value. In essence, the service shareholder has purchased the stock using his services as consideration. The holding period begins on May 5, 2012, the date of the transfer.

   The corporation receives an intangible asset that it must capitalize as an organization expense equal to the value of the stock, and it must amortize the expense over 60 months or longer.

c. Transferor's basis is a substituted basis for the stock. The basis of the note (boot) is its FMV. The holding period of the stock begins on the date of the exchange, December 20, 2012, since the assets transferred were inventory rather than capital assets or § 1231 property. The holding period of the note (boot) begins on the date of the transfer, December 20, 2012.

   Corporation's basis is a carryover basis, and the holding period begins on June 6, 2012, assuming it is relevant (i.e., it is irrelevant if the property is inventory in the hands of the corporation).

2-19 If J exchanges the property for stock, the basis of the property to be depreciated by the corporation is the same as J's. On the other hand, if an installment sale of the property to the corporation is effected, J may increase the basis of the property at the cost of a capital gains tax that may be deferred through the installment sales method. As a result, the S corporation has greater losses (attributable to the higher depreciable basis), which flow through to the individual shareholders and can be used to shelter the income of these shareholders from other sources. Assuming J and D each receive 50 percent of the corporation's stock, and they are unrelated, § 1239 (causing gain recognized on sales of depreciable property in the hands of the buyer between related parties to be treated as ordinary income) is inapplicable since J does *not* own *more than* 50 percent of the stock. For the same reason, the installment sales provisions, which deny the use of the installment sales method for sales between related parties, is also inapplicable. (See Examples 45 and 46 and pp. 2-35 through 2-36.)

2-20

a. JEL may exclude from income both the contribution of the building and the $250,000 cash. Contributions by nonshareholders are excluded if the transfer is an inducement rather than a payment for goods or services. The corporation's tax basis for the building is zero. Thus, the corporation has no depreciation. With respect to the $250,000, the corporation must either spend it within 12 months and reduce the basis of what is purchased, or reduce the basis of other property after the 12-month period has elapsed. The basis of depreciable property is reduced first. [See Example 36, pp. 2-23 and 2-24, and § 362(c)(1).]

b. If JEL shareholders made the contribution, the corporation would realize no income from the receipt of these items. The transfer is treated as a nontaxable shareholder contribution to capital if the contribution does not represent compensation for something the corporation has provided or will provide in the future. The shareholders increase their basis in their stock of JEL by the amount of cash and the basis of the property transferred. JEL's basis in the property transferred is the same as the shareholder's basis. (See p. 2-24.)

2-21 The advantages of using stock are summarized below.

- The issuance of stock enables the corporation to raise capital that need not be repaid at any particular time.

- Dividends are not required to be paid on common stock, so that a corporation pays dividends only if and when it has sufficient funds.

- Dividends paid by a corporation are deductible by corporate recipients (e.g., 70% of the dividend received).

- If the stock qualifies as § 1244 stock, loss or worthlessness may result in ordinary loss treatment.

- If the stock qualifies as qualified small business stock, gain on the sale will qualify for partial exclusion.

Some of the disadvantages of using stock are the following:

- Dividends paid are not deductible;

- Stock in a closely held corporation may be difficult for a shareholder to sell; hence, the shareholder seeking a return of his or her capital investment may be forced to redeem his or her stock, which often results in dividend rather than sale treatment; and

- Earnings cannot be accumulated to redeem the stock without risk of the

accumulated earnings tax.

The advantages of using debt are the following:

- Interest payments are deductible by the corporation (as a result the cost of financing is far less than that of using stock, assuming the corporation must provide similar returns);
- The repayment of the principal amount of the debt by a corporation is tax-free to the holder of the debt;
- The issuance of bonds provides a source of capital for the corporation;
- Debt may be transferred to family members and others without loss of control (a similar result can be obtained with nonvoting stock); and
- Earnings may be accumulated to retire debt without risk of incurring the accumulated earnings tax.

Some of the disadvantages of using debt are listed below:

- On incorporation, debt is treated as boot, causing any gain realized to be recognized;
- Interest payments must be made periodically; and the debt itself ultimately must be repaid in order to avoid default by the corporation;
- Debt may be reclassified as stock if the corporation is too thinly capitalized; and
- Loss or worthlessness of debt evidenced by a security results in a capital loss that is deductible, subject to limitations. (See pp. 2-25 through 2-27.)

2-22

a. The approach taken to determine whether debt is truly debt or stock depends on whether the debt instrument is straight debt or a hybrid instrument. Straight debt (i.e., a debt instrument that contains all the formalities of debt, including an unqualified promise to pay a sum certain at a specific maturity date along with a fixed percentage of interest) is most likely to be treated as stock when the debt-to-equity ratio is high or stock and debt are held in the same proportion. A high debt-to-equity ratio suggests that the corporation is undercapitalized and repayment of the debt is primarily dependent on the earnings of the business. In such case, the creditor assumes so much risk that he or she effectively is a holder of equity. When all debt is held in the same proportion as stock, creditors have little reason to assert their rights as creditors since they would receive the same amount on the corporation's failure whether they exercised their rights as creditors or shareholders.

Accordingly, proportionate holdings of stock and debt suggest that a true debtor-creditor relationship does not exist, and, hence, the debt is stock.

A hybrid instrument (e.g., a bond that is convertible to stock) normally is not considered stock unless it contains characteristics of stock. For example, a bond's interest payment may contain a fixed element plus some percentage of the corporation's annual earnings. Problems with hybrid instruments normally arise in the context of a corporate acquisition. For example, the acquiring corporation may issue subordinated debentures or junk bonds to obtain cash to pay the purchase price of the target corporation's stock. In such case, the cost of acquiring the target is subsidized through the interest deduction on the instruments. If these instruments contain equity features, there is a risk that they will be treated as stock and consequently the interest deduction will be denied. (See Example 39, pp. 2-27 through 2-29, and § 385.)

b. A corporation is said to be "thinly capitalized" when the capital structure consists primarily of debt rather than stock. For many years, debt to equity ratios were considered excessive if they exceeded four to one. (See p. 2-26.)

c. If a corporation's debt is recharacterized as stock, all interest payments previously deducted are normally treated as nondeductible dividend payments. In addition, payments of principal may be treated as redemption of stock, which may cause the payments to be characterized as dividends. (See p. 2-27.)

2-23

a. The losses on both the debt and stock are treated as a loss from worthless securities and, consequently, considered losses arising from the sale of capital assets on the last day of the taxable year in which they become worthless. Thus, the losses could be deducted to the extent of $3,000 plus capital gains. It is important to note, however, that the stock issued in this case would no doubt qualify as § 1244 stock, thus enabling ordinary loss treatment for a portion of the loss. [See Examples 40 and 41, pp. 2-29 through 2-33, and §165(g).]

b. Q would prefer to treat the worthless advances as ordinary losses arising from business bad debts rather than short term capital losses attributable to nonbusiness bad debts. According to the courts, where the creditor is a shareholder-employee, the advance is treated as a nonbusiness bad debt unless the dominant reason for making the advance is to protect the shareholder's employment rather than his or her investment. When the individual is trying to prevent loss of his or her salary, the advance is treated as a business bad debt. Unfortunately, since the loss relates to the taxpayer's employment, it will be considered a miscellaneous itemized deduction. In such case, the loss may be limited by the two percent floor as well as

eliminated for purposes of the alternative minimum tax. (See p. 2-30.)

