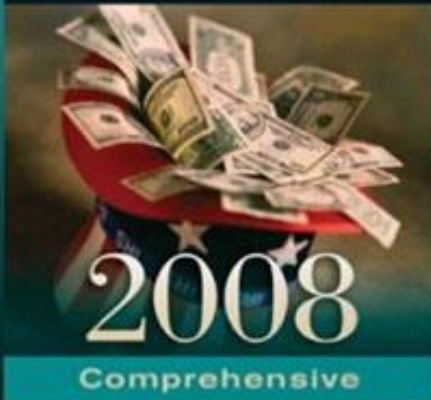


SOLUTIONS MANUAL



PRENTICE HALL'S FEDERAL TAXATION



Comprehensive

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Chapter C:2

Corporate Formations and Capital Structure

Learning Objectives

After studying this chapter, the student should be able to:

1. Explain the tax advantages and disadvantages of using each of the alternative business forms.
2. Apply the check-the-box regulations as they pertain to partnerships, corporations, and trusts.
3. Determine the legal requirements for forming a corporation.
4. Explain the requirements for deferring gain or loss upon incorporation.
5. Understand the tax implications of alternative capital structures.
6. Determine the tax consequences of worthless stock or debt obligations.
7. Understand the financial statement implications of forming a corporation.

Areas of Greater Significance

It is important for the student to understand the tax consequences of forming a corporation, including the impact on both corporation and shareholder. The tax advantages and disadvantages of alternative forms of doing business should also be stressed.

Areas of Lesser Significance

In the interest of time, the instructor may determine that the following areas are best covered by student reading, rather than by class discussion:

1. Capital contributions.
2. Compliance and procedural considerations (Reporting requirements under Sec. 351).
3. Choice of capital structure.

Problem Areas for Students

The following areas may prove especially difficult for students:

1. Allocating basis in a partially tax-free incorporation.
2. Characterization of an instrument as debt or equity.
3. Understanding that the tax basis for property contributed to a corporation is different from the basis that is used for financial accounting purposes.

Highlights of Recent Tax Law Changes

The Jobs and Growth Tax Relief Reconciliation Act of 2003 provided that distributed dividends received by a noncorporate shareholder are taxed at a 15% rate for taxpayers whose ordinary tax bracket exceeds the 15% rate. Capital gains are also taxed at a 15% rate. The 15% rate for dividends and capital gains is scheduled to remain effective through 2008.

The Health Reform Act of 1996 extends the ability of self-employed individuals and partners to deduct a percentage of their health insurance costs incurred on behalf of themselves, their spouses, and their dependents as a trade or business expense. The percentage allowed is 70% in 2005 and 80% in 2006 and thereafter. Excess health insurance costs may be deducted as an itemized deduction subject to the 7.5% of AGI nondeductible floor.

Special check-the-box final regulations, issued in December 1996, replaced the Morrissey rules for classifying business organizations with an elective regime. Under the final regulations, most business entities with two or more members can elect to be classified as a corporation or as a partnership. A business entity with a single owner can elect to be classified as a corporation or have its separate entity status be disregarded (i.e., treated as a sole proprietorship, branch, or division). These regulations apply in years after 1996.

Under Sec. 351, voting or nonvoting stock may be received by the transferors. However, nonqualified preferred stock is now treated as boot. Preferred stock is nonqualified if: 1) the shareholder can require the corporation to redeem the stock, 2) the corporation is either required to redeem the stock or is likely to exercise a right to redeem the stock, or the dividend rate on the stock varies with interest rates, commodity prices or other similar indices. Stock rights or stock warrants are not considered stock for purposes of Sec. 351. These provisions are effective for transactions occurring after June 8, 1997.

Teaching Tips

Use Figure C:2-1 to show the default rules for the new check-the-box regulations.

Limited liability companies (LLCs) and limited liability partnerships (LLPs) have become more prevalent forms of doing business. Some discussion of LLCs and LLPs should take place here with particular emphasis on (1) the treatment of LLCs in the state where your school is located, and (2) the use of LLPs by the Big 6 accounting firms. More discussion on LLCs and LLPs takes place in Chapters C:9 and C:10.

