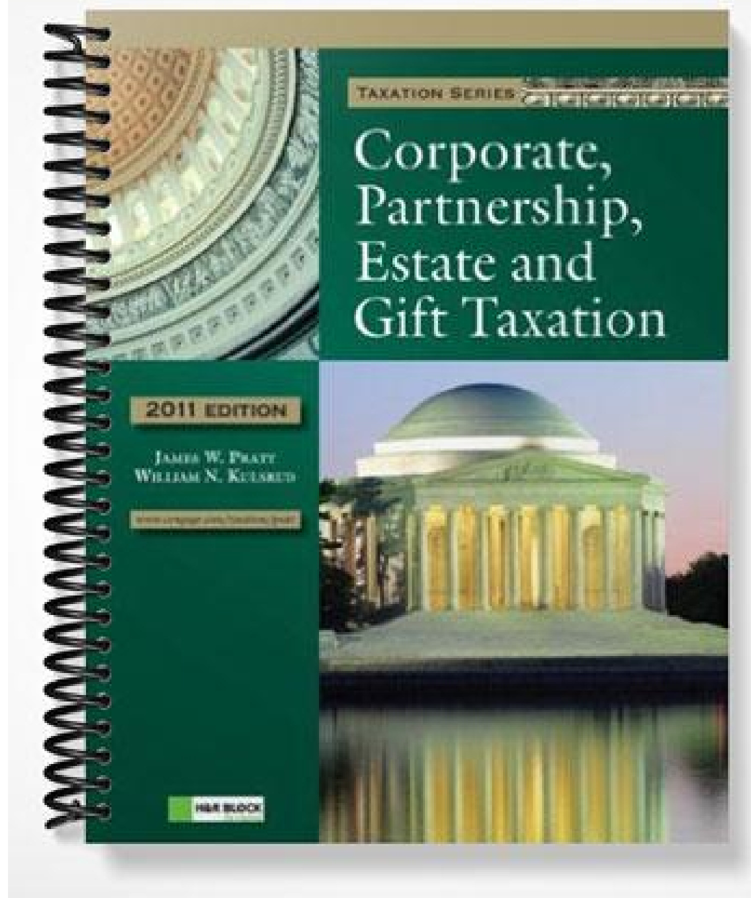
TEST BANK
TAXATION SERIES
Corporate, Partnership, Estate and Gift Taxation
2011 EDITION
JAMES W. PRATT
WILLIAM N. KULSRUD

TAXATION SERIES

SOLUTIONS MANUAL TO ACCOMPANY

Corporate, Partnership, Estate and Gift Taxation

2011 EDITION

JAMES W. PRATT
WILLIAM N. KULSRUD

www.cengage.com/taxation/pratt

★ CHAPTER TWO ★

CORPORATE FORMATION AND CAPITAL STRUCTURE

SOLUTIONS TO PROBLEM MATERIALS

DISCUSSION QUESTIONS

2-1 Some of the tax-related issues that should be considered are:

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. (See Example 1 and p. 2-3.)

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. 2-7 and 2-8.)

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 p. 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 p. 2-8.)

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. 2-7.)

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 p. 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. 2-7).

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. 2-10.)

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. 2-6.)

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. 2-7.)

b. Receipt of rights to purchase stock is not the equivalent of receiving stock; thus gain would be recognized. (See p. 2-7.)

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 43 and 44 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. 2-13, 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. 2-14 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. 2-15.]

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:

	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 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, 2007 since the machine is § 1231 property.

Corporation's basis is a carryover basis and the holding period begins on December 3, 2007.

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, 2010, 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, 2010, 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, 2010.

Corporation's basis is a carryover basis, and the holding period begins on June 6, 2010, 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 44 and 45 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. 2-23.)

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. 2-24 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 39, pp. 2-30 through 2-31, 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. 2-31.)

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 2-35.)

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 5 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 2-35.)

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 2-35.)

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 2-35.)

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. 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 transferor 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. 2-5 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, X and Q, own 85 percent of the stock immediately after the exchange, as determined below. X 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	*Existing Ownership*	*Newly Acquired Ownership*	*Total Owned by Property Transferor*
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 2-13, 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, Examples 27, and pp. 2-16 and 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, 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	$ 80,000
+	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. 2-8, 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	$11,000	$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-transferorô 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 29, and pp. 2-19 and 2-20.)

f. M's holding period for the stock begins on October 4, 2005, 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, 2005, 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 2-15.)

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 p. 2-17.)

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 2 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. 2-32, 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 (FMV of stock at time of transfer)	(300,000)	
	Total loss		$210,000
§ 1244 loss:			
	Amount realized	$ 90,000	
−	Adjusted basis (FMV 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. 2-32.)

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 2-33, 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		
Amount realized	$5,000,000	
Adjusted basis	(100,000)	
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

(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 PROBLEM

The solution to the Tax Return Problems **(2-48)** is contained in the *Instructor's Guide* for 2011.

RESEARCH PROBLEMS

Solutions to the Research Problems **(2-49 through 2-55)** are contained in the *Instructor's Guide* for 2011.

★ CHAPTER TWO ★

CORPORATE FORMATION AND CAPITAL STRUCTURE

SOLUTIONS TO PROBLEM MATERIALS

RESEARCH PROBLEMS

2-49 This case requires the determination of the corporation's basis in assets received upon corporate formation. This determination in turn requires the calculation of the transferor's gain recognized on the exchange. Although the rules as discussed in the text seem relatively precise, the law provides little guidance for determining the tax consequences when multiple assets are transferred in an exchange qualifying under § 351. The IRS has prescribed rules concerning the computation of gain to the transferor in this situation in Revenue Ruling 68-55, as footnoted in the text. However, there is no clear-cut authority for determining how the aggregate basis (or gain), once determined, must be allocated to each asset. Consequently, the student normally must discover an approach that he or she can support. The author's conclusions are discussed below.

Under § 362, the corporation's basis in the assets received is the same as the transferor's, increased by any gain. Accordingly, M's gain recognized must be computed. Under § 351(b), M must recognize any gain realized to the extent that boot is received. When the transferor contributes multiple assets and receives boot as M has done, the issue is whether an aggregate or separate properties approach should be used. [See Rabinovitz, "Allocating Boot in § 351 Exchanges," 24 *Tax Law Review* 337 (1969).]

If an aggregate approach is used, the gain realized is determined by subtracting the total basis of all of the assets transferred from the total amount of stock and boot received on the exchange. In this case, the gain realized would be $285,000 ($450,000 stock + $50,000 cash = $500,000 amount realized − $30,000 basis in the land − $90,000 basis in the building − $100,000 basis in the crane). The gain recognized would be $50,000, the lesser of the $285,000 gain realized or the $50,000 of boot received. Although many are apt to accept this method as consistent with the general approach, the Service has not.

The IRS has employed the separate properties approach for calculating the gain recognized. In Revenue Ruling 68-55, 1968-1 C.B. 140, the gain recognized is determined on an asset by asset basis with boot allocated to each asset according to its relative fair market value. Using this method, M must recognize a $43,000 gain determined as follows:

	Land	*Building*	*Crane*
Amount realized:			
Stock	$270,000	$ 63,000	$ 117,000
Cash*	30,000	7,000	13,000
Amount realized	$300,000	$ 70,000	$ 130,000
Adjusted basis	(25,000)	(90,000)	(100,000)
Gain (loss) realized	$275,000	$(20,000)	$ 30,000
Gain recognized:			
Lesser of			
Gain realized or	$275,000	$ 0	$ 30,000
Boot received	30,000		13,000
Gain recognized	$ 30,000	$ 0	$ 13,000

$$\text{*Fair market value of the asset} \times \frac{\$50{,}000 \text{ cash}}{\$500{,}000 \text{ total consideration}}$$

It should be noted that M recognizes no loss on the transfer of the building even though he is deemed to have received boot.

As noted above, under § 362(a) the corporation's basis in the assets received is the same as the transferor's basis, increased by any gain recognized by the transferor. In this case, the corporation's *aggregate* basis is $258,000, determined below.

Basis:	
Land	$ 25,000
Building	90,000
Crane	100,000
= Total basis	$215,000
+ Gain recognized	43,000
Aggregate basis	$258,000

Once the aggregate basis is determined, the basis of each asset must be computed. Nothing in the Code, Regulations, or rulings explains how the aggregate basis is to be allocated. However, the rationale underlying § 362 provides reasonable guidance. The purpose of § 362 is to assign a basis to each asset such that any unrecognized gain or loss is preserved. This principle is implemented only if each asset receives the basis that it had in the hands of the transferor, increased by the gain recognized by the transferor attributable to that asset. See *P.A. Birren & Son v. Comm.*, 40-2 USTC ¶9826, 26 AFTR 197, 116 F.2d 716 (CA-7, 1940), where it was held that the corporation steps into the shoes of the transferor, maintaining the transferor's basis intact. Thus, the basis of each asset is determined as follows:

	Land		*Building*		*Crane*		
Transferor's basis	$ 25,000		$90,000		$ 100,000		
+ Gain recognized	+30,000		—		+ 13,000		
Adjusted basis	$ 55,000	+	$90,000	+	$ 113,000	=	$258,000

Although the *Birren* case implies the approach above, other methods have been suggested. For example, the aggregate basis could be allocated to the assets based on their relative values. (In such case, part of the basis might have to be allocated to any goodwill that might exist.) Alternatively, the basis of each asset could be carried over intact with only the gain recognized on the exchange allocated. In such case, the gain might be allocated according to the relative fair market values of the assets or relative appreciation or depreciation. Using these methods, however, does not ensure recognition of the deferred gain or loss associated with each asset. For this reason, the method used above would appear to be the most supportable.

12-50 **a.** Q and R may each deduct $50,000 as an ordinary loss in the year the stock becomes worthless. Only the common stock qualifies for ordinary loss treatment under § 1244 according to Regulation § 1.1244(c)-1(b), and not the short-term notes issued by the corporation. The stock meets the requirements of § 1244 in that (1) the stock was issued in exchange for cash or property; (2) at the time the stock was issued the corporation was a small business corporation (i.e., one where the aggregate amount of capital upon issuance of the stock did not exceed $1,000,000); and (3) during the five most recent taxable years ending before the date of the loss, the corporation derived over 50 percent of its aggregate gross receipts from sources other than royalties, rents, dividends, annuities, and sales or exchanges of stock or securities. (Here, since the corporation has not been in existence for five years, the period referred to includes the period of the corporation's taxable years ending before the date of the loss on the stock.) [See §§ 1244(c)(1) and (c)(2)(A)]. Thus, only the common stock issued by SLI Inc. will be eligible for § 1244 ordinary loss treatment. This amounts to $100,000 for each of the investors, Q and R, as each owns $100,000 of common stock; however, the amount of loss that an individual may treat as ordinary in a taxable year is limited to $50,000 in the case of single individuals and $100,000 in the case of married persons filing joint returns; any excess loss

must be treated as loss from the sale of a capital asset. Because both Q and R are single individuals, the amount of loss on the common stock that may receive ordinary loss treatment under § 1244 is limited to $50,000, and the other amount invested in common stock (i.e., $50,000 for Q and R each) must be treated as loss from the sale or exchange of a capital asset.

Regarding the short-term notes, the losses resulting from their worthlessness should be treated as a capital loss (i.e., a loss from the sale or exchange of a capital asset on the last day of the taxable year), according to § 165(g). This is done because the indebtedness of the corporation to Q and R qualifies as securities as defined by § 165(g)(2), since it is evidenced by notes issued by the corporation.

Thus, Q and R may each treat $50,000 of their investments as ordinary loss and must treat the remainder as loss from the sale or exchange of a capital asset.

In addition to identifying the most likely treatment, some consideration should be given to techniques that might be used to avoid capital loss treatment on the notes. For example, the shareholders might attempt to exchange the notes for additional § 1244 stock. However, Regulation § 1.1244(c)-1(d) indicates that stock issued in consideration for cancellation of debt of the corporation is not considered § 1244 stock when the debt is evidenced by a security. Even if the stock were to qualify, the basis for the loss would be limited to the fair market value of the property immediately before the contribution, which would probably be zero [see § 1244(d) and Revenue Ruling 66-293, 1966-2 C.B. 305, where § 1244 stock was received in exchange for the cancellation of a note of the corporation at a time when the basis exceeded its FMV]. Instead of a direct exchange of the notes for § 1244 stock, the shareholders might try an indirect approach. This approach would require Q and R to make further contributions to the corporation in exchange for additional § 1244 stock. These contributions could subsequently be used to repay the notes. Now when the stock becomes worthless, ordinary loss treatment results. The IRS may attempt to collapse this series of transactions as simply an exchange of the notes for stock, in which case the stock does not qualify as § 1244 stock as discussed above.