2-24

a. The significance of owning § 1244 stock derives from the special treatment of losses if the stock is sold or becomes worthless. The investor may treat any loss arising from § 1244 stock as an ordinary loss up to $50,000 ($100,000 for a joint return) annually. This treatment is allowed in lieu of capital loss treatment where a shareholder can deduct annually a maximum of $3,000 plus his or her capital gains. (See p. 31.)

b. 1. No. Only the original holder of § 1244 stock receives favorable treatment.

2. No. Only the original holder is entitled to the benefits of § 1244.

3. No. The § 1244 characteristic does not carry over to a purchaser.

4. Yes. G is the original holder and she received it before total capital exceeded $1,000,000.

5. No. Stock issued for services does not qualify.

(See pp. 2-31 through 2-33.)

2-25 Stock issued after August 10, 1993 is considered qualified small business stock if at the time the stock is issued the corporation issuing the stock is a *qualified small business.* A corporation is a qualified small business if the following requirements are met. (See pp. 2-33 and 2-34.)

1. The corporation is a domestic C corporation

2. The corporation's gross assets do not exceed $50 million

3. The stock is issued for money, property other than stock, or as compensation for services (other than underwriting)

4. During substantially all of the seller's holding period of the stock, the corporation was engaged in an active trade or business other than the following:

   - A business involving the performance of providing services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services or any other business where the principal asset is the reputation or skill of one or more of its employees

   - Banking, insurance, financing, leasing, investing

   - Farming

- Businesses involving the production or extraction of products eligible for depletion
- Business of operating a hotel, motel, or restaurant

5. The corporation generally cannot own

   - Real property with a value that exceeds 10 percent of its total assets unless such property is used in the active conduct of a trade or business (e.g., rental real estate is not an active trade or business)
   - Portfolio stock or securities with a value that exceeds 10 percent of the corporation's total assets in excess of its liabilities

A sale of the stock qualifies for the 50 percent exclusion only for the original owner and only if the stock is held for five years.

a. The B&N stock should qualify since at the time the stock was issued, the corporation is a C corporation, its gross assets do not exceed $50 million. Whether the stock actually qualifies depends on the nature of the business that it conducts. Only the active businesses identified above may be carried on if the stock is to qualify. (See pp. 2-33 and 2-34.)

b. Dr. Payne's stock does not qualify since the performance of the medical services does not constitute a qualified trade or business. In addition, the S election probably bars the stock from § 1202 treatment. Although the corporation was a C corporation at the initial issuance of the stock, it would appear that the prompt S election would make the corporation's stock ineligible. (See pp. 2-33 and 2-34.)

c. Symon Corporation's stock does not qualify since it probably does not meet the active business requirement. Under § 1202(e)(7), this test is not met for any time that the corporation's real estate holdings exceed 10 percent of its total assets unless the real estate is actively used in a trade or business. For this purpose, rental real estate—the rental of the freestanding stores—does not constitute an active trade or business. (See pp. 2-33 and 2-34.)

PROBLEMS

2-26

a. No. In order to obtain nonrecognition under § 351, the transferor of property must own at least 80 percent of the stock immediately after the exchange. In this case, M and N are the only transferor of property (since O transferred services), and they own only 60 percent [(10 + 20)/(10 + 20 + 20)]. (See Example 10 and pp. 2-7 through 2-8.)

b. Yes. Now M and N, the transferors of property, own 85.71 percent [(10 + 20)/(10 + 20 + 5)]. Under § 351, M and N qualify for nonrecognition treatment. However, O must recognize income for the value of the services contributed. (See Example 10 and pp. 2-7 through 2-8.)

2-27 Some answers are identical in all the situations. G has no gain on the cash contributed and has a basis in the stock of $20,000. The corporation, FG, has a basis in the cash of $20,000. The value of the services, $30,000, is taxable as ordinary income by the person who performs them. That person's basis for the 30 shares of stock received for services is the amount of ordinary income recognized, $30,000. FG's basis for the services is $30,000, which may be capitalized as an asset or expensed. (See Examples 5 and 9 and pp. 2-6 and 2-8.)

a. Section 351 is not applicable since services performed by Y do not qualify as property, leaving the transferors of property, F and G, owning only 70% of the stock. The transferors or property must own at least 80% of the stock immediately after the exchange. Consequently, F must recognize her realized gain of $17,000 ($50,000 – $33,000) and has a basis in the stock of $50,000. FG's basis in the equipment is $50,000. (See Example 11 and p. 2-8.)

b. Section 351 is applicable to the initial exchanges since it is unlikely that Y's services could be considered a part of the original contributions-for-stock agreement. Thus, F and G owned 100 percent of the shares after their exchanges. F has recognized no gain and has a substituted basis for her stock of $33,000, and FG has a carryover basis in the equipment of $33,000. (See Examples 6, 15 and 25 and pp. 2-7, 2-10, 2-11, 2-16 and 2-18.)

c. Section 351 is applicable. Since F contributed *both* property and services, all of her stock is counted for the control test. Thus, F and G owned 100 percent of the shares after their exchanges and the answers are identical to those in (b) above. F must recognize income for the value of the stock received for services and take a total basis in the stock of $63,000 ($33,000 substituted basis + $30,000 basis in stock received for services). (See Example 12 and p. 2-8.)

d. The answer is the same as (b) above. Even though the value of G's services exceed his cash contribution, the amount of cash would not be considered *nominal.* G's total basis in the stock received is $50,000 ($20,000 + $30,000). (See Example 13 and p. 2-9.)

2-28

a. The realized gain of A and B would be computed as follows:

A	B	
	Land & Building	Equipment

Amount realized			
Stock received	$100,000	$ 70,000	$ 30,000
Adjusted basis			
Cash	(100,000)		
Land and building		(20,000)	
Equipment		(40,000)	
Gain (loss) realized	$ 0	$ 50,000	$ (10,000)

None of the gain or loss realized by B is recognized because the exchange qualifies under § 351 (i.e., immediately after the exchange, the transferors of property, A and B, own at least 80% of the stock) and no boot is received. As a practical matter, boot in the form of cash is rarely received. (See Examples 4 and 6 and pp. 2-4 and 2-8.)

b. The basis of the stock received under § 358 is normally the same as the property transferred, increased by any gain recognized by the transferor and reduced by any boot received (including nonroutine liabilities). However, the duplication of loss rule may require a different approach. This rule applies only when the aggregate basis of the assets transferred exceed the value of such assets. In this case, the aggregate basis of the assets transferred by A, $60,000, do not exceed their value, $100,000, so the duplication of loss rule does not apply. As a result, the basis of the stock received by A and B is computed as follows:

	A	B
Basis of property transferred		
Cash	$ 100,000	
Land and building		$ 20,000
Equipment		40,000
+ Gain recognized	—	—
– Boot received	—	—
Basis of stock received	$ 100,000	$ 60,000

(See Example 25 and p. 2-16 and p. 2-19.)

c. None. A corporation does not recognize gain or loss on the exchange of

stock for property. (See p. 2-18 and §1032.)

d. The basis of property to the corporation under § 362 is the same as the basis to the transferor increased by any gain. This is usually referred to as a carryover basis. In this case, the transferor did not recognize any gain and, thus, the bases in the land and building are the same as they were in the hands of the transferor: \$20,000 and \$40,000, respectively. (See Example 29 and pp. 2-18 and 2-19.)