Use Examples C:2-11 and C:2-12 to illustrate the rationale behind treating a Sec. 351 transaction as a nontaxable exchange. p. C:2-12. Some discussion might be incorporated about the fact that a corporate liquidation is not a tax-free transaction. As a result, it is inexpensive to create a corporation, but may be expensive to liquidate a corporation.

Table C:2-1 may be used as a format for presenting the tax consequences of a Sec. 351 transaction. p. C:2-10.

Use Example C:2-23 as an illustration of a prearranged disposition of stock that disqualifies a Sec. 351 transaction. p. C:2-16.

Tables C:2-2 and C:2-3 can be used as a format for presenting the advantages and disadvantages of issuing equity vs. debt. Point out that cash flow consideration may make equity more attractive than debt. pp. C:2-29 and C:2-30.

Lecture Outline

I. Organization Forms Available.

Businesses can be conducted in one of several forms. A brief summary of these forms will provide the students with an overview of some of the factors that enter into the business form decision.

- A. **Sole Proprietorships.** A sole proprietorship is a business owned by one individual and often is selected by individuals who are beginning a new business. The income and expenses are reported on a Schedule C of Form 1040 since a sole proprietorship is not a separate tax entity. All of the business assets are owned by the proprietor. Examples C:2-1 and C:2-2 illustrate the effect this will have on the amount of tax that will be paid on business income. A completed Schedule C and the related facts are included in Appendix B. These facts are used (with minor modifications) to illustrate the similarities and differences in the tax reporting process for a sole proprietorship, C corporation, partnership, and S corporation.

1. **Tax Advantages.** The tax advantages of doing business as a sole proprietorship are listed beginning on p. C:2-2.

2. **Tax Disadvantages.** The tax disadvantages of operating as a sole proprietorship are listed beginning on p. C:2-2.

- B. **Partnerships.** A partnership is an unincorporated business carried on by two or more individuals or other entities. A partnership is a tax reporting, non-taxpaying entity, which acts as a conduit. All items of income, expense, gain, loss and credit flow through to the partners' tax returns. A partnership must file a Form 1065 annually. Each partner receives a Schedule K-1 (Form 1065), which provides the information that must be reported on the partner's tax return. Examples C:2-3 and C:2-4, pp. C:2-3 and C:2-4, respectively, illustrate the effect of partnership income and loss on an individual partner's tax liability. Only those partnerships maintaining a fiscal year under the Sec. 444 reporting period rules must make tax payments based on the amount of income deferral. A completed Form 1065 and the related facts are included in Appendix B.

A partnership can be either a general partnership or a limited partnership. In a general partnership, each partner has unlimited liability for partnership debts. In a limited partnership, at least one partner must be a general partner, and at least one partner must be a limited partner. Limited partners are liable only to the extent of their investment plus any amount that they commit to contribute to the partnership if called upon.

1. **Tax Advantages.** A partnership is exempt from taxation. Marginal tax rates of the individual partners may be lower than the marginal corporate tax rate on the same income.

No double taxation is inherent in the use of the partnership form. Profits are taxed only when earned. Generally additional taxes are not imposed on withdrawals.

Losses generally can be used to offset income from other sources. A positive basis adjustment is made when income is earned by the partnership and taxed to the partners. This reduces the gain recognized when a sale or exchange of the partnership interest occurs. No such basis adjustment occurs with a C corporation.

2. **Tax Disadvantages.** All profits are taxed when earned even though reinvested in the business. Marginal tax rates of the partners may be greater than the applicable marginal tax rate if the income is taxed to a corporation.

A partner is not an employee. Employment taxes must be paid on partner's self-employment income from the partnership.

Some tax-exempt fringe benefits are not available to partners.

The partnership's taxable year generally must conform to that of its partners or be a calendar year unless a special election is made to use a fiscal year.

C. **C Corporations.** A C corporation is a separate taxpaying entity that is taxed at rates ranging from 15% to 35%. A corporation must file a Form 1120 annually. Income may be taxed twice, once when earned by the corporation and either when it is paid out as a dividend or when the stock is sold or exchanged. Examples C:2-5 and C:2-6 illustrate this point. A completed Form 1120 with related facts is included in Appendix B.