Alternatively, the shareholders might argue that the notes were, in reality, stock from the outset. Although these techniques have not met with much success, such points should be considered.

b. The question presented in this situation is how the § 1244 treatment of stock will be allocated among investors Q, R, and S, since the total amount of stock issued by the corporation exceeds $1,000,000 and no specific shares of stock held by the investors were ever designated as § 1244 stock (or otherwise).

In this case, the Regulations provide that the following rules apply:

1. The first taxable year in which the corporation issues stock and in which such an issuance results in the total capital receipts of the corporation exceeding $1,000,000 is called *the transitional year*. See Regulation § 1.1244(c)-2(b)(2).

2. Stock issued for money or property before the transitional year qualifies as § 1244 stock without affirmative designation by the corporation.

3. When a corporation issues stock in a transitional year and fails to designate certain shares of the stock as § 1244 stock, the following rules apply:

a. Section 1244 treatment is extended to losses sustained on common stock issued for money or other property in taxable years before the transitional year.

b. Subject to the annual loss limitation, an ordinary loss on common stock issued for money or other property in the transitional year is allowed to each individual. The amount for each bears the same ratio to the total loss sustained by the individual that the amount of "eligible capital" bears to the total capital received by the corporation in the transitional year. The amount of "eligible capital" is determined by subtracting the amount of capital received by the corporation after 1958 and before the transitional year from $1 million (the total amount of capital stock that may receive § 1244 treatment). See Regulation § 1.1244(c)-2(b)(3).

According to the above rules, the following results would occur in the situation involving SLI Inc. and investors Q, R, and S. Subject to the annual limitations, Q and R would deduct losses on their stock in SLI Inc., which was issued before the transitional year. This refers to the common stock

worth $100,000 to each Q and R for the formation of the corporation. Next, the allocation of § 1244 would have to be made to the stock issued during the transitional year. This step requires that the total "eligible capital" be determined. This is the amount left after subtracting the $200,000 received by the corporation for the common stock (before the transitional year and after 1958) from $1 million; the remainder is $800,000. The $800,000 is the numerator in the ratios, and the denominator is $1,500,000, the total amount of capital receipts in the transitional year. This ratio is thus $800,000 : $1,500,000, or 8:15. The denominator in the other ratio is the total loss of the shareholder (relating to transitional year stock). For each shareholder, Q, R, and S, this amount is $500,000. Thus, the amount of transitional year § 1244 treatment is calculated as follows:

$$\frac{X}{500,000} = \frac{\$800,000\ (\$1,000,000 - \$200,000)}{\$1,500,000}$$

(each shareholder's total loss on transitional year stock) (total amount received by SLI Inc. in transitional year)

$X = \$266,667$

The total losses of each shareholder, subject to annual limitations, that may receive § 1244 treatment, are as follows:

	Q	*R*	*S*
Loss related to transitional year stock	$ 100,000	$ 100,000	$ 0
+ Loss related to transitional year stock	+266,667	+ 266,667	+ 266,667
= Total loss eligible for § 1244	$ 366,667	$ 366,667	$ 266,667

Thus, while Q and R may receive § 1244 treatment on the pre-transitional year stock, Q, R, and S must share the § 1244 treatment proportionately on the stock issued in the transitional year. Note that the total amount of § 1244 treatment allowed is limited to $1 million when the total capital receipts of the corporation exceed $1 million. [See Regulation § 1.1244(c)-2(b)(4), Example 5]. It is important to realize that the annual limitations on the § 1244 treatment afforded to shareholders apply, as described in Regulation § 1.1244(b)-1; thus, regardless how much of a loss may be allowed § 1244 treatment, the amount that can be used by the taxpayer in the year the loss occurs is limited, with the excess being treated as a loss from the sale or exchange of a capital asset.

2-51 T can be confronted with two potential problems. First, the IRS might argue that the incorporation does not meet the requirements for nonrecognition under § 351. If the government is successful, T will recognize depreciation recapture and investment credit recapture. One of the requirements of § 351 is that the transferrers be in control of the corporation immediately after the transfer. Section 368(c) defines *control* as at least 80 percent of the voting stock and the way the transaction is structured, T will end up with only 60 percent of the voting stock. T should argue that the incorporation and the gifts are separate transactions as there is nothing in § 351 that requires him to maintain control, only that he have control immediately after the transfer. As support for the argument that the gift is a separate transaction, T should rely on *American Bantam Car*, 11 T.C. 397. The facts in *American Bantam Car* are sufficiently different to be immaterial, but the rule of law that two steps will not be treated as one if each is viable and would have been undertaken without the other does apply. The incorporation is a separate economic step, and the gifts are not necessary for the incorporated business to function and be a benefit to T. Therefore, they

should be treated as separate transactions. From a planning perspective, T should delay the gifts as long as possible to ensure that the incorporation is treated as a separate transaction.

Secondly, even if the incorporation meets the conditions of § 351, T might still be required to recapture any investment credit. Under § 47, investment credit is recaptured anytime there is a premature disposition of § 38 property, even if the transaction is nontaxable. However, T should argue that the incorporation is a mere change in the form of conducting the business and is excepted from the recapture requirement by Reg. § 1.47-3(f)(1). The government probably will concede that the corporation does not require recapture, but will then argue that the gift does. The government will refer to *Blevins*, 61 T.C. 547 as support.

In the *Blevins* case, the Tax Court required recapture on a gift following an incorporation. T should concede the applicability of *Blevins*. However, T can distinguish his facts from *Blevins* since he has maintained a substantial interest in the corporation whereas *Blevins* did not. *Blevins* ended up with only 21 percent of the corporation. (In addition, *Blevins* had to apply the special rules for partnerships that require an earlier recapture than a sole proprietorship.) Reg. § 1.47-3(f)(6), Example 1 provides that 45 percent of the stock of a corporation is a substantial interest. T owns 60 percent of the corporation's stock, which would certainly qualify as a substantial interest and prevent investment credit recapture.

If T restructures the transaction so that the corporation issues nonvoting stock directly to the children, then the incorporation will not qualify under § 351. Rev. Rul. 59-259 interprets the control requirement as meaning at least 80 percent of the voting control, and at least 80 percent of each class of nonvoting stock. Since the children will own 100 percent of the nonvoting stock, § 351 will not apply. If T wants to give the children nonvoting stock, the transaction should be structured so that he receives the voting and nonvoting stock and then gives the nonvoting stock to his children, should qualify as discussed above.

2-52 The contribution of land by E to the RST Corporation in exchange for 60 shares of common stock will not qualify for nonrecognition treatment under § 351. Section 351 requires that the transferrers be in control of the corporation immediately after the transaction. [Control is defined as at least 80 percent of the voting power by § 368(c)]. E would own 60 shares of a total, issued and outstanding, of 560 (the 500 currently outstanding plus the 60 shares issued to E), significantly less than 80 percent.

To meet the control requirements, the transferrers must own at least 448 shares (80% × 560 shares) after the transfer. This could only be accomplished if R, S, and T also transferred property at the same time that E transferred the land. However, Reg. § 1.351-1(a)(1)(ii) prevents tax avoidance by providing that transfer of relatively little property by current shareholders will be ignored in determining who the transferrers are. Therefore, R, S, and T must transfer significant property along with E for the transaction to qualify under § 351. The regulation does not define significant property, but Rev. Proc. 77-37 provides that, for ruling purposes, a transfer of property equal to at least 10 percent of the value of the currently owned stock and securities will be considered significant. Since the current net worth of the corporation is $300,000, R, S, and T will be required to transfer at least $30,000. R should transfer $12,000 (40% × $30,000), and S and T should each transfer $9,000 (30% × $30,000).

E has indicated a willingness to accept securities in exchange for the land. However, the receipt of any securities is considered boot, and E would be required to recognize gain. The gain may be deferred and reported as payments are received.

12-53 **a.** Whenever individuals are contemplating the contribution of property in the formation of a corporation pursuant to § 351, the difference in the basis of the contributed property and its fair market value (upon which the stock allocations are based) should be addressed. In the case of a cash contribution, there is no difficulty; the amount contributed equals the fair market value. However, when a contributor transfers low-basis depreciable property with a high fair market value, as H.R. plans, the corporation's tax benefit resulting from depreciation of the property will always be less than the benefit obtained had the corporation purchased the asset with cash contributions and depreciated the higher basis. Under the proposed plan, H.R. is shifting to the corporation the unfavorable tax consequences resulting from the transfer of low-basis property. He receives the benefit of receipt of 50% stock ownership based on the fair market value of the building while the corporation benefits from depreciation based on only $12,000 basis. In order for the deal to be truly equitable, H.R. should

agree to either (1) receipt of a lower percentage of stock or (2) an additional cash contribution to compensate for the corporation's future tax costs resulting from the lower depreciation deductions.

Theoretically, the value of H.R.'s building is the fair market value, $75,000, less the present value of this tax cost. The difficulty in calculating this cost lies in the number of independent variables involved in determining it: the discount rate needed to calculate the present value, the corporation's marginal tax rate, and the number of years over which the building will be depreciated. If the brothers can reach an agreement as to these variables, a method is available to calculate any additional cash contribution necessary to achieve an equitable 50-50 stock allocation. [See Charles W. Christian and Michael A. O'Dell, "Determining Equitable Contributions to Capital in a Section 351 Incorporation," *Taxes* (October, 1986), pp. 681-691.]

The proposed plan presents a potential problem for H.R. as well, despite his attorney's reassurances. Mr. Stare correctly pointed out that H.R. would be required to recognize, under the initial agreement, a $13,000 gain on the contribution under § 357(c). However, his recommended solution, issuance of a note to the corporation for the excess liability, is founded neither on IRS interpretation of the Code, nor on the bulk of the case law pertaining to this issue. In a § 351 transaction, gain or loss is not generally recognized when parties receive only stock in exchange for the property transferred, provided they are in control of the corporation immediately after the exchange. If, as part of the consideration, the corporation assumes the liabilities of the transferor, or acquires property subject to a liability, § 357(a) provides that such an acquisition or assumption will not prevent the exchange from qualifying as a § 351 transaction. In the event that the acquired mortgage or assumed liabilities exceed the basis of the properties transferred, § 357(c) requires that gain be recognized for the amount of the excess.

The crucial question in this case is whether or not a note transferred would have a basis of $13,000 in H.R.'s hands. If so, the total basis of the transferred assets would equal the $25,000 mortgage to which the property is subject. Under § 1012, a taxpayer's basis in property is generally determined by his cost in acquiring the property. The IRS first addressed its position on this issue in Rev. Rul. 68-629. 1968-2 CB 154, holding that a taxpayer who issues a note to offset excess liabilities in a § 351 transaction has no basis in that note, as he incurred no cost in making it. As a result, the basis of the assets transferred is not increased so as to prevent § 357(c) gain.

The Court first applied Rev. Rul. 68-629 in *Alderman*, 55 T.C. 662 (1971). Here a taxpayer, in exchange for stock, transferred all assets of his sole proprietorship to a newly formed corporation. The taxpayer argued that by issuing a note to the corporation for an amount equal to the excess debt, the corporation did not in fact assume the liability, therefore § 357(c) was not applicable. The court applied the zero basis rule of Rev. Rul. 68-629 in rejecting this argument. The court also found that the taxpayer, despite assertions to the contrary, never actually paid on the note and the debts were later paid by the corporation. In *Wiebuch*, 59 T.C. 777 (1973), aff'd 487 F.2d 515 (CA-8, 1975), the court held that the transfer of property subject to excess debt triggered § 357(c) gain recognition regardless of whether the debts were assumed by the corporation or the shareholder retained any personal liability.