2-29 Section 351 should apply because the transferor of property, × and Q, own 85 percent of the stock immediately after the exchange, as determined below. × will have a substituted basis of \$20,000 in the 200 shares received and QZ, Inc. will have a \$20,000 carryover basis in the land. Q will have a \$30,000 basis in the additional 100 shares received.

Transferor of Property Acquired Ownership Transferor		*Existing Ownership Total Owned by Property*	*Newly*
Q 550	100	650	
X—	200	200	
Total	550	300	850

$$\frac{\text{Transferor'ownership}}{\text{Total shares outstanding}} = \frac{850}{650 + 200 + 150 + 1,000} = 85\%$$

Note that in applying the 80 percent test, Q's existing stock ownership is counted in addition to the stock acquired on the exchange. This is allowed as long as Q's transfer is not considered nominal. For advance ruling purposes, the IRS will not count a shareholder's preexisting equity interest unless the value of that shareholder's transfer is at least 10 percent of the value of the stock already owned. This test is met in this case, as determined below.

$$\frac{\text{Value of Q's newly acquired ownership}}{\text{Value of Q's existing ownership}} = \frac{\$300*/\text{share} \times 100 = \$30,000}{\$300/\text{share} \times 550 = \$165,000} = 18.18\% \geq 10\%$$

*\$30,000/100

(See Examples 7 and 14 and pp. 2-7 and 2-9.)

2-30

a. Although both F and V *realize* a gain on the exchange, neither *recognizes* any of the gain because of the exception provided by § 351. The gain realized by F and V is computed below.

	F	*V*
Amount realized:		
FMV of stock received ($400/share × 50)	$ 20,000	$ 20,000
Liability assumed by corporation		5,000
Less adjusted basis	(18,000)	(10,000)
Gain realized	$ 2,000	$ 15,000

The transaction qualifies for nonrecognition treatment under § 351 since F and V, the transferor of property, own all of the stock of the corporation immediately after the exchange. Since the shareholders did not receive any boot on the exchange (for this purpose relief of the liability is not treated as boot), no gain is recognized. [See Example 17, pp. 2-11 and 2-12, and§351(a)and(b)and§357(a).]

b. None. A corporation recognizes no gain or loss on the issuance of stock in exchange for property. However, it should be emphasized that if services are contributed, issuance of stock for services will have an effect on the corporation's taxable income. (See p. 2-18 and § 1032.)

c. The basis of the stock received by F and V is a substituted basis computed as follows:

		F	*V*
	Basis of property transferred	$ 18,000	$ 10,000
+	Gain recognized	0	0
–	Boot received, including liabilities	0	(5,000)
=	Basis of stock received	$18,000	$ 5,000

Observe that in the computation of V's basis the liabilities are treated as boot while they were not treated as boot for purposes of determining the amount of gain recognized. Note, however, that liabilities that give rise to deductions when paid by the transferee corporation are ignored for basis purposes. (See Exhibit 2.1, Example 27, and p. 2-17.)

d. The basis of the assets received by SWS, Inc. is a carryover basis computed below:

	Equipment	*Warehouse*
Adjusted basis to transferor	$18,000	$10,000

+	Transferor's gain	0	0
=	Corporation's basis	$18,000	$10,000

(See Exhibit 2.2, Examples 29, and pp. 2-18 and 2-19.)

2-31 This problem illustrates the tax consequences of receiving boot on transfers to a controlled corporation that would otherwise qualify for nonrecognition treatment under § 351. The problem also illustrates application of the control test to the admission of new shareholders to an existing corporation. Finally, the problem requires knowledge of how the loss duplication rules apply.

a. The transaction qualifies for § 351 since the transferor of property own at least 80 percent of the stock, as computed below. Note that the existing ownership of R, as well as the stock received on the exchange, is included in determining the stock owned by the transferor of property. (See Example 7 and p. 2-7.)

Transferor of Property	*Existing Ownership*	*Newly Acquired Ownership*	*Total Owned by Property Transferor*
R	50	100	150
S	—	100	100
T	—	70	70
U		30	30
Total			350

$$\frac{\text{Transferor' ownership}}{\text{Total shares outstanding}} = \frac{350}{50 + 150 + 100 + 70 + 30 = 400} = 87.5\%$$

b. The gain and loss realized and recognized by the transferor is computed below. Under the general rule of § 351, no gain or loss is recognized. However, under § 351(b), gain, but not loss, must be recognized to the extent the transferor receives boot. (See Example 17 and p. 2-11.)

	S	*T*	*U*	*R*
Amount realized				
Stock received	$100,000	$ 70,000	$ 30,000	$ 100,000
Cash received	10,000	10,000	10,000	—
Total	$110,000	$ 80,000	$ 40,000	$ 100,000

Adjusted basis of property transferred	(60,000)	(74,000)	(66,000)	(100,000)
Gain (loss) realized	$ 50,000	$ 6,000	$(26,000)	$ 0
Boot received	$ 10,000	$ 10,000	$ 10,000	$ 0
Gain recognized				
(Lesser of gain realized or boot received)	$ 10,000	$ 6,000	$ 0*	$ 0

*No loss is recognized.

c. The basis of the stock received for each shareholder is normally a substituted basis; that is, the basis of the property transferred is substituted for the basis of the stock and securities received. (See Exhibit 2.1, Example 26, and pp. 2-17 and 2-18.) The basis of the stock of each shareholder is computed as follows.

	S	*T*	*U*	*R*
Basis of property transferred	$60,000	$74,000	$66,000	$100,000
+ Gain recognized	10,000	6,000	0	0
– Boot received	(10,000)	(10,000)	(10,000)	0
= Basis of stock received	$ 60,000	$ 70,000	$ 56,000	$100,000

The loss duplication rules of § 362(e)(2) may impact the calculation of U's stock basis. See the answer to part d below.

d. The bases of the assets received by the corporation are normally the same as their bases in the hands of the transferor increased by any gain recognized. This is referred to as a carryover basis. (See Exhibit 2.2, Example 29, and p. 2-19.) The corporation's basis in the property received from each shareholder is computed as follows.

	S	*T*	*U*	*R*
Basis of property transferred	$60,000	$74,000	$66,000	$100,000
+ Gain recognized	10,000	6,000	0	0
= Basis of assets	$70,000	$80,000	$66,000*	$100,000

* The loss duplication rules of § 362(e)(2) apply in determining the corporation's basis of the embroidery equipment contributed by U. Under this provision, if the aggregate basis of the property ($66,000) transferred by the transferor (U) exceeds the value of such assets ($40,000)— that is, there is a net built-in loss ($26,000)—the aggregate basis of the assets transferred cannot exceed their value. In this situation, the corporation's basis would normally be a substituted basis of $66,000. However, because the aggregate basis of the property transferred, $66,000, exceeds the aggregate value of the property, $40,000, and there is a net built-in loss ($26,000) the corporation's basis of each loss asset is reduced by the loss asset's proportionate share of the total net built-in loss. Since the equipment is the only asset transferred by U, the basis of the asset is reduced by its proportionate share of the loss, $26,000, from $66,000 to $40,000. The computation is shown below. (See Example 31 and pp. 2-19 and 2-20.)