1. **Tax Advantages.** A corporation is taxed at marginal tax rates of 15% on the first \$50,000 of taxable income and 25% on the next \$25,000 of taxable income. These tax rates may be lower than the shareholder's marginal tax rate. As long as earnings are not distributed and taxed to both the shareholder and the corporation a tax savings may result. Personal service corporations, personal holding companies and corporations accumulating earnings beyond the reasonable needs of the business have special taxing provisions.

Shareholders employed by the corporation are treated as employees for fringe benefit purposes. As employees they are eligible to receive deductible salary payments. This allows them to adjust their compensation (within limits) to cause the income to be taxed partly on the corporate return and partly on the shareholders' returns, to minimize their overall tax liability.

A C corporation is allowed to use a fiscal year. There are restrictions on using a fiscal year that apply to personal service corporations unless a special election is made under Sec. 444 by the corporation.

2. **Tax Disadvantages.** Double taxation occurs when dividends are paid or the corporation's stock is sold or exchanged.

Shareholders can generally not withdraw money from the corporation without tax consequences. Distributions are taxable as dividends to the extent of earnings and profits.

Net operating losses can only be carried back or forward to offset income from other taxable years. Losses cannot be used to offset the shareholder's personal income.

Capital losses provide no benefit in the year that they are incurred. They can only be used to offset capital gains.

D. **S Corporations.** S corporations are corporations that elect to be taxed as a partnership. Generally no tax is paid by the corporation. Instead, all items of income, deduction, gain, loss and credit flow through to the individual shareholders. Corporate rules apply unless overridden by the Subchapter S provisions. A completed Form 1120S (U.S. Income Tax Return for an S Corporation) is included in Appendix B.

1. **Tax Advantages.** S corporations are generally exempt from taxation. The shareholder's pay tax at their marginal tax rates, which are generally lower than the C corporation's marginal tax rate. See the **Tax Strategy Tip** on p. C:2-7.

Losses flow through to shareholders and generally can be used to offset income earned from other sources. Passive loss rules may limit loss deductions to shareholders. (See Chapter C:11.)

Capital gains are taxed to individual shareholders as though they were earned by the individual. An individual may be able to offset these gains with capital losses from other sources or have them taxed at the 28% maximum rate applicable to individuals.

Capital losses flow through separately to the shareholders and can be used to offset other capital gains and to a limited extent ordinary income.

Shareholders can contribute or withdraw money from the S corporation without adverse tax consequence. Profits are taxed as earned. The earnings are generally not taxed a second time when distributed as dividends.

A positive basis adjustment is made when income is earned by the S corporation and taxed to the shareholders. This reduces the gain recognized when a sale or exchange of the S corporation stock occurs. No such basis adjustment occurs with a C corporation.

2. **Tax Disadvantages.** All the corporation's profits are taxed when earned whether distributed or not. Distributions generally are made to at least cover the taxes paid by the shareholders on their share of the corporation's earnings.

If the shareholders marginal tax rates exceed those for a C corporation, the capital that remains for reinvestment may be reduced.

Tax-free fringe benefits are generally not available to shareholders. When provided, they are deductible by the corporation and taxable to the shareholder as compensation. Shareholders are treated as employees for purposes of social security taxes.

S corporation generally must select a calendar year as its tax year unless a special election is made under Sec. 444 to use a fiscal year.

- E. **Limited Liability Company.** A limited liability company (LLC) combines the best features of a partnership and corporation even though it is neither. It is taxed like a partnership while providing the limited liability of a corporation.
- F. **Limited Liability Partnership.** Many states also have statutes that allow a business to operate as a limited liability partnership (LLP). This partnership form is particularly attractive to professional service partnerships, such as public accounting firms. Under state LLP laws, partners are liable for their own acts and the acts of individuals under their direction. LLP partners are not liable for the negligence or misconduct of other partners.
- G. A side-by-side comparison of the tax and nontax attributes of C corporations, partnerships, and S corporations is presented in Appendix F. It might be helpful to periodically refer to this comparison throughout Chapters C:2 through C:11.