Mr. Stare has undoubtedly based his advice to H.R. on the surprising and unprecedented decision of the Second Circuit in *Lessinger*, 872 F.2d 519 (CA-2, 1989), rev'ing 85 T.C. 824 (1985). The taxpayer here transferred assets and liabilities of his sole proprietorship to his existing corporation for the purpose of satisfying his lender of working capital, who could obtain higher interest rates from corporate borrowers. The Tax Court applied § 1012, Rev. Rul. 68-629, and *Alderman* in holding that the excess liability could not be offset by transferring the taxpayer's obligation to the corporation as an asset because *the basis in the note to the taxpayer and to the corporation* was zero.

In rejecting the lower court's decision, the Second Circuit became the first court to hold that a shareholder's note to a corporation given in a § 351 transaction is an asset to the corporation with a basis equal to its face value, while at the same time acknowledging that a shareholder has no basis in its own obligation because it is a liability to him rather that an asset. *When the taxpayer recognizes no gain*, as the court determined here, the conflicting nature of these two statements is obvious in light of § 362(a), which provides that in a § 351 transaction, a corporation's basis is the transferor's basis plus any gain recognized on the exchange. The court reconciled this apparent conflict by

reasoning that while § 362(a) generally holds true, it should not apply to the corporation's valuation of the taxpayer's obligation because the corporation incurred a cost in acquiring the obligation by accepting liabilities in excess of assets. Therefore, its basis should be equal to its face amount. In this light, the taxpayer would recognize no gain. Lastly, the court expressed concern that unless the corporation had basis in the note, it would be required to recognize income as the taxpayer made payments on it. The court's final justification of its decision was based on an economic benefit analysis of the circumstances of this particular case. The court noted that by giving his note to the corporation, the taxpayer realized no economic benefit that could be appropriately recognized at the time of incorporation. The formation of the corporation under § 351 was for the sole purpose of continuing financing for operations; the excess debt was a result of the insolvency of the business.

The impact of *Lessinger* in cases where the taxpayer issues a note for excess debt is uncertain. In a more recent ruling, the Ninth Circuit [see *Owen*, 881 F.2d 832 (CA-9, 1989), cert. denied, 110 S.Ct. 113 (1990)] issued an opinion diametrically opposed to that reached in *Lessinger*, despite the similarity of the cases. The court in this instance ignored a taxpayer's personal guarantee of a debt transferred to the corporation because § 357(c) simply does not specifically provide for an exception under those circumstances. The court relied on a strictly literal interpretation of § 357(c) and ignored the inequity that resulted, thus rejecting the use of the economic benefit analysis employed by the Second Circuit. In doing so, the Ninth Circuit aligns itself with the majority of courts which have addressed this issue.

The decision in *Lessinger* has received a great deal of criticism. [See Michael Megaard and Susan Megaard, "Can Shareholder's Note Avoid Gain on Transfer of Excess Liabilities?" *Journal of Taxation* (October 1989), pp. 224-250 and Colleen Matin, "*Lessinger* and Section 357(c): Why a Personal Guarantee Should Result in *Owen* Taxes," *Virginia Tax Review* (Summer, 1990) pp. 215-236.] Regardless of whether the Second Circuit Court's interpretation of § 357(c) was right or wrong, its goal was to avert an unjust outcome in a § 351 transaction where the taxpayer's motive was not tax avoidance, but business necessity. It is unlikely that the Second Circuit would be so generous if deciding this issue based on the circumstances of H.R.'s case. One only needs to examine the legislative history of § 357(c) in order to recognize that H.R.'s situation is precisely that which Congress was attempting to address. The Senate report contains the following example:

> [I]f an individual transfers, under § 351, property having a basis in his hands of $20,000, but subject to a mortgage of $50,000, to a corporation controlled by him, such individual will be subject to tax with respect to $30,000, the excess of the amount of the liability over the adjusted basis of the property in the hands of the transferor.

S. Rep. No. 1622, 83rd Cong., 2nd Sess 270.

This issue was recently revisited in *Donald J. Peracchi*, 143 F3d 487 (CA-9, 1998), Rev'g and remd'g 71 TCM 2830, TC Memo. 1996-191. In *Peracchi*, the taxpayer needed to contribute additional capital to his closely-held corporation (NAC) to comply with Nevada's minimum premium-to-asset ratio for insurance companies. Peracchi contributed two parcels of real estate. The parcels were encumbered with liabilities which together exceeded Peracchi's total basis in the properties by more than half a million dollars. In an effort to avoid § 357(c), Peracchi also executed a promissory note, promising to pay the corporation $1,060,000 over a term of ten years at 11% interest. Peracchi maintained that the note had a basis equal to its face amount, thereby making his total basis in the property contributed greater than the total liabilities. In saying that the note gave Peracchi basis, the court focused on what would occur if the corporation went bankrupt. According to the court:

> "Contributing the note puts a million dollar nut within the corporate shell, exposing Peracchi to the cruel nutcracker of corporate creditors in the event NAC goes bankrupt. And it does so to the tune of $1,060,000, the full face amount of the note. Without the note, no matter how deeply the corporation went into debt, creditors could not reach Peracchi's personal assets. With the note on the books, however, creditors can reach into Peracchi's pocket by enforcing the note as an unliquidated asset of the corporation.

The court then asked whether bankruptcy was significant enough a contingency to confer substantial economic effect on this transaction. Believing that bankruptcy was not a remote possibility, it felt that Peracchi's investment in the corporation through his obligation on the note was real. Consequently, the court held that Peracchi should get basis in the note. The court recognized that its decision could essentially make § 357(c) moot but felt that such result was justified, saying:

> We are aware of the mischief that can result when taxpayers are permitted to calculate basis in excess of their true economic investment. See *Commissioner v. Tufts* [83-1 USTC ¶9328], 461 U.S. 300 (1983). For two reasons, however, we do not believe our holding will have such pernicious effects. First, and most significantly, by increasing the taxpayer's personal exposure, the contribution of a valid, unconditional promissory note has substantial economic effects which reflect his true economic investment in the enterprise. The main problem with attributing basis to nonrecourse debt financing is that the tax benefits enjoyed as a result of increased basis do not reflect the true economic risk. Here Peracchi will have to pay the full amount of the note with after-tax dollars if NAC's economic situation heads south. Second, the tax treatment of nonrecourse debt primarily creates problems in the partnership context, where the entity's loss deductions (resulting from depreciation based on basis inflated above and beyond the taxpayer's true economic investment) can be passed through to the taxpayer. It is the pass-through of losses that makes artificial increases in equity interests of particular concern. See, e.g., *Levy v. Commissioner* [84-1 USTC ¶9470], 732 F.2d 1435, 1437 (9th Cir. 1984). We don't have to tread quite so lightly in the C Corp context, since a C Corp doesn't funnel losses to the shareholder.

b. The addition of a new shareholder under the circumstances proposed by Buster and H.R. poses a problem because of the control requirement of § 351. The fact that they will still own 100% of the common voting stock following formation of the corporation does not alone satisfy this control requirement. Section 368(c) defines the term control as:

> the ownership of stock possessing 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 of the corporation.

Since X will own 100% of the non-voting stock following formation of the corporation, the control requirement necessary to qualify for § 351 treatment is not met. In Rev. Rul. 59-259, 1959-2 C.B. 115, the IRS addressed a similar case in which the transferrers owned 83% of both the voting and non-voting common stock but only 22% of the non-voting *preferred* stock. The Service ruled that the failure by the transferrers to obtain ownership of 80% of the preferred stock disqualified the transfer as a nontaxable event under § 351.

Unless Buster and H.R. alter the stock allocations of this proposed plan, the contribution of the building by H.R. will taxed as a $63,000 capital gain. There are several alternatives open to them. First, the corporation could issue 20 shares of non-voting stock and 38 shares of voting stock to each of the Block brothers and 10 shares of the non-voting stock to X. H.R. and Buster would control 100% of the voting stock and 80% of the non-voting stock. A second alternative would be to give X a percentage of the voting stock rather than non-voting shares. The brothers would still maintain 92% of the voting stock.

2-54 Section 166 allows a deduction for worthless bad debts. However, the treatment is quite different depending on whether the worthless loan is a business or nonbusiness bad debt. If the loan is a nonbusiness bad debt, § 166(d) provides that the loss must be treated as a short-term capital loss for which the deduction is severely limited (capital gains plus $3,000 of ordinary income). In contrast, if the loan is a business bad debt, § 166(a) treats the loss as an ordinary loss that is fully deductible in the year of worthlessness. Moreover, the loss can add to or create a net operating loss which the taxpayer could immediately carryback to generate a refund.

Unfortunately, the Code and Regulations provide little guidance as to when a worthless bad debt is a business or nonbusiness bad debt. Section 166(d)(2) defines a nonbusiness bad debt as a debt other than "(A) a debt created or acquired. . .in connection with a trade or business of the taxpayer; or (B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business." Regulation 1.166-5(b) echoes the Code providing that a business debt is a debt which is created, or acquired, in the course of a trade or business of the taxpayer, determined without regard to the relationship of the debt to a trade or business of the taxpayer at the time when the debt becomes worthless; or a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business. The Regulations go on to explain that the "question whether a debt is a nonbusiness debt is a question of fact in each particular case." The Regulations also indicate that " the character of the debt is to be determined by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a *proximate* one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt is a business bad debt.

The long list of court cases that have dealt with this problem have struggled to identify when a debt has the requisite "proximate" relationship to the taxpayer's trade or business. In a landmark case in this area, *Whipple v. Comm.* 63-1 USTC ¶9466, 11 AFTR2d 1454, 373 U.S. 193 (USSC, 1963), Whipple had made sizable cash advances to the Mission Orange Bottling Co., one of the several enterprises that he owned. He spent considerable effort related to these enterprises but received no type of compensation, either salary, interest, or rent. When the advances subsequently became worthless, Whipple deducted them as a business bad debt. The Supreme Court held that the loans made by the shareholder to his closely held corporation were nonbusiness bad debts even though Whipple had worked for the company. According to the Court:

> Devoting one's time and energies to the affairs of a corporation is not of itself, and without more, a trade or business of the person so engaged. Though such activities may produce income, profit or gain in the form of dividends—this return is distinctive to the process of investing—as distinguished from the trade or business of the taxpayer himself. When the only return is that of an investor, the taxpayer has not satisfied his burden of demonstrating that he is engaged in a trade or business.

Since this holding, taxpayers have achieved limited success where they have been able to convince the court that the loans were made to protect their employment rather than their investment. In this regard, taxpayers must demonstrate that protection of employment is not just one of the reasons for which the loan was made but the primary reason. In *U.S. v. Generes* 72-1 USTC ¶9259 (USSC, 1972), the Supreme Court indicated that "in determining whether a bad debt has a proximate relation to the taxpayer's trade or business-the proper standard is that of dominant motivation." Coupling the court's arguments in *Whipple* and *Generes*, Malone can claim ordinary loss treatment only if he is able to show that the primary reason for making the loan was to protect his employment and not his investment.

To assess the motivation for the loan, subsequent decisions have generally tried to look at the relationship between the taxpayer's investment in the corporation (the fair market value of the corporation at the time of the loan), his or her compensation from the corporation, and other sources of income. As a general rule, if the taxpayer has a small investment but a large salary, the implication is that the loan is to protect the salary and not the investment. Conversely, if the taxpayer has a large investment and draws a small salary, the belief is that the loan is to protect the investment. A thorough analysis of the issue will go beyond these obvious observations and attempt to focus-as the courts have done-on the relationship between the investment and salary. For example, in *Generes*, the Supreme Court in holding against the taxpayer partially seized on the fact that the taxpayer's investment was over five times his aftertax salary. In contrast, the court found for the taxpayer in *Litwin* 93-1 USTC ¶50,041 (CA-10, 1993) where the taxpayer's investment was only about 2 and ½ times has salary. One issue that should be discussed is whether the analysis should be based on the value of the original investment or the value of the corporation at the time the loan was made.

In *Charles L. Hutchinson*, 43 T.C.M. 440 (1982) the court found a loan could not be obtained from traditional sources, suggesting that the value of the corporation at the time the loan was made would not support it. The court also saw this as one fact that suggested the loan was made to protect the taxpayer's

salary rather than his investment. The situation appears similar here. Although Malone had invested over $200,000 initially, it would appear that the value at the time of the loan was far less. This is suggested by the fact that Malone made the loan rather than securing it from traditional sources such as a bank. Presumably lenders would not make the loan because the corporation's value would not support it. As in *Hutchinson*, this fact suggests that the motivation for the loan was to protect the taxpayer's salary. If this is the case, the salary might exceed the value of the investment. But, this is not made clear from the facts. The facts indicate only that Malone was forced to loan the corporation money in order to keep it afloat. (Instructors can make this case more interesting by telling the students that there may be critical facts missing and they are free to make an appointment with the taxpayer (the instructor) to ask additional questions). If in fact the value of the company is minimal, this would suggest the primary motivation for the loan was to protect the taxpayer's salary.