Aggregate basis of assets transferred $66,000

Basis reduction

Net built-in loss × asset's loss/total built-in loss

$26,000 ($66,000 aggregate basis – $40,000 aggregate value) × $26,000/$26,000 = (26,000)

Basis $40,000

In lieu of reducing the basis of the assets, if the shareholder-transferor U and the corporation both elect, the transferor can reduce the basis of the stock received. The basis of the shareholder-transferor's shall not exceed the value of the stock. Normally the basis of the stock would be $56,000 but if the election is made the basis cannot exceed the value of the stock or $40,000. It should be emphasized that this election is in lieu of reducing the basis of the assets.

2-32

a Section 351 is applicable since the three shareholders own 100 percent of the stock after the exchanges and since all three assets qualify as property. Thus, there is no recognized gain or loss, and each owner has a substituted basis for his or her shares equal to the basis of the assets contributed: $68,000, $15,000, and $80,000, respectively. However, the loss duplication rules of § 362(e)(2) may have an impact on K's stock basis as explained below.

Normally the corporation's basis of the assets received is a carryover basis, the basis of the assets to the transferor increased by any gain recognized. In this case, EHK's basis would be $68,000, $15,000 and $80,000 respectively. However, the loss duplication rules apply in determining the corporation's basis of the equipment contributed by K. Under this provision, if the aggregate

basis of the property ($80,000) transferred by transferor K exceeds the value of such assets ($60,000)—that is, there is a net built-in loss ($20,000)—the aggregate basis of the assets transferred cannot exceed their value. In this situation, the corporation's basis would normally be a substituted basis of $80,000. However, because the aggregate basis of the property transferred, $80,000, exceeds the aggregate value of the property, $60,000, and there is a net built-in loss ($20,000), the corporation's basis of each loss asset is reduced by the loss asset's proportionate share of the total net built-in loss. Since the equipment is the only asset transferred by K, the basis of the asset is reduced by its proportionate share of the loss, $20,000, from $80,000 to $60,000. The computation is shown below. (See Example 31 and pp. 2-19 and 2-20.)

Aggregate basis of assets transferred $80,000

Basis reduction

Net built-in loss × asset's loss/total built-in loss

$20,000 ($80,000 aggregate basis – $60,000 aggregate value) × $20,000/$20,000 = (20,000)

Basis $60,000

In lieu of reducing the basis of the assets, if the shareholder-transferor K and the corporation both elect, the transferor reduces the basis of the stock received. The basis of the shareholder-transferor's stock cannot exceed the value of the stock. Normally the basis of the stock would be $80,000 but if the election is made, the basis cannot exceed the value of the stock or $60,000. It should be emphasized that this election is in lieu of reducing the basis of the assets. If the election is made, the basis of the equipment would be $80,000.

b. Section 351 is applicable since the three shareholders own 100 percent of the stock after the exchanges. However, each of them has received $10,000 boot since four-year notes are not stock. Each one's recognized gain is the lesser of the realized gain or the $10,000 boot as determined below. All recognized gain occurs as payments on the notes are collected [Reg. § 1.453-1(f)(3)].

	E	*H*	*K*	
Amount realized:				
FMV of stock received		$ 60,000	$ 60,000	$ 50,000
Note payable	10,000	10,000	10,000	
Total amount realized	$ 70,000	$ 70,000	$ 60,000	

Less adjusted basis	(68,000)	(15,000)	(80,000)
Gain (loss) realized	$ 2,000	$ 55,000	($ 20,000)

Gain recognized = Lesser of: Gain realized or $10,000 boot received $ 2,000 $ 10,000 No loss recognized

K has a realized loss of $20,000 ($60,000 – $80,000), but since losses are never recognized on a § 351 exchange, K has no recognized gain or loss. In all instances, the basis for boot (the note) is its market value, $10,000 in this situation for each shareholder. The basis for the stock is normally determined as follows:

	E	*H*	*K*
Adjusted basis of property to the transferor	$ 68,000	$ 15,000	$ 15,000
+ Gain recognized on the exchange	2,000	10,000	0
= Aggregate basis of property received	$ 70,000	$ 25,000	$ 80,000
– Boot received	(10,000)	(10,000)	(10,000)
= Basis of the stock	$ 60,000	$ 15,000	$ 70,000

EHK's basis in the assets normally is identical to the aggregate basis of property received (transferor's adjusted basis for property transferred + gain recognized by the transferor) as shown above: $70,000, $25,000, and $80,000 respectively. (See Exhibit 2.1 and 2.2 and Examples 25 and 29; and pp. 2-10 and 2-16 through 2-20.)

Like above, the loss duplication rules apply in determining the corporation s basis of the equipment contributed by K and therefore the corporation s basis would be $60,000 (see above). In addition, in lieu of reducing the basis of the assets by $20,000, if the shareholder-transferor K and the corporation both elect, transferor K reduces the basis of the stock received. The basis of the shareholder-transferor s stock cannot exceed the value of the stock. Normally the basis of the stock would be $70,000 but if the election, is made the basis cannot exceed the value of the stock or $60,000. It should be emphasized that this election is in lieu of reducing the basis of the assets. If the election is made, the basis of the equipment would be $80,000.

c. Section 351 is applicable to E and H with the same answers for them as in (a) above. However, K's exchange does not qualify under § 351, and he recognizes the $20,000 loss ($60,000 – $80,000). Section 267 does not prohibit deduction of the loss since K does not own more than 50%. Both the

basis for his shares and EHK's basis for the equipment are $60,000. (See Example 15 and p. 2-10.)

2-33

a. The transaction does not qualify for § 351 treatment since the transferor of property do not own 80 percent of the stock immediately after the exchange. In this case, the property transferor, M, A, and F, own only 75 percent (300/400) of the stock. The remaining 25 percent of the stock (i.e., 100/400) owned by V cannot be counted towards control since she contributed services. (See Example 10, p. 2-7, and §351.)

b. Calculations for the following answers are shown below.

- M realizes a $5,000 gain, of which $3,000 must be recognized. (See Example 17 and pp. 2-10 and 2-11.) As explained in part (h), the gain would be ordinary under the recapture rules of § 1245. Any gain recognized is recaptured to the extent thereof.

- A realizes a $12,000 gain, none of which must be recognized under the normal boot rules; however, she must recognize $2,000 in gain since liabilities transferred exceed basis. (See Example 22 and p. 2-14.)

- F realizes a $5,000 loss, none of which is recognized. Although F realized a loss of $5,000 and received boot (the short-term note of $1,000), loss is not recognized under § 351. (See Example 17 and pp. 2-11.)