II. CHECK-THE-BOX REGULATIONS

Effective January 1, 1997, most unincorporated businesses are able to choose whether to be taxed as a partnership or corporation. The new rules are commonly referred to as "check-the-box" regulations. Treasury Regulations provide that an unincorporated business with two or more owners is taxed as a partnership unless it elects to be taxed as a corporation. An unincorporated business with one owner may elect to be taxed as a corporation or be disregarded as a separate entity and be taxed directly to the owner on a Schedule C. This election is not available to corporations, trusts, or certain special entities such as a Real Estate Investment Trusts, Real Estate Mortgage Investment Conduits, or Publicly Traded Partnerships.

An eligible entity may affirmatively elect its classification on Form 8832 [Entity Classification Election]. Examples C:2-8 and C:2-9 illustrate the default rules. If an entity makes an election to change its classification, it cannot again change its classification by election during the 60 months following the effective date of the election. There are tax consequences to the changing of classifications.

III. Legal Requirements for Forming a Corporation.

The legal requirements for forming a corporation depend on the laws of the state in which the corporation is incorporated. These laws provide for legal capital minimums, incorporation fee, franchise tax, and corporate tax rules. Most corporations are incorporated in the state in which they commence business. Articles of incorporation must be filed. A fee is charged for incorporation and an annual franchise tax is collected.

IV. Tax Considerations in Forming a Corporation.

Property, money or services are transferred to the corporation in exchange for a debt or equity interest. Tax consequences may occur for both the shareholder, debtholder, and the corporation. Example C:2-10 illustrates these tax consequences for the corporation and its shareholders.

At this point you may wish to use Table C:2-1, Overview of Corporate Formation Rules. This summary is found on p. C:2-10 of the text and is a good tool to be used to explain each of the parts of the incorporation transaction. Book-tax accounting issues are discussed later in this chapter.

V. Section 351: Deferring Gain or Loss Upon Incorporation.

No gain or loss is recognized when property is transferred to a corporation solely in exchange for stock provided immediately after the exchange the transferors are in control. Recognition of gain or loss is deferred through adjustment of the shareholder's basis in the stock. (See Example C:2-11.) The requirements for nonrecognition treatment are discussed below.

A. **The Property Requirement.** Property must be transferred to the corporation in an exchange transaction. Property includes money, and almost any other kind of property including installment obligations, accounts receivable, inventory, equipment, patents and other intangibles representing "know-how," trademarks, trade names, and computer software.

Statutorily excluded from the property definition are services received in exchange for stock in a corporation, indebtedness of the transferee corporation that is not evidenced by a security, and interest on an indebtedness of the transferee corporation that accrued on or after the beginning of the transferor's holding period for the debt.

B. **The Control Requirement.** The transferors as a group must be in control immediately after the exchange. Control is 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. Only stock received for property is counted when determining if control has been received. Stock received for services does not count for purposes of determining control unless property is also contributed.

A transfer of property to an existing corporation will be tax-free only if an 80% interest in the corporation is acquired, or existing shareholders also transfer enough additional property to the corporation to permit the 80% requirement to be satisfied by the transferors as a group.

Transferors must be in control of the corporation immediately after the exchange. The exchanges do not need to be simultaneous, but must be agreed to beforehand and executed in an expeditious and orderly manner.

- C. **The Stock Requirement.** No gain or loss is recognized by transferors who exchange property solely for transferee corporation stock. Voting or nonvoting stock may be received by the transferors. However, nonqualified preferred stock is treated as boot. Preferred stock is nonqualified if: 1) the shareholder can require the corporation to redeem the stock; 2) the corporation is either required to redeem the stock or is likely to exercise a right to redeem the stock; or 3) the dividend rate on the stock varies with interest rates, commodity prices, or other similar indices. Stock rights or stock warrants are not considered stock for purposes of Sec. 351.

At this point, you may wish to review with the students by referencing Topic Review C:2-1, which provides a concise overview of the requirements of Sec. 351. This review is found on p. C:2-17 in the text.

- D. **Effect of Sec. 351 on the Transferors.** If all the requirements of Sec. 351 are met, the transferors do not recognize any gain or loss on contribution of their property to the corporation. The receipt of property other than stock does not completely disqualify the transaction from coming under Sec. 351. However the receipt of property other than stock may cause the exchange to be partly taxable.