The courts also take into account other sources of income available to the taxpayer. If the taxpayer has other sources of income, this suggests that the salary is of less importance than the investment. For example, in *Hutchinson*, the court held for the taxpayer in part because the taxpayer's only source of *salary* income was from the corporation to which he made the loan and this constituted about 60 percent of his entire gross income. In this case, the taxpayer has pension income of $20,000, making has salary 78 percent ($70,000/$90,000) of his total income. A thorough analysis of this issue might assess how other court's have evaluated this relationship. For example, in *Generes*, the salary was about 30 percent of the taxpayer's total income and the court held against the taxpayer.

The courts have also looked at the size of the loan relative to the size of the investment to ascertain the primary motivation. For example, in *Litwin*, the loan was far greater than the investment suggesting that the motivation was to protect something other than the investment.

Other facts have helped to sway the court one way or another. For example, the courts have looked at whether or not the individual could obtain other employment if the borrowing corporation were to fail. For example, in *Litwin*, the taxpayer was 82 years old, causing the court to conclude that he would be unable to secure employment if he were to lose the job provided by his corporation. Similar facts seem to be present here since Malone is about 77. Another factor to consider is the amount of time spent working for the corporation. In *Generes*, the taxpayer spent only six to eight hours a week working at the business. In this case, Malone spends 20 hours a week.

Although it is far from clear, based on the facts and circumstances, it would appear that Malone's dominant motivation for the loan was to protect his employment and the salary he was drawing. Consequently, he should be able to treat the loan as a business bad debt.

2-55 The problem here is whether Sack's must include the $5,000,000 payment as taxable income. At first glance, it may appear that the payment is simply compensation for services or property to be provided and Sacks has taxable income under the general rule of § 61. However, a possible exception looms in § 118(a), which provides guidance as to the treatment of contributions to the capital of a corporation. Under § 118, contributions to a corporation by its shareholders are nontaxable. Over the years, however, ingenious taxpayers occasionally have attempted to characterize payments received as nontaxable contributions when in reality the payments represented taxable compensation. The controversy normally surrounds whether the contributor—in this case, MHS—actually receives a direct tangible benefit because of the payment. Alternatively, if the payment is viewed as a mere inducement rather than payment for corporate goods or services, the courts have sided with the taxpayer.

Regulation § 1.118-1 provides limited guidance as it restates the general rule that "section 118 provides an exclusion from gross income with respect to any contribution of money or property to the capital of the corporation." But, the Regulation does extend the rule to contributions by persons other than shareholders such as MHS. It states that "for example, the exclusion applies to the value of land or other property by a civic group for the purpose of induce the corporation to locate its business in a particular community, or for the purpose of enabling the corporation to expand its operations." While MHS is not a civic group or government, it is not difficult to manufacture an argument that the same rule could apply when the payments are received from a taxable entity. However, the regulation also makes it clear that "the exclusion of Section 118 does not apply to money or property transferred to a corporation in consideration for good or services to be rendered?. . ."

One of the earlier cases to consider the issue was *Federated Department Stores v Commissioner*, 51 TC 500 (1968) aff'd 70-1 USTC ¶9426, (CA- 1970). In this case, Sharpstown Realty Co., which was building a new shopping mall in Houston, sought Federated as a tenant in the mall. According to the facts,

> Sharpstown believed that the development of its shopping center and the sale of its other lands would be accelerated and would produce greater income for Sharpstown if petitioner could be induced to open a full-line department store in the shopping center. Furthermore, Sharpstown believed that as long as petitioner maintained a branch store of its Foley's division at the shopping center, Sharpstown would attract additional customers, obtain better tenants, and receive a greater rental income on its percentage of sales leases. The installation and operation of a store commensurate with Foley's reputation in the proposed center would have involved a substantial investment which petitioner may not have been willing to make at that time in an area whose economic potential was regarded as speculative. Therefore, in order to persuade petitioner to obligate itself to open and operate a Foley's store in Sharpstown's proposed shopping center, Sharpstown offered substantial inducements to petitioner. Neither Federated Department Store nor Sharpstown Realty owned any interest in each other's business nor did any of their shareholders.

After negotiations, Sharpstown agreed to convey to Federated in fee and at no cost to petitioner, a 10-acre tract of land situated in Sharpstown's proposed shopping center. In addition, Sharpstown agreed to pay to petitioner the sum of $200,000 per year for a consecutive 10-year period beginning July 1, 1960. In return, petitioner agreed to construct, equip, open, and operate a full-line Foley Branch Department Store on the tract of land conveyed to petitioner. Federated subsequently excluded the land and payments under § 118. Consequently, if the exclusion of § 118 were to apply, it would involve contributions by nonshareholders.

The IRS argued that § 118 was not applicable in this case because Sharpstown's financial interest was the motivating factor behind the payment and not that of the general welfare of the community. In this regard, the government relied on *United Grocers, Ltd. v. United States*, 308 F.2d 634 (C.A. 9, 1962), asserting

> that motive and intent of the payor in making the payments is the dominant factor in determining whether they are a capital contribution or payment for goods or services. As such, the Commissioner believes that here Sharpstown's motive for making the payments and the distributing of the land to petitioner were purely for business reasons as it was in the "best business interest for the success of Sharpstown to induce Federated to locate a branch in its shopping center." Thus, the payments never bore a semblance of a donation or contribution but rather were made solely in exchange for petitioner's promise to construct, open, and operate a branch store in the developer's shopping center.

However, the Tax Court disagreed, noting that it had held previously held that contributions to construct and operate a railroad and accompanying facilities, warehousing facilities, plants and factories in certain locations had been nontaxable under § 118. The Court emphasized that Federated was not receiving payments from a former customer so that it could receive goods at a lower price. It emphasized the language found Senate Finance Committee Report (83rd Cong., 2d Sec., S. Rept. No. 1622 (1954)), which provided:

> Section 118 deals with cases where a contribution is made to a corporation by a governmental unit, chamber of commerce, or other association of individuals having no proprietary interests in the corporation. In many such cases because the contributor expects to derive indirect benefits, the contribution cannot be called a gift; yet the anticipated future benefits may also be so **intangible** as to not warrant treating the contribution as a payment for future services."

While the government asserted that the extension of the exclusion of § 118 to nonshareholders was limited to contributions by a government or civic groups, the Tax Court did not agree. In the end, the Tax Court simply concluded that Federated had received only a nontaxable intangible benefit, "so intangible as to not warrant treating the contribution as a payment for future services." The Sixth Circuit agreed with the Tax Court saying

> The payments by Sharpstown to taxpayer were admittedly made with the expectation that the existence of taxpayer's department store would promote Sharpstown's financial interests. However, this expectation was clearly of such a speculative nature that any benefit necessarily must be regarded as indirect. In all the cases relied on by the government, the contributions had a reasonable nexus with the services which it was the business of the recipient corporation to provide. Such is not this case. Under these circumstances, we agree with the Tax Court that any benefit expected to be derived by Sharpstown was so intangible as not to warrant treating its contribution as a payment to taxpayer for future services.

A similar issue was heard *United States v Chicago, Burlington & Quincy Railroad Co.*, 73-1 USTC ¶9478, (USSC, 1973). In this case, the Court examined payments received by the railroad company from the federal government. However, notwithstanding a five-part test set forth in the case, the payments were from a government so its significance may be questionable.

A more relevant can be found in *The May Department Stores Company v. Comm.* 36 AFTR 2d 75-5503 (CA-8, 1975) aff'g TC Memo 1974-253. Here, the U.S. Court of Appeals for the Eight Circuit affirmed the Tax Court's decision, allowing The May Department Store Co. to exclude a similar payment on somewhat related facts.

In *May*, the Segerstrom family formulated a plan to develop a portion of 2,000 acres near Orange County, California as a shopping center. According to the facts, "[I]n the initial stage of its development the center was to consist of two large anchor stores connected by an enclosed mall with facilities which could accommodate 70 smaller retain establishments." According to the court's findings of fact, "it was critical to the financial success of this venture that popularly known retailers locate" in the shopping center. To this end, the Segerstroms tried to secure May Department Stores as one of the anchors. The negotiations resulted in an agreement in 1965 under which the Segerstroms transferred 16.4 acres of land worth $656,000 at the site of the shopping center to May in exchange for the company's promise to build a store on the tract that it received. May also obligated itself to operate a store on the premises for 25 years. No additional consideration in the form of cash, goods, or services passed to May in the transaction. Apparently, the Segerstroms were not to have title to the building constructed nor was it to be placed at their disposal.

Like Federated, May excluded the value of the land it received presumably on the theory that it was a nontaxable contribution to capital under § 118. In its brief memorandum decision, Judge Fay of the Tax Court sided with the taxpayer. According to Judge Fay, resolution of the issue depended wholly on whether the benefits, which the Segerstroms expected to derive from the transaction, were indirect and intangible. The Court believed that, if there is merely an indirect benefit to be derived by the party rather than some direct receipt of property or services, the payment could be considered a nontaxable contribution to capital. Citing *Federated*, the court believed that the benefits to be received by the Segerstroms from the conveyance were not sufficiently direct to justify a finding that the conveyance was compensation for services to be rendered by May rather than as contribution to capital.

Based on the holdings in *Federated* and *May* it would appear that Sack's could arguably exclude the payments received by MHS under § 118 on the theory that the benefits to be received by MHS are too remote and indirect. Since the payments cannot be tied directly to a particular benefit to be received by MHS—but only a speculative one—the exclusion should be allowed.

⋆ CHAPTER TWO ⋆

CORPORATE FORMATION AND CAPITAL STRUCTURE

TEST BANK

True or False

______ **1.** During the year, R and S established T Corporation, which issued 100 shares of stock. R transferred land worth $9,000 (basis $8,000) to the corporation for 90 shares of stock while S contributed services worth $1,000 for 10 shares of stock. Neither R nor S must recognize income due to their respective transfers.

______ **2.** An individual provides accounting services to a corporation in exchange for stock. The shareholder must recognize income and the corporation may deduct or capitalize the expenditure as would be appropriate.

______ **3.** B owns 85 percent of the stock of D Corporation, and C owns the remaining 15 percent. The corporation has been in operation for three years. During the year, B transferred land worth $20,000 (basis $11,000) to the corporation for additional shares, increasing his ownership to 88 percent. B is not required to recognize gain on the transfer.

______ **4.** G owns 85 percent of the stock of X Corporation, and H owns the remaining 15 percent. The corporation has been in operation for three years. During the year, G transferred land worth $20,000 (basis $11,000) to the corporation for a note bearing 10 percent interest and maturing in 15 years. G is not required to recognize gain on the transfer.

______ **5.** J owns all 150 shares of stock of Y Corporation, worth $500,000. This year he convinced his son K to come into business with him. To this end, K contributes appreciated property worth $100,000 (basis $5,000) to the corporation for 50 shares of Y stock. K should recognize no gain on the transfer, assuming his father also transfers cash of $25,000.

______ **6.** M incorporated her proprietorship this year. After receiving all of the stock of her new corporation, she immediately transferred 30 percent of the stock to her sister. M's exchange is not taxable even though she retained control only briefly after the exchange.

______ **7.** J formed X Corporation during the year by transferring land worth $50,000 to the corporation in exchange for all of its stock. The property had a basis of $20,000 and was subject to a mortgage of $15,000, which the corporation assumed. As a general rule, J must recognize gain of $15,000.

______ **8.** P formed Y Corporation by transferring property worth $70,000 to the corporation for all of its stock. The property had a basis of $30,000 and was subject to a mortgage of $10,000. P's basis in her stock is $20,000.

______ **9.** During the year, Proprietor incorporated his hobby shop in a transaction that generally qualifies for nonrecognition under § 351. As part of the formation, he transferred various liabilities to the new corporation, including a bill for a recent shipment of Prestochangos, the hottest toy on the market.