- V must recognize $10,000 of income since her transfer of services is not governed by § 351. Rather, she is treated as having received compensation paid in the form of stock. (See Example 5 and p. 2-6.)

The gain or loss realized and recognized by the transferor, M, A, and F, who have exchanged their property under § 351 is computed below.

	M	*A*	*F*
Amount realized:			
Stock (100 shares × $100/share)	$ 10,000	$ 10,000	$ 10,000
Notes received, liabilities assumed	3,000	15,000	1,000
Total	$ 13,000	$ 25,000	$ 11,000
Adj. basis of property transferred	(8,000)*	(13,000)	(16,000)

Gain (loss) realized	$ 5,000	$ 12,000	$ (5,000)
Boot received (short-term note)	$ 3,000	$ 0	$ 1,000
Gain recognized:			
Lesser of boot or realized gain	$ 3,000	$ 0**	$ 0***
Character	Ordinary		

* Cost $12,000 – Depreciation $4,000

** Under § 357, A must recognize gain to the extent that the aggregate liabilities that she transferred exceeded her basis or $2,000 ($15,000 – $13,000).

*** No loss recognized

c. V's basis for the stock received for services is her "cost," $10,000 under § 1012, and is not computed under the rules of § 358 (concerning the basis for distributees in an exchange to which § 351 applies). The basis of the *stock* of M, A, and F is computed under the substituted basis rules of § 358 below.

M		*A*	*F*	
Basis of property transferred	$8,000	$13,000	$16,000	
+ Gain recognized by transferor		3,000	2,000	0
– Boot received and liabilities transferred		(3,000)	(15,000)	(1,000)
= Basis of stock received	$ 8,000	$ 0	$15,000	

The basis of the notes received is their fair market values, $1,000 and $3,000, since the notes are considered other property (i.e., boot). (See Exhibit 2.1, Examples 26 and 27, and pp. 2-17.)

The loss duplication rules of § 362(e)(2) may impact the calculation of U's stock basis. See the answer to part e below.

d. The corporation is entitled to treat the payment of stock for V's services as if the services had been paid for in cash. Consequently, MDI treats the payment as an organization expense of $10,000, which may be amortized over a period not less than 60 months. As a result, MDI's taxable income is reduced by the amortization for the year, $1,500 ($10,000/60 × 9). The corporation does not recognize any income on the receipt of property in exchange for its

stock under § 1032. (See Example 5, pp. 2-6 and 2-18, and Rev. Rul. 62-217, 1962-2 C.B. 59.)

e. The corporation's basis in the assets received is normally a carryover basis determined under § 362 below.

	Equipment	*Building*	*Furniture*
Basis to transferor	$ 8,000	$13,000	$16,000
+ Transferor's gain recognized	3,000	2,000	0
= Corporation's basis	$ 15,000	$15,000	$16,000*

*The loss duplication rules of § 362(e)(2) apply in determining the corporation's basis of the furniture contributed by F. Under this provision, if the aggregate basis of the property ($16,000) transferred by the transferor (U) exceeds the value of such assets ($11,000)—that is, there is a net built-in loss ($5,000)—the aggregate basis of the assets transferred cannot exceed their value. In this situation, the corporation's basis would normally be a substituted basis of $16,000. However, because the aggregate basis of the property transferred, $16,000, exceeds the aggregate value of the property, $11,000, and there is a net built-in loss ($5,000), the corporation's basis of each loss asset is reduced by the loss asset's proportionate share of the total net built-in loss. Since the furniture is the only asset transferred by F, the basis of the asset is reduced by its proportionate share of the loss, $5,000, from $16,000 to $11,000. The computation is shown below. (See Example 31 and pp. 2-19 and 2-20.)

Aggregate basis of assets transferred $16,000

Basis reduction

Net built-in loss × asset's loss/total built-in loss

5,000 ($16,000 aggregate basis – $11,000 aggregate value) × $5,000/$5,000 = (5,000)

Basis $11,000

In lieu of reducing the basis of the assets, if the shareholder-transferor F and the corporation both elect, the transferor reduces the basis of the stock received. The basis of the shareholder-transferor's cannot exceed the value of the stock. Normally the basis of the stock would be $56,000 but if the election is made the basis cannot exceed the value of the stock or $11,000. It should be emphasized that this election is in lieu of reducing the basis of the assets. If the election is made, the basis of the assets is $16,000.(See Exhibit 2.2, Example 31, and pp. 2-19 and 2-20.)

f. M's holding period for the stock begins on October 4, 2007, the same day that he purchased the restaurant equipment. The transferor's holding period of the asset transferred tacks to that for the stock when the asset transferred is a capital asset or § 1231 property, and there is a carryover basis. In this case, the basis of M carries over to MDI, and the equipment transferred is § 1231 property. (See p. 2-18 and §1223.)

g. The corporation's holding period for the equipment begins on October 4, 2007, the date on which M (the transferor) acquired the equipment. The corporation's holding period includes that of the transferor since the basis is determined in reference to the transferor. (See p. 2-18 and § 1223.)

h. M recognizes $3,000 of income on the transfer all of which is ordinary under the recapture rules of § 1245. The balance of the recapture, $1,000, is subject to recapture by the corporation when it later sells the property. [See Example 32 and p. 2-21 and § 1245(b)(3).]

2-34 Under § 357(c), M is required to recognize gain to the extent that the mortgage exceeds the basis of the land or $10,000 ($100,000 – $90,000). Assuming M is in the 50 percent tax bracket, this results in $5,000 of tax. Under § 357(b), however, all liabilities transferred are considered boot when the principal purpose of the transfer was to avoid tax or there was no bona fide business purpose for the transfer. Assuming the Service's view prevails, M has realized a $60,000 gain ($150,000 – $90,000), all of which must be recognized since the $100,000 of liabilities constitute boot. Assuming M is in the 50 percent tax bracket, this results in a tax of $30,000, or $25,000 ($30,000 – $5,000) more than under § 357(c). Note that § 357(b) predominates when both provisions apply. (See footnote 28, Examples 19, 20, and 22 and pp. 2-13 through 2-14.)

2-35

a. Q recognizes no income on the transfer. There are insufficient facts to determine whether Q realizes a gain on the exchange. In any event, however, he has not received any boot since assumption of the liabilities by the corporation is not considered boot under § 357(a). Moreover, Q does not recognize any gain under § 357(c), which requires gain recognition where liabilities exceed basis. In determining liabilities for this purpose, liabilities do not include those that would give rise to a deduction when paid by the corporation or those to which § 736(a) (concerning payments to a retired or deceased partner) apply. In this case, all of the accounts payable except the $200 bill for attorney fees is deductible when paid. The $200 bill must be capitalized as an organization expense. Thus, the comparison of aggregate liabilities to aggregate basis is made as follows:

Total liabilities ($4,000 + $ 1,500)	$ 5,500
– Accounts payable routinely deducted ($4,000 – $200)	(3,800)

= Liabilities for § 357(c) $ 1,700

Basis of assets:

Cash	$ 1,000
+ Receivables	0
+ Equipment	2,000
= Total basis	$ 3,000

Since total liabilities of $1,700 do not exceed the total basis of $3,000, no gain is recognized. [See Examples 23 and 24, pp. 2-15 and 2-16, and § 357(c)(3).]

b. Dr. Q's basis in the stock is $1,300, determined as follows:

	Adjusted basis of property transferred			
	Cash	$1,000		
	Equipment	2,000		
	Receivables	0		
	Total adjusted basis		$ 3,000	
+	Gain recognized		0	
–	Boot received (nondeductible liabilities):			
	Note payable	$1,500		
	Account payable	200		
			(1,700)	
	Adjusted basis of stock			$ 1,300

Liabilities normally are treated as boot for computing basis. For this purpose, however, liabilities that would give rise to a deduction when paid are ignored. (See Example 28 and pp. 2-17 and 2-18.)