Property other than stock that is received is considered **boot**. Gain is recognized to the extent of the lesser of (1) the transferor's realized gain or (2) the amount of money plus FMV of the nonmoney boot property received. A loss is never recognized. The character of the gain depends upon the type of the property transferred. (See Example C:2-24.) Where several properties are transferred a "separate properties approach" is used. (See Example C:2-25.)

- E. **Basis of Stock Received.** The basis of the stock received in a Sec. 351 exchange is the adjusted basis of the property transferred plus any gain recognized by the transferor minus (1) any money received (including liabilities transferred to the corporation that are treated like money) and (2) the FMV of any nonmoney boot property that is received. (See Example C:2-26.)

- F. **Effect of Sec. 351 on Transferee Corporation.** The transferee corporation needs to determine the amount of gain or loss (if any) it must recognize and the basis of property or services acquired. No gain or loss is recognized by a transferee corporation exchanging stock or debt instruments for property. A transferee corporation must recognize gain (but not loss) if it transfers appreciated property to a transferor as part of a Sec. 351 exchange. (See Example C:2-30.)

If the transaction is taxable to the transferor, the basis of the property acquired is its acquisition cost. If the transaction falls under Sec. 351, the basis of the property to the transferee corporation is the transferor's basis plus gain recognized by the transferor. The corporation's holding period includes the transferor's period in the case of a Sec. 351 transaction. (See Example C:2-31.)

Topic Review C:2-2 presents a summary of the tax consequences of a tax-free asset transfer to the transferor and the transferee corporation and may be referred to at this point to summarize the more important material relating to partially tax-free in corporations. This review is presented on p. C:2-20.

- G. **Assumption of the Transferor's Liabilities.** The assumption of liabilities does not cause the transferor to recognize part or all of his realized gain unless (1) the transfer is made for a tax avoidance purpose or there is no bona fide business purpose for the acquisition and/or assumption of the debt, or (2) the liabilities assumed are in excess of the basis of the properties transferred.

The most important factor in determining whether a tax avoidance purpose is present is the length of time between the incurrence of the liability and the transfer of the liability to the corporation. Liabilities are considered to have a business purpose if the liabilities are incurred in the normal course of business or in the course of acquiring business property. If no business purpose is found, all of the liabilities assumed or acquired are considered boot.

If the total amount of liabilities transferred to a controlled corporation by a transferor exceeds the total adjusted basis of all properties transferred by the transferor, the excess liability is a gain that is taxable to the transferor. (See Example C:2-35.)

The term liabilities for a cash or hybrid method of accounting transferor does not include (1) any amount that would give rise to a deduction when paid or (2) any amount that is payable to a retired partner or to liquidate a deceased partner's interest. (See Example C:2-35.)

Topic Review C:2-3 presents a summary of the liability assumption and acquisition rules of Sec. 357 and may now be used to review this material with the students. This review is presented on p. C:2-25.

H. **Other Considerations in a Sec. 351 Exchange.**

1. **Recapture of Depreciation.** If a Sec. 351 exchange is nontaxable, no depreciation recapture is required. The transferor's recapture potential is transferred to the transferee corporation. (See Example C:2-39.)
2. **Computing Depreciation.** When a shareholder transfers depreciable property to a corporation in a Sec. 351 transaction, the corporation must continue to use the same depreciation method and recovery period with respect to the shareholder's basis in the property. An allocation of the depreciation for the year that includes the transfer date must be made between the transferor and transferee. If a basis adjustment occurs because the transferor recognizes a gain, a second depreciable asset is created which is generally depreciated as a new asset under the MACRS rules. (See Example C:2-40.)
3. **Assignment of Income Doctrine.** This doctrine is a judicial requirement that income be taxed to the person who earns it. This doctrine does not apply to a Sec. 351 exchange if the transferor transfers substantially all the business assets and liabilities to the corporation and a business purpose exists for the transfer. Accounts receivable take a zero basis in the corporation's hands and are included in income when collected. (See Example C:2-42.)