When the corporation later paid the bill, it properly charged the items to its inventory account. In determining the tax consequences of exchange, the liability is ignored for determining Proprietor's gain recognized.

______ **10.** N established L Corporation by transferring property worth $100,000 (basis $25,000) to the corporation for all of its stock. N's basis in the stock received is the same as the corporation's basis for the property, $25,000.

______ **11.** The holding period of stock received in an exchange qualifying for nontaxable treatment under § 351 begins on the date the transferred asset was acquired, assuming the asset was a building used in the transferor's sole proprietorship.

______ **12.** If a corporation receives a nonshareholder contribution representing an inducement rather than payment for corporate goods or services, the corporation must include the transfer in gross income.

______ **13.** L and R each want to start their own business. L transfers $500,000 to his corporation for shares of stock and a note bearing 10 percent interest, the interest being payable in annual installments of $50,000 for 20 years. R transfers to his corporation $500,000 solely in exchange for stock. Both wish to receive $50,000 from their corporations at the end of the first year. L receives a $50,000 interest payment and R receives a $50,000 dividend. On their individual returns L and R will report ordinary income of $50,000, but only L's corporation can claim a $50,000 deductible expense.

______ **14.** A court decision that recharacterizes a corporation's debt obligations as stock normally would result in unfavorable tax consequences for an individual holding the purported debt.

______ **15.** Assuming both investments become worthless after three years, a married individual investing in a corporation would be indifferent to whether he receives a $20,000 note or $20,000 of § 1244 stock in exchange for a $20,000 transfer.

______ **16.** Holder contributed $50,000 to a newly formed corporation in exchange for § 1244 stock. During the year, he sold the stock to Buyer. The stock qualifies as § 1244 stock in Buyer's hands.

______ **17.** Contributor transferred $50,000 to his newly formed corporation in exchange for § 1244 stock. During the year, he gave some of the stock to his son who will someday own the entire business. The stock qualifies as § 1244 stock in the son's hands.

______ **18.** T Corporation transferred $75,000 to a newly formed corporation in exchange for stock. At the time of the contribution, the new corporation's total capital was $500,000. T Corporation's stock qualifies as § 1244 stock.

______ **19.** Transferor contributed $180,000 of cash to his newly formed corporation in exchange for stock. As part of the same plan, Manager received $20,000 of stock for services to be performed during the first year of business. Manager's stock qualifies as § 1244 stock.

______ **20.** Transferor contributed $120,000 to a newly formed corporation in exchange for stock. At the time of the contribution, the corporation's total contributed capital was $5 million. Transferor's stock qualifies as § 1244 stock.

Multiple Choice

21. This year D transferred property worth $10,000 (basis $6,000) to a newly formed corporation in exchange for all of its stock worth $10,000.

a. D realizes a $4,000 gain which is not recognized. In addition, D will never pay any tax on this gain. Congress elected to forgive taxes in this instance to ensure that tax considerations do not interfere with the choice of business form.
b. D realizes a $4,000 gain which is not recognized. The gain escapes tax only temporarily.
c. D realizes a $4,000 gain which must be recognized at the time of the exchange. When the shareholder has income, it must be reported.
d. D realizes a gain of $4,000. In this case, the gain must be recognized under the continuity of interest doctrine.

22. Several years ago, Theodore Theory started his own company for manufacturing peripheral equipment such as memory chips and boards. This year he transferred all of the assets and liabilities of his high-tech business, worth $10 million, to a newly formed corporation in exchange for 10 percent of its stock. The other transferor was a large conglomerate that contributed the assets of its technology division, worth $90 million, to the corporation in exchange for 90 percent of the stock. Theo retired to Florida and followed his investment in *The Wall Street Journal* while the conglomerate took over total control of the new enterprise. Which of the following statements is true?

a. Theo should qualify for nonrecognition under § 351 in this situation, since the transaction meets its literal requirements and is consistent with the policy underlying the provision.
b. Theo will qualify for nonrecognition under a literal interpretation of the Code even though the application of § 351 in this situation is inconsistent with the policy underlying the provision.
c. Theo will not qualify for nonrecognition in this situation under § 351, since he has neither met the literal requirements of the provision nor satisfied the policy underlying the law.
d. Although application of § 351 is consistent with the policy underlying the provision in this situation, Theo will not qualify for nonrecognition because he has not met the provision's literal requirements.

23. This year C and D formed a new corporation. C and D both contributed appreciated property, receiving 90 and 10 shares of the corporation's stock respectively.

a. C must recognize gain.
b. D must recognize gain.
c. C and D must recognize gain.
d. Neither C nor D must recognize gain.

24. T Corporation was formed 10 years ago by J, K, and L. These three shareholders currently own all of the corporation's stock as follows: J owns 500 shares, K owns 100 shares, and L owns 100 shares. This year J contributed property worth $90,000 (basis $20,000) to the corporation in exchange for an additional 300 shares. J will

a. recognize gain on the exchange because on the exchange he received only 30 percent of the stock outstanding after the exchange.
b. recognize gain because the transfer is not to a newly formed corporation.
c. recognize no gain because transfers to a corporation by a shareholder in exchange for a stock interest are nontaxable regardless of the transferor's stock ownership.
d. recognize no gain because he has sufficient stock ownership after the exchange.

25. During the year, M, N, and O formed a new corporation. Solely in exchange for stock, M and N contributed appreciated property, while O contributed services. The exchanges of M and N will be nontaxable if

a. O receives 30 percent of the stock.
b. O receives 80 percent of the stock.
c. O receives 10 percent of the stock.
d. M and N receive 50 percent of the stock.
e. None of the above.

26. During the year, R, S, T, and U formed a new corporation. R contributed appreciated property, S and T contributed cash, and U contributed services. R, S, T, and U each received ¼ of the stock. Based on these facts

a. R must report taxable income.
b. R and U must report taxable income.
c. U must report taxable income.
d. transfers to a corporation in exchange for stock are nontaxable and thus none of the parties report taxable income.

27. This year X, Y, and Z formed a new corporation. X and Y contributed appreciated property for 50 percent of the stock. Z contributed property and services for the remaining 50 percent of the stock. *Of the amounts given below*, what is the minimum amount of stock that Z must receive for his property contribution if the exchanges of X and Y are to be nontaxable.

a. 8 percent
b. 10 percent
c. 20 percent
d. 30 percent
e. 50 percent

28. F and G formed a corporation on March 1 this year. F transferred equipment worth $40,000 (basis $15,000) in exchange for 40 shares of stock, and performed services worth $10,000 in exchange for 10 shares of stock. In exchange for 50 shares of stock, G contributed land worth $70,000 (basis $9,000) subject to a mortgage of $20,000, which the corporation assumed. What amount of gross income must F recognize due to the incorporation transaction?

a. $0
b. $10,000
c. $25,000
d. $35,000
e. None of the above.

29. F and G formed a corporation on March 1 this year. F transferred equipment worth $40,000 (basis $15,000) in exchange for 40 shares of stock, and performed services worth $10,000 in exchange for 10 shares of stock. In exchange for 50 shares of stock, G contributed land worth $70,000 (basis $9,000) subject to a mortgage of $20,000, which the corporation assumed. What is F's total basis in the stock that he received?

a. $15,000
b. $40,000
c. $25,000
d. $50,000
e. None of the above.

30. F and G formed a corporation on March 1 this year. F transferred equipment worth $40,000 (basis $15,000) in exchange for 40 shares of stock, and performed services worth $10,000 in exchange for 10 shares of stock. In exchange for 50 shares of stock, G contributed land worth $70,000 (basis $9,000) subject to a mortgage of $20,000, which the corporation assumed. What amount of gross income must G recognize due to the incorporation transaction?

a. $0
b. $20,000
c. $11,000
d. $61,000
e. None of the above.

31. F and G formed a corporation on March 1 this year. F transferred equipment worth $40,000 (basis $15,000) in exchange for 40 shares of stock, and performed services worth $10,000 in exchange for 10 shares of stock. In exchange for 50 shares of stock, G contributed land worth $70,000 (basis $9,000) subject to a mortgage of $20,000, which the corporation assumed. What is G's basis in his stock after the exchange?

a. $0
b. $9,000
c. $20,000
d. $11,000
e. None of the above.

32. F and G formed a corporation on March 1 this year. F transferred equipment worth $40,000 (basis $15,000) in exchange for 40 shares of stock, and performed services worth $10,000 in exchange for 10 shares of stock. In exchange for 50 shares of stock, G contributed land worth $70,000 (basis $9,000) subject to a mortgage of $20,000, which the corporation assumed. Due to the exchange, the corporation will report

a. neither income nor deduction.
b. some amount of income but no amount of deduction.
c. no income but some amount of deduction.
d. some amount of income and some amount of deduction.

33. F and G formed a corporation on March 1 this year. F transferred equipment worth $40,000 (basis $15,000) in exchange for 40 shares of stock, and performed services worth $10,000 in exchange for 10 shares of stock. In exchange for 50 shares of stock, G contributed land worth $70,000 (basis $9,000) subject to a mortgage of $20,000, which the corporation assumed. Assuming G recognized $27,500 of gain on the exchange, the corporation's basis for the land received is

a. $9,000
b. $70,000
c. $36,500
d. $50,000

34. F and G formed a corporation on March 1 this year. F transferred equipment worth $40,000 (basis $15,000) in exchange for 40 shares of stock, and performed services worth $10,000 in exchange for 10 shares of stock. In exchange for 50 shares of stock, G contributed land worth $70,000 (basis $9,000) subject to a mortgage of $20,000, which the corporation assumed. If G should sell his stock, the holding period will

a. include the holding period of the land.
b. begin on the date of the transfer.
c. always be considered long-term regardless of the holding period of the land or the date of the transfer.
d. always be considered short-term regardless of the holding period of the land or the date of the transfer.

35. F and G formed a corporation on March 1 this year. F transferred equipment worth $40,000 (basis $15,000) in exchange for 40 shares of stock, and performed services worth $10,000 in exchange for 10 shares of stock. In exchange for 50 shares of stock, G contributed land worth $70,000 (basis $9,000) subject to a mortgage of $20,000, which the corporation assumed. The following statements concern the computation of depreciation of the equipment contributed by F. In which statement is the computation of depreciation correctly described?

- **a.** Assuming F and G were incorporating their partnership, the partnership will report no depreciation and the corporation will report all the depreciation allowable.
- **b.** Assuming F and G had never before been in business, the corporation will compute its depreciation deduction for the entire year by applying the depreciation percentage to the adjusted basis of the property.
- **c.** Assuming F contributed the equipment that she had used in her sole proprietorship business for two years (which is continued by the corporation), the corporation may treat the asset as newly acquired property, use the first year depreciation percentage, and claim 10/12 of the amount so determined in computing depreciation.
- **d.** Assuming F transferred equipment that she had used in her own business, the corporation will merely step into the shoes of F and claim the deduction she would otherwise be able to claim, and F will not claim any depreciation for the year of the transfer.
- **e.** None of the above.

36. This year D, E, and F formed a new corporation. D exchanged equipment worth $40,000 for 40 percent of the stock and services worth $15,000 for 15 percent of the stock. E exchanged machinery worth $30,000 for 30 percent of the stock and services worth $10,000 for 10 percent of the stock. F exchanged land worth $5,000 for 5 percent of the stock. Which of the following statements is true?

- **a.** F's transfer does not qualify for nonrecognition treatment under § 351 because he did not receive a sufficient equity interest.
- **b.** For § 351 purposes, D, E, and F are treated as owning only 75 percent of the stock and therefore their exchanges of property do not qualify for § 351 treatment.
- **c.** All of the property exchanges qualify for nonrecognition treatment under § 351.
- **d.** More than one of the above is true.
- **e.** None of the above is true.

37. J, L, and R formed a new corporation. J exchanged equipment worth $35,000 (basis $8,000) for 35 percent of the stock, and services worth $25,000 for 25 percent of the stock; L exchanged land worth $25,000 (basis $5,000) for 25 percent of the stock; and R received 15 percent of the stock in exchange for securities worth $15,000 (basis $10,000). Which of the following statements is true?