2-36

a. Due to the transfer, D has *realized* a gain of $60,000 ($50,000 stock + $100,000 liability relief -$90,000 basis).

b. Under the general rule of § 357(a), the liability from which D is relieved is not

treated as boot. However, § 357(c) requires that when the aggregate amount of liabilities exceeds the aggregate basis of the assets transferred, the transferor must recognize the excess as gain. Thus, D must recognize a gain of $10,000, the excess of the mortgage on the property, $100,000, over the total basis of *all* of the assets transferred, $90,000. (See Example 22 and p. 2-14.)

c. D's basis in his stock is zero computed as follows:

Basis of property transferred	$ 90,000
+ Gain	10,000
– Boot (liabilities)	(100,000)
= Basis of stock received	$ 0

If D subsequently sells the stock for its $50,000 value, the remaining realized gain of $50,000 would be recognized. (See Examples 22 and 27 and pp. 2-14 and 2-17.)

d. The corporation's basis for land is $100,000 ($90,000 basis of property transferred + $10,000 gain recognized by the transferor). (See Example 29 and pp. 2-19.)

e. Because determination of whether liabilities exceed bases is made using an aggregate approach (and not an asset-by-asset basis), D could contribute additional assets with a basis of at least $10,000 to avoid gain recognition, or could pay off at least $10,000 of the mortgage before the transfer. (See p. 2-14.)

2-37 This problem requires a step-by-step examination of the treatment of liabilities under §§ 357(a), (b), and (c). Part (a) illustrates the general rule that nondeductible liabilities are not treated as boot for purposes of gain or loss but are treated as boot for basis. Part (b) shows that gain must be recognized when liabilities exceed basis. Part (c) deals with liability bailouts prohibited by § 357(b). Part (d) deals with the exception of § 357(c)(3) concerning liabilities of a cash basis taxpayer.

a. (1) The *realized* gain is $60,000, as computed below.

Amount realized:	
FMV of stock received	$ 100,000
Liability relief	20,000
Total amount realized	$ 120,000

Less adjusted basis	(60,000)
Gain realized	$ 60,000

None of this gain is recognized because liabilities are not treated as boot under § 357(a). (See Example 18 and p. 2-13.)

(2) The basis of the stock received is $40,000, computed as follows:

Basis of property transferred	$ 60,000
+ Gain recognized	0
– Boot received	(20,000)
= Basis of stock received	$ 40,000

Liabilities are generally treated as boot for purposes of computing the shareholder's basis in the stock received. Note that a later sale for $100,000 produces the gain that was postponed on the exchange, $60,000. (See Example 27 and p. 2-17.)

(3) The corporation's basis in the property received is $60,000, computed as follows. (See Example 29 and p. 2-19.)

Basis of property transferred	$60,000
+ Gain recognized	0
= Basis of property received	$60,000

b. (1) The gain *realized* is $80,000, as computed below.

Amount realized:

FMV of stock received	$ 70,000
Liability relief	50,000
Total amount realized	$ 120,000
Less adjusted basis	(40,000)
Gain realized	$ 80,000

Although the liabilities are not treated as boot, § 357(c) requires the transferor to recognize gain to the extent that the total liabilities transferred exceed the total basis of the property transferred. Thus, S must recognize a gain of $10,000 ($50,000 – $40,000). (See Example 22 and pp. 2-14 and 2-15.)

(2) The basis of the stock received is $0, as computed below. Note that a later sale of stock for $70,000 produces the deferred gain of $70,000. (See Examples 22 and 27 and pp. 2-14 and 2-17.)

Basis of property transferred	$ 40,000
+ Gain recognized	10,000
– Boot received	(50,000)
= Basis of stock received	$ 0

(3) Basis is $50,000, as computed below. (See Example 29 and p. 2-19.)

Basis of property transferred	$40,000
+ Gain recognized	10,000
= Basis of property received	$50,000

c. (1) It appears that the liability was created as a bailout device inasmuch as the loan was obtained shortly before the transfer and the proceeds were used for personal purposes. Note that if, at a later date, the corporation had made dividend payments to S which he had used to pay off a loan obtained to take the trip, double taxation would have resulted. If this scheme works, the funds are indirectly paid to S as the note is paid off, but double taxation is avoided. In situations such as these, when there is no business purpose for the transfer of the liability or the transfer is for tax avoidance, § 357(b) treats all liabilities (not just the tainted liability) as boot. As a result, $50,000 of the $80,000 gain realized must be recognized, as summarized below.

Amount realized:	
FMV of stock received	$ 70,000
Liability relief	50,000
Total amount realized	$120,000
Less adjusted basis	(40,000)
Gain realized	$ 80,000
Gain recognized	
Lesser of:	
Gain realized or $50,000 liability treated as boot received	$ 50,000

(See pp. 2-13 and 2-14.)

(2) The basis of the stock received is $40,000, as computed below. Note that a later sale for $70,000 produces the remaining $30,000 gain. (See Example 27 and p. 2-17.)

Basis of property transferred $ 40,000

Gain recognized 50,000

– Boot received (50,000)

= Basis of stock received $ 40,000

(3) Basis is $90,000, as computed below. (See Example 29 and p. 2-19.)

Basis of property transferred $40,000

+ Gain recognized 50,000

= Basis of property received $90,000

d. (1) Upon the transfer, the taxpayer *realizes* a gain of $52,000, as computed below.

Amount realized:

FMV of stock received $ 50,000

Liability relief

Note payable 10,000

Accounts payable 7,000

Total amount realized $ 67,000

Less adjusted basis

Dental equipment (15,000)

Gain realized $ 52,000

Although the taxpayer realizes a $52,000 gain, he escapes recognition because of several exceptions. The relief of liabilities, although equivalent to cash received, is not considered boot under the general exception of § 357. Nevertheless, § 357(c) normally requires the taxpayer to recognize gain to the extent the total value of the liabilities transferred exceeds the total basis of the assets transferred. Although this would appear to be the case here ($17,000

exceeds $15,000), § 357(c)(3) provides that liabilities that give rise to a deduction when paid are ignored. As a result, the $7,000 of accounts payable for routine lab bills are disregarded. Thus, no gain is recognized since the total liabilities, $10,000 note payable, do not exceed the total basis of the assets transferred, $15,000. (See Examples 23 and 24 and pp. 2-15 and 2-16.)

(2) The shareholder's basis for the stock is $5,000, as computed below. Note that the deductible liabilities are excluded for both gain and basis purposes. However, the note payable secured by the equipment is included for computing the basis. (See Example 28 and p. 2-17.)