VI. **Choice of Capital Structure.**

- A. **Characterization of Obligations as Debt or Equity Capital.** The tax laws provide an incentive for closely held corporations to use as much debt as possible. Where debt financing resembles equity obligations, the form of the transaction will be ignored and debt will be reclassified as common or preferred stock. No single factor is controlling in determining when reclassification will occur.
- B. **Debt Capital.**
 1. **Issuance of Debt.** If assets are exchanged for debt instruments, whether part of an otherwise tax-free transaction or not, the FMV of the debt received is treated as boot.
 2. **When Interest Is Paid.** Interest paid on debt is deductible by the payor. Dividends paid on stock are not deductible by the corporation. Noncorporate investors who borrow funds in order to make an investment in a C corporation will find that the interest expense incurred to carry such an investment is generally subject to the investment interest limitation; unless the investment is a passive activity and the interest expense comes under the passive activity limitation rules.

3. **When an Indebtedness Is Satisfied.** Repayment of an indebtedness is not considered an exchange transaction. An obligation that is repaid by a corporation does not result in a gain or loss being recognized by the creditor. The satisfaction of a debt instrument (e.g., note, bond, or a debenture) is an exchange for the holder of a debt instrument and gain or loss will be recognized if the amount received is different from the asset's basis.

Table C:2-2 presents the tax advantages and disadvantages of using debt in the capital structure. This table may be found on p. C:2-29. You may want to discuss the case presented in the box on p. C:2-31 concerning extremely long-term debt issued to raise capital by a corporation.

- C. **Equity Capital.** The reasons for use of multiple classes of stock are found on p. C:2-29. Because of the many different types of equity issues that are possible, all tax and nontax advantages of each type cannot be listed. Table C:2-3, Tax Advantages and Disadvantages of Using Stock in the Capital Structure is found on p. C:2-30.
- D. **Capital Contributions by Shareholders.** A corporation does not recognize any income when it receives money or property as a capital contribution from a shareholder. If additional contributions are made without additional stock being issued, the payments are regarded as an additional price paid for the existing stock. (See Example C:2-44.)
- E. **Capital Contributions by Nonshareholders.** The basis of property contributed by a nonshareholder is zero. If money is contributed, the basis of any property acquired with such money during a 12-month period beginning on the day the contribution was received is reduced by the amount of the contribution used towards the purchase. The amount of any monies contributed by nonshareholders that are not spent to purchase property during the 12-month period reduces first the basis of depreciable property, then amortizable property, depletable property and all other property. Basis is not reduced below zero. (See Example C:2-45.)

VII. Worthlessness of Stock or Debt Obligations.

- A. **Securities.** A debt or equity investment that is evidenced by a security and that becomes worthless results in a capital loss for the investor on the last day of the tax year in which the worthlessness occurs.

Ordinary loss can be reported in some situations. An example of this would be securities that are held by dealers as inventory. A domestic corporation is also permitted to claim an ordinary loss in connection with the worthlessness of a security of an affiliated corporation.

The Sec. 1244 rules permit an ordinary loss to be claimed for qualifying stock issued by a small business corporation that is sold, exchanged or becomes worthless. Ordinary loss treatment is only allowed an individual who was originally issued the stock, or by a partner in a partnership that was originally issued the stock, and whose distributive share includes the losses for the corporate stock. If a shareholder contributes additional money or property to a corporation after acquiring Sec. 1244 stock, the amount of ordinary loss recognized upon the sale, exchange, or worthlessness of the Sec. 1244 stock is limited to the shareholder's capital contribution at the time the shares were issued. The ordinary loss is limited to \$50,000 (or \$100,000 if the taxpayer is married and files jointly). Losses in excess of the dollar ceiling are capital losses. The ordinary loss can be carried back or forward as part of a net operating loss. (See Example C:2-48.)

B. Unsecured Debt Obligations. Shareholders may make loans to corporations. The type of loss that can be claimed on these advances depends on the nature of the loan. If the advance is treated as paid-in capital, the amount of the loan increases the worthless securities loss on the stock.