- **a.** The transaction would not be eligible for nonrecognition because more than 20 percent of the stock received was in exchange for services.
- **b.** The transaction will be eligible for nonrecognition, but J will have to recognize gain on the compensation for services.
- **c.** Only the basis of the property transferred is considered in determining whether nonrecognition is granted; the three shareholders owned 80 percent of the property transferred.
- **d.** None of the above.

38. This year T transferred property worth $10,000 (basis $3,000) to C Corporation in exchange for a 15 year bond worth $5,000 and all of C's stock worth $5,000.

- **a.** The transfer is nontaxable because the transferor received stock and debt on the exchange.
- **b.** T must recognize gain of $7,000 since § 351 does not apply to the transaction.
- **c.** T must recognize gain of $5,000.
- **d.** None of the above.

39. S has decided to incorporate her proprietorship. She anticipates transferring all of the assets to the corporation for 100 percent of its stock. The corporation will issue only voting common stock. Immediately after the exchange, S plans to give 15 percent of the stock to her daughter and sell another 20 percent to an interested investor. S is under no obligation to give stock to her daughter or to sell stock to the investor. If the provisions of § 351 are applied to the transfer,

- **a.** control is measured before the gift and sale and, therefore, no gain or loss is recognized by S on the transfer.
- **b.** control is measured immediately after the gift and sale and, inasmuch as S no longer controls 80 percent of the stock, she must recognize gain or loss on the transfer of the proprietorship assets into the corporation.
- **c.** because S has made a plan to circumvent the § 351 requirement concerning control, gain or loss must be recognized.
- **d.** b and c above are true.
- **e.** none of the above are true.

40. S transfers land to a new corporation for stock. The corporation plans to issue 1,000 shares of voting common stock and 500 shares of nonvoting preferred stock. Common stock notwithstanding, the minimum number of preferred shares that S must receive to be in control is

- **a.** 0
- **b.** 251
- **c.** 375
- **d.** 400

41. In a § 351 transfer, stock includes all of the following except

- **a.** preferred.
- **b.** preferred and nonvoting.
- **c.** nonparticipating.
- **d.** stock rights and warrants.

42. This year, T transferred appreciated property to a newly formed corporation. Which of the following items may *not* be received if the exchange is to be tax-free?

- **a.** Bonds with a maturity of 15 years.
- **b.** Nonvoting cumulative participating preferred stock.
- **c.** Neither of the above may be received.
- **d.** Both of the above may be received.

43. Which of the following is a true statement about § 351 transfers?

- **a.** A transferor who contributes appreciated property to a corporation can receive items other than stock and the entire exchange may still qualify for tax-free treatment.
- **b.** The amount of boot received as a result of the assumption of liabilities by the corporation is limited to the excess of liabilities over basis of assets transferred.
- **c.** Partnerships may not be incorporated under this provision.
- **d.** None of the above are true.

44. This year, A transferred land worth $150,000 (basis $90,000) to his wholly owned corporation in exchange for voting, preferred stock. The land was subject to a mortgage of $40,000. Due to the transfer, A must recognize gain of

a. $0
b. $40,000
c. $60,000
d. $100,000

45. This year P and Q formed ABC Corporation. P transferred a building worth $90,000 (basis $25,000) to the corporation in an exchange generally qualifying under § 351. The building was subject to a mortgage of $10,000, and P received stock worth $80,000 on the exchange. P will recognize

a. no gain or loss and have a basis in his stock of $25,000.
b. no gain or loss and have a basis in his stock of $15,000.
c. a gain of $10,000 and have a basis in his stock of $25,000.
d. a gain of $15,000.
e. a gain of $65,000.

46. This year J and K formed New Corporation. J transferred the assets below to New in exchange for stock.

	Adjusted Basis	*Fair Market Value*
Building	$ 45,000	$ 90,000
Equipment	100,000	110,000
Total	$145,000	$200,000

In addition the building was subject to a mortgage of $50,000. J received stock worth $150,000 on the exchange. Assume that the transfer meets the requirements of § 351. J will recognize

a. no gain or loss.
b. $5,000 gain.
c. $50,000 gain.
d. $60,000 gain.

47. This year J and K formed New Corporation. J transferred the assets below to New in exchange for stock.

	Adjusted Basis	*Fair Market Value*
Building	$ 45,000	$ 90,000
Equipment	100,000	110,000
Total	$145,000	$200,000

In addition the building was subject to a mortgage of $50,000. J received stock worth $150,000 on the exchange. Assume that the transfer meets the requirements of § 351. J's basis in his stock is

a. $145,000.
b. $95,000.
c. $100,000.
d. $150,000.
e. some other amount.

48. Promoter incorporated his real estate business, transferring the following liabilities:

1. $100,000 mortgage on real estate acquired four years ago (the $100,000 represented the unpaid balance of the original mortgage).
2. $25,000 second mortgage on real estate (Promoter had borrowed the $25,000 to use for personal purposes one week before the transfer).
3. $40,000 of accounts payable for expenses incurred for architectural fees related to construction of a new 2,000-unit complex.

Upon review, the IRS would probably treat which of the following amounts as boot?

a. $165,000
b. $25,000
c. $65,000
d. $140,000
e. $125,000

49. Entrepreneur, a cash basis taxpayer, incorporated his solely owned software business during the year. Among the items transferred to the newly formed corporation were various liabilities, including a bill from a supplier for 1,000 floppy disks on which Entrepreneur's world famous program TX 4-5-6 is copied for later sale. *Assuming the cost of the disks is properly deducted* when the corporation pays the bill, which of the following statements is true regarding the treatment of the liability on the exchange?

a. The liability must be considered for purposes of determining Entrepreneur's gain but is ignored for determining his basis in his stock.
b. The liability must be considered for purposes of determining both Entrepreneur's gain and his basis in his stock.
c. The liability need not be considered for purposes of determining Entrepreneur's gain but must be considered for determining his basis in his stock.
d. The liability need not be considered for purposes of determining Entrepreneur's gain or basis in his stock.

50. Which of the following is not directly considered in calculating the basis of stock received in a § 351 transfer?

a. Basis of the property transferred.
b. Fair market value of the stock received.
c. Fair market value of the property received.
d. Liabilities assumed by the corporation.

51. B transferred depreciable equipment worth $12,000 (basis $9,000) to his wholly owned corporation this year in exchange for stock worth $7,000 and cash of $5,000. B's gain or loss on the transaction and his basis for the stock received is

a. $3,000 gain, $7,000 basis.
b. $0 gain, $9,000 basis.
c. $3,000 gain, $12,000 basis.
d. $5,000 gain, $9,000 basis.
e. none of the above.

52. B, C, and D each own 30 shares of the 90 shares of stock outstanding of We-Cater-To-You Corporation. This year B contributed a van previously used in his proprietorship worth $10,000 (basis $12,000) in exchange for 10 shares of stock. R will

a. recognize no gain or loss on the exchange and have a basis in the stock received of $10,000.
b. recognize a $2,000 loss on the exchange and have a basis in the stock received of $10,000.
c. recognize no gain or loss on the exchange and have a basis in the stock received of $12,000.
d. recognize a $2,000 loss on the exchange and have a basis in the stock received of $12,000.

53. C incorporated her sole proprietorship two years ago by transferring equipment that was worth $100,000 and had a basis of $40,000 (cost $70,000, depreciation claimed and deducted $30,000). The corporation sold the equipment for $65,000. During the period that the corporation held the asset, it had claimed and deducted $10,000 in depreciation. The corporation must recognize

a. § 1231 gain of $25,000 and § 1245 gain of $10,000.
b. § 1231 gain of $35,000 only.
c. § 1245 gain of $35,000 only.
d. § 1245 gain of $5,000 only.
e. none of the above.

54. G incorporated his sole proprietorship three years ago by transferring all of the business assets to the corporation for all of its stock. Included among the assets transferred was equipment on which there was unearned investment credit. Which of the following statements is true?

a. A sale of the equipment by the corporation will trigger unearned investment credit recapture, all of which must be recaptured by the corporation.
b. A sale by G of his entire interest in the corporation will trigger unearned investment credit recapture, all of which must be recaptured by G.
c. Unearned investment credit must be recaptured by G subsequent to the transfer because it is triggered upon transfer.
d. None of the above are true.

55. Although the investment credit was generally repealed beginning in 1986, the possibility for the recapture of unearned credits continues to exist. The recapture rules relating to the investment credit generally provide that the credit must be recaptured upon a disposition prior to the time when the credit has been fully earned. In a transfer of property to a corporation, investment credit recapture

a. is the obligation of the corporation.
b. is required if the transferor retains a substantial interest in the business.
c. is not required if a mere change in form occurs.
d. may be required regardless of whether the transfer qualifies for nonrecognition treatment under § 351.
e. c and d above.

56. X incorporated her calendar year proprietorship on October 1 of this year. In exchange for all of its stock, she transferred her business's assets, including a computer that she had purchased for $20,000 in June of the prior year and used only in her business. Assume the applicable depreciation percentages are 10 percent for last year and 20 percent for the current year. What is the total amount of depreciation that can be properly deducted by X for her proprietorship for the current and the prior year?

a. $6,000
b. $5,000
c. $2,000
d. Choice of a or b.

57. During the year, the city of Houston contributed land worth $100,000 to XYZ, Inc. in order to lure the company to establish a factory in the city. XYZ will report

a. $100,000 income and will have a basis in the property of $100,000.
b. no income and will have a basis in the property of $100,000.
c. no income and will have a zero basis in the property.
d. $100,000 income and will have a zero basis in the property.

58. From an individual's perspective, which of the following is not an advantage of utilizing debt when determining whether debt (i.e., long-term securities) or stock should be used as part of the capital structure of the business?

a. It is less costly to pay a return to the investor.
b. It can be transferred without concern for control.
c. It provides a defense against possible imposition of the accumulated earnings tax.
d. It receives more favorable treatment should it become worthless.

59. L and R each received $500,000 from their mother to start their own businesses. L transferred her $500,000 to her corporation for shares of stock worth $200,000 and a $300,000 note bearing 10 percent interest. The interest is payable in annual installments of $30,000 for 15 years. In contrast, R contributed his $500,000 to his corporation in exchange solely for stock. Assume both corporations are equally successful and have current EP (earnings and profits) exceeding $30,000 at the end of their first year. During the year, L receives an annual principal payment of $25,000. To acquire $25,000, R redeems stock of his corporation worth $25,000. Which of the following statements is true?

a. L's principal payment is tax-free.
b. L's debt could be reclassified as stock if the corporation were too thinly capitalized.
c. R's $25,000 will be taxed as a dividend.
d. All of the above.

60. Several years ago, R incorporated his sole proprietorship, receiving stock and debt as part of the transaction. In which of the following situations is the debt likely to be recharacterized as stock?

a. 85 percent debt, 15 percent stock
b. 50 percent debt, 50 percent stock
c. 15 percent debt, 85 percent stock
d. 40 percent debt, 60 percent stock

61. Hybrid securities are quite susceptible to being reclassified as stock. Which of the following is characteristic of hybrid securities?

a. A maturity date that is reasonably close in time.
b. Interest payable regardless of the corporation's income.
c. Not subordinated to debt of general creditors.
d. None of the above.

62. N Corporation was formed by L in 2001, issuing $2 million in stock. Several years ago, M was admitted as a new shareholder, receiving 100 shares of stock and a note in exchange for property. The stock and note have a basis of $30,000 and $40,000, respectively. On October 5 of the current year, the corporation declared bankruptcy, and the stock and note became worthless. How much may M deduct on her individual return for this year?

- **a.** $70,000, if married status.
- **b.** $50,000, if single status.
- **c.** $73,000, if married status.
- **d.** $51,500, if single status.
- **e.** $3,000, if married or single status.

63. In January last year, D, single, established a corporation and acquired § 1244 stock. This year the stock, which had a basis of $120,000, became worthless. D had no other property transactions during the year. D's adjusted gross income will decrease because of these transactions by

- **a.** $50,000.
- **b.** $120,000.
- **c.** $3,000.
- **d.** $53,000.
- **e.** $103,000.

64. Taxable transfers of property to a corporation may be desirable under certain conditions. Taxpayers may avert nonrecognition by

- **a.** selling the property to the corporation for debt.
- **b.** exchanging the property in a § 351 transaction in which boot is received.
- **c.** exchanging the property with the corporation where § 351 does not apply.
- **d.** all of the above.