Basis of property transferred	$ 15,000
+ Gain recognized	0
– Boot received	(10,000)
= Basis of stock received	$ 5,000

(3) The corporation's basis for all of the property is $15,000. The basis of the receivables is zero and the basis of the equipment is $15,000. (See Example 29 and p. 2-19.)

Basis of property transferred	$ 15,000
+ Gain recognized	0
= Basis of property received	$15,000

2-38 The corporation must recapture not only the depreciation it has claimed, $1,500, but also the $2,000 claimed by the transferor, B. Any depreciation recapture potential of the transferor shifts to the corporation. (See Example 32 and p. 2-21.)

Amount realized		$14,000
Adjusted basis		
Cost	$10,000	
Depreciation:		
B	(2,000)	
Corporation	(1,500)	
		$(6,500)
Gain		$ 7,500

Recapture

Depreciation:

B	$(2,000)	
Corporation	(1,500)	
Total ordinary income (§ 1245 recapture)		(3,500)
§1231 gain		$ 4,000

2-39 MND recognizes no income on the receipt of the contribution of land and cash. The land and cash are considered nonshareholder capital contributions representing inducements to the company to remain in the city rather than compensation for services provided or to be provided. Under § 118, MND must reduce the basis of the plant by $200,000. After the reduction, the basis in the plant is $700,000 and the basis in the land is zero. (See Example 36 and p. 2-24.)

2-40

a. Total depreciation for the truck for the year of the transfer, the second year of ownership, is computed and then allocated between K and the corporation as shown below. The corporation receives the depreciation for the month of the transfer.

Total year two depreciation:	$5,000 × 32% =	$1,600
Depreciation to K:	$1,600 × 9/12 =	$1,200
Depreciation to corporation:	$1,600 × 3/12 =	$ 400

(See Example 33 and pp. 2-21 and 2-22.)

Depreciation for van: $10,000 × 20% = $2,000

The corporation is not considered as having a short taxable year because K has been engaged in this business the entire year. The corporation, although newly formed, did not start a new business. Also, note that although the basis of the asset in the hands of the corporation (upon the transfer to the corporation) is $2,800 ($5,000 — $1,000 — $1,200), depreciation is computed using the transferor's original basis of $5,000. [See p. 2-21 and Prop. Reg. § 1.168-2(f)(4).]

b. In this case, the corporation has a short taxable year since no business was conducted prior to incorporation. When the corporation has a short taxable year, it is entitled to depreciation for half the number of months in the short taxable year. In this case, the corporation has a short taxable year of three months (October, November, and December). Thus, the corporation would be

entitled to 1.5 months (3 × ½) of the annual depreciation. Since the half year convention is already reflected in the depreciation percentages, depreciation computed using the tables must be multiplied by 3/12. Depreciation is calculated as follows:

Truck:	$5,000 × 20% × 3/12	=	$250
Van:	$10,000 × 20% × 3/12	=	$500

(See Example 35 and p. 2-22.)

c. Even though the corporation has a short taxable year, there is no special adjustment for depreciation of real property. (See p. 2-22 and Reg. § 1.168-2(f)(1). This by itself does not answer the question as to how the depreciation is computed. If the depreciation table is to be used, the month in service must be known and in the table depreciation percentages for 12 months are given. While not discussed in the text, the Regulations explain that the depreciation is computed as if the tax year was a full taxable year and the month placed in service is the same as if the tax year was a full taxable year [Reg. § 1.168-2(f)(1)Ex(3)]. Consequently, since the corporation is on the calendar year the building would be treated as if it were placed in service in the tenth month of its first year. The first year's depreciation would be $535 ($100,000 × .535% from Table H-7).

(See Appendix H for depreciation percentages applicable to nonresidential real property.)

2-41 S realizes $170,000 ($40,000 – $210,000) loss on the sale of the stock. He may claim an ordinary loss on the sale of the stock up to a maximum of $50,000 since he is single and the stock qualifies as § 1244 stock. The balance of the loss, $120,000 ($170,000 – $50,000), is treated as long-term capital loss. S's taxable income, after accounting for the stock sale, is $16,000 computed as follows:

	Ordinary taxable income ($70,000 – $1,000)		$ 69,000
–	§ 1244 ordinary loss		(50,000)
=	Ordinary taxable income		$ 19,000
	Net long-term capital loss:		
	Short-term capital gain	$ 1,000	
	Long-term capital loss	(120,000)	
	Total capital loss	$(119,000)	
–	Limitation on deduction of capital loss		(3,000)

Taxable income	$ 16,000

S carries over $116,000 ($119,000 – $3,000) as a long-term capital loss. (See Example 41, p. 2-31, and § 1244.)

2-42 Special rules are applicable in determining the loss on the sale of the § 1244 stock to ensure that taxpayers cannot convert capital losses into ordinary losses using § 1244. In effect, the built-in-loss at the time of the transfer of $180,000 ($120,000 – $300,000) does not qualify for § 1244 treatment. This is accomplished by reducing the basis of the stock for § 1244 purposes to its value at the time of the transfer. The total loss is $210,000 ($90,000 – $300,000), $30,000 of which is an ordinary loss under § 1244 while the balance of $180,000 is a capital loss.

Total loss:

	Amount realized	$ 90,000	
–	Adjusted basis		
	(FM V of stock at time of transfer)		(300,000)
	Total loss		$210,000

§ 1244 loss:

	Amount realized	$ 90,000	
–	Adjusted basis		
	(FM V of stock at time of transfer)		(120,000)
§ 1244 loss			30,000

Capital loss (on the sale of the stock)
$180,000

In computing his A.G.I., M may deduct the $30,000 ordinary loss determined under § 1244 and $3,000 of the $180,000 capital loss (assuming he has no capital gains). (See p. 2-31.)

2-43 P's losses from the stock (basis $50,000) and the note (basis $10,000) are considered losses from worthless securities. Such losses are treated as arising from the sale or exchange of the security on the last day of the taxable year in which it became worthless and, thus, are capital losses. Note that the loss attributable to the indebtedness of $10,000 is treated as a loss from a worthless security because the debt is evidenced by a note. Assuming the stock is § 1244 stock, however, P is entitled to a $50,000 ordinary loss deduction. The loss on the note is $10,000 long-term capital loss.

P's loss from the $20,000 advance is not considered as arising from a worthless security since the advance is not evidenced by a note. Instead, the loss is considered a bad debt. Since the debt was incurred to protect P's employment, the debt is treated as a business bad debt, and P may deduct the entire $20,000 without limitation. Had the debt been incurred to protect P's investment, it would have been considered a nonbusiness bad debt and, thus, treated as a short-term capital loss, deducted subject to the capital loss limitations. [See Example 40, pp. 2-30 through 2-32, and §§ 165(g)(2) and 166(e).]