A loan made to a corporation that is not evidenced by a security can be deducted under either the business or nonbusiness bad debt rules. Most unsecured advances are considered to be made outside the shareholder's trade or business. If a noncorporate shareholder makes the loan, it will generally be considered a nonbusiness bad debt that is a short-term capital loss, and is limited to a \$3,000 deduction per year.

VIII. Tax Planning Considerations.

Sec. 351 treatment is mandatory, not elective, if the provisions are met. In some cases shareholders may wish to recognize gains or losses. In order to accomplish this, one of the provisions necessary for the application of Sec. 351 must be violated. (See Example C:2-50.)

IX. Compliance and Procedural Requirements.

Every person who receives stock, securities, or other property in an exchange qualifying under Sec. 351 must attach a statement to his tax return for the period that includes the date of the exchange. A list of the required information for the transferor is found on p. C:2-36. The transferee corporation must attach a statement to its tax return for the year in which the exchange takes place. A list of the transferee corporation's required information is found on p. C:2-36.

X. Financial Statement Implications.

Formation of a corporation under Sec. 351 is similar to a nontaxable business combination I that the amounts recorded for financial statement purposes differ from the carryover tax bases of transferred assets. For business combinations, SFAS No. 109 prescribes that the

corporation recognize a deferred tax asset or liability for differences between the assigned financial statement values and the tax bases of the transferred assets and liabilities. Goodwill for which the corporation is not allowed an amortization deduction, however, does not give rise to a temporary difference. Use the example in the text to illustrate how a corporate formation is recorded for financial reporting purposes.

Court Case Briefs

Charles E. Wolfe v. U.S., 612 F. Supp 605 (DC Mont, 1985) aff'd. 798 F.2d 1241 (9th Cir., 1986).

The taxpayer, Charles E. Wolfe, was the sole shareholder and president of Wolfe & Company, a corporation which leased tractor-trailers. Mr. Wolfe also operated an "over-the-road" trucking business as a sole proprietorship. The corporation incurred a large federal tax bill which was paid by Mr. Wolfe personally when the corporation was unable to pay. Mr. Wolfe contended that he should not be held personally liable for the tax liability of the corporation.

The main issue was whether the corporation was the alter ego of Mr. Wolfe. If so, then the Internal Revenue Service could "pierce the corporate veil" and look to Mr. Wolfe's personal assets for satisfaction of the corporate tax liability. The court considered eleven factors, including level of ownership and control of the corporation, commingling of personal and corporate funds, common books and records, distribution of earnings and profits, and representation of corporate-personal relationship. In this case, the facts represented a classic case of a shareholder so dominating corporate affairs such that the corporation and the shareholder did not appear to have separate identities.

Therefore, the Service could pierce the corporate veil and look to the personal assets of the sole shareholder for payment of the taxes. Further, neither economic difficulties nor employee's illness constituted reasonable cause for failure to file or pay tax.

American Bantam Car Company v. CIR, 11 T.C. 397 (1948), aff'd. per curiam 177 F.2d 513 (3rd Cir., 1949).

This is a leading case in the determination of whether a transfer to a corporation is a tax-free transfer to a controlled corporation under the Code Sec. 351. This case is based on Section 112(b)(5) of the Revenue Act of 1936, the precursor of Code Sec. 351.

In this case, property was transferred to the newly formed American Bantam Car Company in exchange for stock of the corporation by three individuals, who immediately after the transfer owned greater than an 80% interest in the corporation. Subsequent to this transfer, the corporation entered into agreements with underwriters for the public offering of stock of the corporation, which if such offering had resulted in sufficient sales, would have reduced the interests of these three initial shareholders, based on the voting rights endowed upon the stock in the articles of incorporation.

The issue before the court was whether these transactions were all part of an integrated plan, thereby eliminating tax-free exchange treatment under Section 112(b)(5) or whether they were actually

separate transactions. The court looked at four factors in making their decision: 1) intent of the parties, 2) mutual interdependence of steps, 3) time element, and 4) ultimate result. There is a detailed analysis of each factor and a summary of prior court cases in this case. The court held that the transactions were indeed separate and that the transfer of assets to the corporation should be treated as a tax-free exchange. Therefore, the basis of the assets for the corporation was their basis in the hands of the transferors on the date of the exchange.