65. Ten years ago J purchased land for $40,000. The land has appreciated in value and now could be subdivided and sold for $450,000. The land currently constitutes a capital asset for J under § 1221. What form of development of the property would have the most favorable tax consequences for J?

- **a.** Subdivide the property and sell the lots.
- **b.** Form a corporation and transfer the property for stock under the nonrecognition provisions of § 351.
- **c.** Form a corporation to develop the land and sell the land to it, taking an installment note payable for the sales price.

★ CHAPTER TWO ★

CORPORATE FORMATION AND CAPITAL STRUCTURE

SOLUTIONS TO TEST BANK

True or False

1. False. Under § 351, R does not recognize gain because immediately after the exchange he owned 90 percent of the stock, which exceeds the control threshold of 80 percent. However, S must recognize income of $1,000 because he is not a transferor of property. (See Example 9 and pp. 2-7 through 2-9.)
2. True. Section 351(d)(1) provides that stock issued for services is not considered issued for property and thus does not qualify as a nontaxable exchange. The Service has ruled that the corporation may treat the transfer as if it had paid cash, and thus it may deduct or capitalize the expenditure as would be appropriate. (See Example 5, p. 2-6, and Rev. Rul. 217, 1962-2 C.B. 59.)
3. True. Under § 351, B does not recognize gain because immediately after the exchange he owns 88 percent of the stock, which exceeds the control threshold of 80 percent. Note that § 351 applies to transfers to an existing corporation as well as a new corporation. (See Example 7 and p. 2-7.)
4. False. Receipt of a security under § 351 is treated as boot and causes recognition of gain. (See p. 2-12.)
5. False. Due to the nominal nature of J's transfer, it is unlikely that J's ownership will be counted toward the 80 percent control test, causing K to recognize gain. Rev. Proc. 77-37, 1977-2 C.B. 568 requires that property constituting at least 10 percent of the value of the pre-existing ownership must be transferred before such ownership may be considered. In this case, J transfers $25,000, which is only 5 percent of the $500,000 value of his ownership. (See Example 14 and pp. 2-8 and 2-9.)
6. True. Momentary control is sufficient for nonrecognition as long as the transferor has the freedom to determine whether he or she will make a transfer after the exchange. A transferor does not have control if a prearranged plan exists that requires the transferor to make the transfer leading to loss of control. (See Example 16 and pp. 2-10 and 2-11.)
7. False. Liabilities transferred generally are not treated as boot under § 357(a); thus, J is not required to recognize gain. (See Example 18 and pp. 2-12 to 2-14.)
8. True. The shareholder's basis under § 358 is the basis of the property transferred increased by any gain recognized and decreased by any boot received. Although the liabilities are not treated as boot for purposes of determining gain or loss, they normally are considered in the basis calculation. Thus, the basis of the stock is $20,000 ($30,000 − $10,000). (See Exhibit 2-1, Example 27, and pp. 2-16 and 2-17.)
9. False. Under § 357(c)(3), liabilities that are properly capitalized by the corporation when paid are treated as liabilities for purposes of determining whether liabilities exceed basis of the assets transferred. In this case, after the corporation paid the expense it was capitalized as part of inventory. Thus, it must be considered a liability for purposes of determining whether liabilities transferred exceed basis. (See Example 24 and pp. 2-16 and 2-17.)
10. True. Under § 358, the shareholder's basis in the stock received is the same as the basis of the property transferred, adjusted for boot received and gain recognized, neither of which were present in this situation. Thus, the basis in the stock is $25,000. Under § 362, the corporation's basis is the same as the shareholder's basis increased by any gain recognized. (See Exhibits 2-1 and 2-2, Examples 25 and 29, and pp. 2-16, 2-19 and 2-20.)

11. True. Since the basis for the stock is determined by using the basis of the property transferred, the transferor's holding period for any stock received in exchange for a capital asset or § 1231 property is the same as that of the asset. [See p. 2-19 and § 1223(1).]

12. False. Such nonshareholder contributions may be excluded from gross income. If the contribution is property, the basis of the property is considered zero so that normal tax benefits associated with basis (e.g., depreciation) cannot be obtained. (See Example 36, p. 2-24 and § 118.)

13. True. Because L designed her capital structure to include debt, L's corporation distributes the $50,000 to L in the form of a *deductible* interest payment. In contrast, R's $50,000 distribution is taxed a second time (once to the corporation and once to the individual) because dividends are nondeductible by the corporation. (See Example 37 and pp. 2-25 and 2-26.)

14. True. For an individual taxpayer, recharacterization of debt as equity would cause interest payments to be treated as dividends, resulting in double taxation. In addition, repayments of principal would no longer be tax-free but under the redemption rules would probably be treated as dividends as well. (See Example 37 and 38 and pp. 2-25 and 2-26.)

15. False. The loss on the § 1244 stock would be an ordinary loss while the loss on the security would be a capital loss. The ordinary loss would be deductible in full on the individual return ($100,000 limit on joint return), whereas the capital loss deduction would be limited to $3,000. (See Examples 40 and 41 and pp. 2-30 through 2-32.)

16. False. Only the original holders of the stock are entitled to § 1244 treatment. Since Buyer purchased the stock from an original holder, she is denied § 1244 treatment. (See p. 2-31.)

17. False. Only the original holders of the stock are entitled to § 1244 treatment. Because the son received the stock from an original holder, he is denied § 1244 treatment. (See p. 2-31.)

18. False. Only stock issued to individuals and partnerships qualifies for § 1244 stock treatment. Because T is a corporation, it does not receive § 1244 treatment. (See p. 2-31.)

19. False. Stock received for services does not qualify as § 1244 stock. (See p. 2-32.)

20. False. The corporation must qualify as a "small business corporation" when the stock was issued. To meet this requirement, the total amount contributed for stock may not exceed $1 million. Consequently, the corporation is not considered a small business corporation and the stock is not § 1244 stock. (See p. 2-32.)

Multiple Choice

21. b. Under § 351, a transfer is nontaxable only if those that transfer property, as a group, own 80 percent of the stock immediately after the exchange. In this case, D's exchange qualifies for § 351 because immediately after the exchange he owns 100 percent of the stock. As a result, the realized gain of $4,000 ($10,000 − $6,000) is not recognized. This gain does not escape tax permanently, however, but is deferred through the basis that D must assign to his stock. D's basis in the stock is generally a substituted basis, in this case, $6,000. Thus, if D sells his stock for its $10,000 value, the deferred gain would be recognized. (See Examples 4 and 25 and pp. 2-5 and 2-16.)

22. b. Theo qualifies for nonrecognition, since the literal requirements of § 351 are satisfied (i.e., Theo is one of the transferrers that own at least 80 percent of the stock immediately after the exchange). However, it is doubtful whether the policy of § 351 is well served, since there has been more than a mere change in the form of Theo's investment. He has discarded the role of entrepreneur for that of investor in a huge conglomerate. (See p. 2-4.)

23. d. Neither must recognize gain. Under § 351, a transfer is nontaxable if those that transfer property, as a group, own 80 percent of the stock immediately after the exchange. In this case, C and D own 100 percent of the stock. (See Example 6 and p. 2-7.)

24. d. Under § 351, a transfer is nontaxable only if those that transfer property, as a group, own 80 percent of the stock immediately after the exchange. In this case, J owns 80 percent of the stock after the exchange (500 + his preexisting equity interest of 300 shares or 800 of the total 1,000 shares outstanding). Therefore the transaction is nontaxable. (See Example 7 and p. 2-7.)

25. c. Under § 351, a transfer is nontaxable if those that transfer property, as a group, own 80 percent of the stock immediately after the exchange. Therefore, if the transfers of the property transferrers are to be nontaxable, a person that contributes only services can receive at most 20 percent of the stock. (See Example 9 and p. 2-8.)

26. b. Under § 351, a transfer is nontaxable if those that transfer property, as a group, own 80 percent of the stock immediately after the exchange. In this case, those who transfer property, R, S, and T, receive only 75 percent of the stock. Thus, R's transfer is taxable. In addition, § 351 does not apply to a contribution of services. Stock received for services is treated as compensation, and thus, U must include the value of the stock received for services rendered as income. (See Example 10 and pp. 2-8 and 2-9.)

27. a. Under § 351, a transfer is nontaxable only if those that transfer property, as a group, own 80 percent of the stock immediately after the exchange. For purposes of the 80 percent test, the Regulations provide that all of the stock received by a transferor of both property and services is counted toward control, not just the amount received for property. The Regulations provide, however, that property contributions which are nominal in amount are disregarded for this purpose. The Service has indicated that for ruling purposes, the value of the stock received for property must be at least 10 percent of the value of services. Therefore, the minimum amount of stock that X can receive for services is 4.55 percent determined as follows:

x = Value of stock received for services
$.10\,x$ = Value of stock received for property

$x + .10\,x = 50\%$
$x = 45.45\%$
$.10\,x = 4.55\%$

Of the percentages given, 8 percent is the closest to 4.55 percent. (See Example 13 and pp. 2-7 and 2-8.)

28. b. The transfer generally qualifies for nonrecognition under § 351, since the transferrors of property, F and G, control the corporation immediately after the exchange. However, § 351 does not apply to contributions of services. Consequently, F must recognize income equal to the value of the services. (See Example 5 and pp. 2-6 through 2-9.)

29. c. The transfer generally qualifies for nonrecognition under § 351, since the transferrors of property, F and G, control the corporation immediately after the exchange. However, § 351 does not apply to contributions of services. Consequently, F must recognize income equal to the value of the services. Under § 358, F's basis is $15,000, the same as the property transferred, increased by gain recognized ($0) and decreased by boot received ($0). The basis for the stock received for services is equal to the income recognized, or $10,000. Thus, the total basis is $25,000 ($15,000 + $10,000). (See Example 17 and pp. 2-7, 2-8, 2-10, 2-11, 2-16 and 2-17.)

30. c. Since the transaction qualifies for nontaxable treatment under § 351, no gain is recognized unless boot is received. For this purpose, the liabilities are not considered boot under § 357. However, § 357(c) provides that gain must be recognized to the extent liabilities exceed the aggregate of the basis of property transferred, which in this case is $11,000 ($20,000 − $9,000). (See Examples 21 and 22 and p. 2-14.)

31. a. Under § 358, G's basis is $0, the same as the property transferred ($9,000), increased by gain recognized ($11,000), and decreased by boot received ($20,000 liability). (See Example 27 and p. 2-17.)

32. c. The corporation recognizes no income on the exchange, but is entitled to deduct the amount paid for the services, or alternatively to capitalize and amortize a portion of the amount attributable to the services. (See p. 2-18 and § 1032.)

33. c. The corporation's basis under § 362 is the same as the transferor's, increased by any gain recognized, or $36,500 ($27,500 + $9,000). (See Exhibit 2-2, Example 29 and pp. 2-18 and 2-19.)

34. a. Under § 1223, the holding period of the asset transferred (the land) tacks to the stock, since the asset is § 1231 property or a capital asset and the basis of the stock is determined by reference to the basis of the land. (See p. 2-18.)

35. e. The corporation must use the same method for computing the depreciation as the transferor and claim 10/12 of that amount. (See Examples 33 through 35 and pp. 2-21and 2-22.)

36. c. Under § 351, a transfer is nontaxable only if those that transfer property, as a group, own 80 percent of the stock immediately after the exchange. For purposes of the 80 percent test, the Regulations generally provide that all of the stock received by a transferor of both property and services is counted toward control not just the amount received for property. Therefore, D, E, and F are deemed to own 100 percent of the stock after their exchanges. As a result, each of their property exchanges are nontaxable. (See Examples 11 and 12 and p. 2-8.)

37. b. Section 351 provides that all the stock received where a shareholder exchanges both services and property can be considered toward the 80 percent required for control. However, income must be recognized by the shareholder on the compensation for services. There is no requirement that for nonrecognition, the amount of property involved in transfers to a corporation be limited to a set percentage. (See pp. 2-7 and 2-8.)

38. c. If the transferor exchanges property for debt of the corporation, such debt is considered boot. Therefore, T's gain realized of $7,000 ($10,000 − $3,000) must be recognized to the extent of the debt received, $5,000. (See p. 2-11.)

39. a. Section 351 requires control to exist "immediately after the exchange." However, "momentary control" has been ruled sufficient if the transferor has—on receipt of the stock—freedom to retain or dispose of the stock. Intent in no way invalidates this transfer, *as long as loss of control is not inevitable.* (See pp. 2-9 and 2-10.)