2-44

	Situation A	*Situation B*		
Corporation:				
Interest expense		$ 4,000		
Corporate tax saved (34%)			1,360	
Shareholders:				
Interest income (taxable)			$ 4,000	
Debt reduction (nontaxable)			8,000*	
Dividend income (taxable)		$30,000		18,000
Taxable income received		30,000		22,000
Shareholders' tax cost (28%)		8,400	6,160	

*(1/5 × $40,000)

The tax cost is $8,400 for situation A compared with a net tax cost of $4,800 ($6,160 shareholder cost $1,360 corporate savings) for Situation B. (See Example 37 and pp. 2-25 and 2-26.)

2-45

	Situation A	*Situation B*		
§ 1244 stock ordinary loss to X		$50,000		$50,000
Y	36,000	24,000		
Stock capital loss to X		3,000	3,000	
Debt capital loss to X			0	

Y		3,000	
Total deduction	$89,000	$80,000	
Tax savings (28%)	24,920	22,400	
Capital loss carryover for X		31,000	13,000
Y	0	17,000	

The maximum ordinary loss deduction for § 1244 stock is $50,000 per taxpayer in the year of loss. All remaining stock loss for X ($84,000 – $50,000 = $34,000 for Situation A and $56,000 – $50,000 = $6,000 for Situation B) is capital loss. The loss on the debt also is a capital loss. The maximum capital loss deduction each year is $3,000. Thus, X has a capital loss carryover of $31,000 ($34,000 – $3,000) for Situation A and $13,000 ($6,000 + $10,000 – $3,000) for Situation B. Y has a capital loss carryover only in Situation B of $17,000 ($20,000 – $3,000). Since interest income has not been received, it has not been recognized and has no basis for computing loss. (See Example 40 and Example 41 and pp. 2-30 through 2-33.)

2-46

a. B has realized gain of $4,900,000 ($5,000,000 – $100,000). Whether she is eligible for the special 50 percent exclusion for qualified small business stock depends on whether her stock meets several requirements. Stock issued after August 10, 1993 is considered qualified small business stock if at the time the stock is issued the corporation issuing the stock is a *qualified small business.* A corporation is a qualified small business if:

1. The corporation is a domestic C corporation
2. The corporation's gross assets do not exceed $50 million
3. The stock is issued for money, property other than stock, or as compensation for services (other than underwriting)
4. During substantially all of the seller's holding period of the stock, the corporation was engaged in an active trade or business other than certain service businesses.

In addition, the seller must be original owner of the stock and the stock must be held more than five years.

In this case, the stock meets all of the requirements and because B is the original owner of the stock, she is entitled to the 50 percent exclusion, $2,450,000 (50% × $4,900,000). As a result, B will report a taxable gain of $2,450,000 computed as follows:

Realized gain	$5,000,000	
Amount realized	(100,000)	
Adjusted basis		
Realized gain		$4,900,000
Exclusion on QSB stock		
Amount realized	$5,000,000	
Adjusted basis for QSB stock		(100,000)
Realized gain	$4,900,000	
		× 50%
Exclusion		(2,450,000)
Taxable gain		$2,450,000

One-half of the excluded gain, $1,225,000 (50% × $2,450,000), is a tax preference item for purposes of the alternative minimum tax.

b. B realizes a gain of $14,900,000 ($15,000,000 – $100,000) and may exclude $7,450,000. As a result, her taxable gain is $7,450,000. Note that the limitation on the amount of gain that may be excluded [the larger of $10 million or 10 times the adjusted basis of all qualified stock of the corporation that the taxpayer sold during the tax year, $1,000,000 (10 × $100,000)] does not apply.

c. Because B's basis is the same as the property transferred, $20,000, B's realized gain is $4,980,000 ($5,000,000 – $20,000). For purposes of computing the amount of the exclusion, the basis of any stock received for property is no less than the fair market value of the property at the time that the stock is issued, in this case, $100,000. Thus the amount of the exclusion is $2,450,000 [50% × $5,000,000 – $100,000 = $4,900,000)]. B's total taxable gain is $2,530,000 ($4,980,000 – $2,450,000). This may be summarized as follows:

Realized gain	$5,000,000	
Amount realized	(20,000)	
Adjusted basis		
Realized gain		$4,980,000
Exclusion on QSB stock		

Amount realized	$5,000,000	
Adjusted basis for QSB stock		(100,000)
Realized gain	$4,900,000	
		× 50%
Exclusion		(2,450,000)
Taxable gain		$2,530,000

d. No. B may use the rollover provision of Section 1045 to defer the recognition of the gain by using the proceeds from the sale to purchase other QSB stock.

(See Example 43 and p. 2-33.)

2-47

a. In this problem as often is the case, one of the parties to a new venture wants an equity interest in the business in exchange for his or her services. The obvious problem concerns the issuance of stock to D.Q. for her services. Because the stock is issued solely for services and is part of the plan to incorporate, D.Q.'s stock ownership is not counted towards the control test and the test is failed. In such case, S.W. is quite vulnerable since he would be required to recognize gain on the contribution of appreciated property. For this reason, it would be unwise for S.W. to consummate the transaction as currently planned.

No doubt there are several ways that the transaction could be altered in order to secure § 351 treatment. Perhaps the most straight forward is to cut D.Q. out of the initial deal and promise to give her stock at a later date. If this can be done, S.W.'s transfer would be nontaxable because S.W. and H.R. would be the only transferor of property and together they own the required 80 percent of the stock. From a tax view, D.Q. should not object since her transaction cannot be protected by § 351 and is taxable whether received now or later. However, D.Q. might not perform the services if this approach is taken. She may want stock now.

Perhaps the more obvious approach is simply to require D.Q. to buy her stock for $20,000 and receive an increased retainer in the future. Of course, if D.Q. is cash poor this could be a problem. However, it is unnecessary for D.Q. to pay the entire $20,000. The regulations allow the stock ownership of a service shareholder to be counted towards the control test if she contributes both property and services. Note that all of the stock is counted, not simply the amount received for property. But Regulation § 1.351-1(a)(1)(ii) warns that to rely on this rule the service shareholder's contribution of property must not be nominal (e.g., a contribution by D.Q. of $1,000 would not get the job done).

For ruling purposes, the IRS requires that the value of the property must be at least 10 percent of the value of the services (Rev. Proc. 77-37,1977-2 C.B. 568). Thus it seems that if an arrangement is structured so that D.Q. meets this test, D.Q.'s property contribution would be greatly reduced.

Although the above plan is good, it still does not solve the problem if D.Q. cannot come up with the cash to contribute. A technique that should work is to have D.Q. contribute a note payable to the corporation for $20,000 in exchange for the stock. The note could be payable over a five-year period at $4,000 a year from D.Q.'s retainer. The note should qualify as property for § 351 and, therefore, D.Q. will be admitted to the control club, enabling the transaction to qualify for § 351 treatment. b. H.R. should not do the deal as planned since his property is more valuable than that of S.W. S.W. is contributing high-value low-basis property. Consequently, H.R. should demand that S W. contribute additional property or cash to make up for the fact that H R.'s cash contribution is more valuable.

TAX RETURN PROBLEMS

Solutions to the Tax Return Problems (2-48) are contained in the *Instructor's Resource Guide and Test Bank* for 2013.

TAX RESEARCH PROBLEMS

Solutions to the Tax Research Problems (2-49–2-55) are contained in the *Instructor's Resource Guide and Test Bank* for 2013.