40. d. 500 shares 80 percent = 400 shares. The transferor must receive at least 80 percent of each class of stock. (See p. 2-7.)

41. d. Stock rights and warrants do not qualify as stock, since they only give a *right* to obtain an equity interest. (See p. 2-7.)

42. a. Any type of security is treated as cash, which requires gain recognition. A taxpayer can receive any type of stock in a tax-free incorporation. (See pp. 2-7 and 2-11.)

43. d. Choice **a** is false because a transferor can receive only stock and qualify for tax-free treatment under § 351. Choice **b** is false because the excess of liabilities over basis does not represent boot but represents gain that the transferor must recognize. Choice **c** is false because partnerships may be incorporated under § 351. (See p. 2-10.)

44. a. When a taxpayer is relieved of a liability, it is normally treated as if the taxpayer received cash and then paid off the liability (*U.S. v. Hendler*). This decision made many incorporation transactions taxable. Section 357(a) was enacted so that relief of a liability is not treated as boot, and thus no gain is recognized. (See Example 18 and p. 2-13.)

45. **b.** P realizes a gain of $65,000 ($80,000 + $10,000 − $25,000). Although P has effectively received cash to the extent he was relieved of the $10,000 liability, such relief is not considered boot under § 357(a). Therefore no gain is recognized. (See Example 18 and pp. 2-11 and 2-12.) However, relief of the liability must be considered in the basis calculation. Therefore, P's basis is $15,000 (the same as the basis of the property transferred, $25,000, increased by gain, $0, and reduced by the liability, $10,000). (See Example 27 and p. 2-17.)

46. **a.** J realizes a gain of $55,000 ($150,000 + $50,000 − $145,000). Although J has effectively received cash to the extent he was relieved of the $50,000 liability, such relief is not considered boot under § 357(a). In addition, § 357(c) (requiring gain to be recognized when the taxpayer is relieved of liabilities that exceed basis) does not apply here because the total liabilities from which J was relieved, $50,000, does not exceed the total basis of the property transferred, $145,000. When applying the test of § 357(c), aggregate liabilities must be compared to aggregate basis. Thus, no gain is recognized. (See Example 22 and p. 2-14.)

47. **b.** J realizes a gain of $55,000 ($150,000 + $50,000 − $145,000). Although J has effectively received cash to the extent he was relieved of the $50,000 liability, such relief is not considered boot under § 357(a). In addition, § 357(c) (requiring gain to be recognized when the taxpayer is relieved of liabilities that exceed basis) does not apply here because the total liabilities from which J was relieved, $50,000, does not exceed the total basis of the property transferred, $145,000. When applying the test of § 357(c), aggregate liabilities must be compared to aggregate basis. Thus, no gain is recognized. However, the liability is considered for basis purposes. Consequently, J's basis is $95,000 (basis of the property transferred, $145,000, + gain, $0, − liability $50,000). (See Examples 18 and 27 and pp. 2-13 and 2-17.)

48. **a.** Because there is no valid business purpose for the second mortgage, § 357(b) and Reg. § 1.357-1(c) require that *all* liabilities from which the taxpayer was relieved—not just the tainted ones—are to be treated as boot ($100,000 + $40,000 + $25,000). (See footnote 29 and pp. 2-14 and 2-15.)

49. **d.** Code § 357(a) provides that liabilities generally are not treated as boot for purposes of determining the transferor's gain or loss recognized on an exchange. However, § 357(c) generally requires the taxpayer to recognize gain to the extent the liabilities transferred exceed the total basis of the property transferred. In making this calculation, § 357(c)(3) provides that those liabilities relating to routine *deductible* expenditures are not considered liabilities. In addition, such liabilities are ignored in computing the shareholder's basis. Because the liability is not considered for purposes of determining Entrepreneur's gain choices **a** and **b** are incorrect. Choice **b** is also wrong because such liabilities are similarly ignored in determining shareholder's basis. Choice **c** is wrong because it states that the liability must be considered for the determination of Entrepreneur's basis in his stock. (See Example 28 and pp. 2-17 and 2-18.)

50. **b.** The fair market value of the stock received is not used to determine the shareholder's basis but is used to determine the gain realized. (See Exhibit 2-1 and pp. 2-17 and 2-18.)

51. **a.** Because the cash received exceeds the gain realized, all of the gain of $3,000 must be recognized. The basis in the stock is the same as the basis of the property, $9,000, increased by the $3,000 gain and decreased by the $5,000 boot, or $7,000. (See Example 26 and p. 2-17.)

52. **b.** Under § 351, a transfer is nontaxable only if those that transfer property, as a group, own 80 percent of the stock immediately after the exchange. In this case, B is the only transferor of property, and immediately after the exchange he owns only 40 percent [30 + (10/100)]. Therefore, his transfer is a taxable transaction, allowing him to recognize a loss of $2,000 ($10,000 − $12,000). Note that § 267 (relating to losses on sales between related parties) does not apply because B does not own more than 50 percent of the corporation's stock. Because the transaction is taxable B's basis in his stock is $10,000. In effect, he has acquired the stock by giving property worth $10,000. (See Example 8 and pp. 2-7 and 2-16.)

53. **c.** The basis of the property to the corporation under § 362 is the same as the transferor's, or $40,000. This amount must be reduced by the $10,000 depreciation to give the corporation a basis of $30,000. Thus, the corporation recognizes a $35,000 ($65,000 − $30,000) gain on the sale. All of the $30,000 depreciation recapture potential carries over to the corporation and is added to the $10,000 claimed by the corporation, resulting in total depreciation recapture potential of $40,000. Thus, all $35,000 of the gain is ordinary income under § 1245. (See p. 2-21.)

54. **b.** Answer **a** is false because investment credit is recaptured by the shareholder. Answer **c** is false because investment credit need not be recaptured if all substantial assets are transferred and the transferor retains a substantial interest in the corporation. (See p. 2-20.)

55. **e.** Recapture is *not* required if a substantial interest is retained in the business—if a "mere change in the form of conducting the business" is deemed to occur. Recapture is the obligation of the transferor-shareholder, not the corporation. (See p. 2-21.)

56. **b.** A may properly deduct depreciation of $5,000: $2,000 for the prior year (10% × $20,000) and $3,000 for the current year (20% × $20,000 = $4,000) × 9/12, for her portion of the year before transferring the asset to the corporation. (See Example 33 and pp. 2-21 and 2-22.)

57. **c.** Contributions to capital by a nonshareholder are excluded from income as are shareholder contributions. However, property contributed by a nonshareholder is assigned a zero basis. (See Example 36 and p. 2-24.)

58. **d.** Loss on a worthless security that is a capital asset, whether stock or debt, is treated as a loss from the sale or exchange of a capital asset on the last day of the taxable year. Thus, worthless debt and worthless stock are treated the same. Moreover, if the stock were § 1244 stock, the treatment of stock would be more favorable, since ordinary loss treatment is allowed, subject to limitations. (See pp. 2-30 and 2-31.)

59. **d.** This example points out the advantages of owning debt over stock. But if the capital structure consists primarily of debt and little stock, it is said to be too *thinly capitalized*, and the debt may be reclassified as stock. (See pp. 2-25 through 2-27.)

60. **a.** The clearest indication that "debt" is actually a disguised equity interest is a ratio of debt to stock ownership exceeding 4:1. (Here, 85%:15% = 5.67:1.) Proportionate holdings are not conclusive evidence that the debt is equity, especially in the case of a solely owned corporation with properly structured debt. (See pp. 2-25 through 2-27.)

61. **d.** All of these are characteristics of *straight debt*, which contains an unqualified promise to pay a certain sum at a maturity date along with a fixed percentage in interest. (See pp. 2-27 through 2-29.)

62. **e.** Since the note and stock are worthless and have been held for longer than one year, M has a long-term capital loss of $70,000. M may deduct a maximum of $3,000 due to the limitations on deductions of capital losses. Note that the stock involved could not be § 1244 stock because the initial capitalization exceeded $1 million. (See pp. 2-30 through 2-31.)

63. **d.** The loss on § 1244 stock is treated as an ordinary loss up to a maximum of $50,000 annually for a single taxpayer. The remainder of the loss is treated as a capital loss, for which the maximum deduction is $3,000. Thus, D's A.G.I. decreases by $53,000. (See Example 41 and pp. 2-31 and 2-32.)

64. **d.** All three methods are used by taxpayers to make use of the advantages of taxable transfers. These plans do not always avert nonrecognition, however. (See pp. 2-35 through 2-38.)

65. **c.** Although J sold the land to the corporation and must recognize gain, all the gain is capital gain. By selling the land for debt, J has obtained cash out of his corporation via deductible interest payments and tax-free payments of principal, instead of dividends (**b**). Income from the sale of lots (**a**) would probably be taxable as ordinary income. (See Example 45 and pp. 2-36 and 2-37.)

⋆ CHAPTER TWO ⋆

CORPORATE FORMATION AND CAPITAL STRUCTURE

FACTS FOR COMPREHENSIVE PROBLEMS

1. B, C, D, and E formed X Corporation on May 1 of this year. The following transfers were made:

- B transferred depreciable equipment currently worth $12,000. The equipment had a basis in his hands of $9,000 (cost $15,000, depreciation $6,000). He purchased the equipment several years ago for $15,000, and had used it in his manufacturing business since that time. B received 1,000 shares of X stock worth $10 per share and $2,000 cash.
- C transferred $6,000 cash and performed management services for the corporation worth $4,000. C received 1,000 shares of X stock worth $10,000.
- D transferred land worth $15,000 subject to a mortgage of $7,000. The basis of the land was $6,000. D received 800 shares of X stock worth $8,000.
- E transferred cash of $3,000, accounts receivable of $7,000 (basis $0) and accounts payable for rent, utilities, and other routine operating expenses of $4,000. E received 600 shares of X stock worth $6,000.

COMPREHENSIVE PROBLEMS

Assume the transaction qualifies for § 351 treatment.

a. Compute the income, deduction, gain or loss recognized, if any, for B, C, D, and E.
b. What effect, if any, will the transaction have on the corporation's taxable income?
c. Compute the basis of the stock for each shareholder.
d. Compute the basis of the contributed property to X.
e. Explain the tax consequences to X when it collects the receivables and pays the payables contributed by E.
f. Assume that X sells the equipment that it received from B several years after the transfer for $20,000 after it had claimed $2,000 of depreciation. What amount of gain must X recognize and what is its character?
g. Explain how the depreciation calculation would be made for the equipment contributed by B.

SOLUTIONS FOR COMPREHENSIVE PROBLEMS

a. Under § 351, a transfer is nontaxable only if those that transfer property, as a group, own 80 percent of the stock immediately after the exchange. However, this general rule is subject to several exceptions as discussed below for each of the individual transferrers. The gain realized for each of the property transferrers is computed below.

	B	*D*	*E*
Amount realized			
Stock received	$10,000	$ 8,000	$ 6,000
Other	2,000	7,000	4,000
Total	$12,000	$15,000	$10,000
Adjusted basis of property transferred	(9,000)	(6,000)	(3,000)
Gain (Loss) realized	$ 3,000	$ 9,000	$ 7,000
Boot received	$ 2,000		
Gain recognized		$ 1,000	$ 0
Lesser of gain realized or boot received	$ 2,000		

B must recognize a $2,000 gain. Although the transaction is generally nontaxable under § 351, a transferor must recognize gain to the extent that he receives boot, but not to exceed the realized gain. In this case, B receives boot of $2,000 and thus must recognize $2,000 of gain. Note that the gain would be ordinary income due to the recapture provisions of § 1245. (See Example 17 and p. 2-11.)

C must recognize income of $4,000. Section 351 applies only to transfers of property in exchange for stock or securities. For this purpose, property does not include services. Thus, § 351 does not apply to C's contribution of services in exchange for stock, and, therefore, C must recognize income equal to the value of the stock received for the services, $4,000. (See Example 9 and p. 2-8.)

D must recognize a gain of $1,000 ($7,000 − $6,000). Although D has effectively received cash to the extent he was relieved of the $7,000 liability, such relief is not considered boot under § 357(a). However, § 357(c), requiring gain to be recognized when the taxpayer is relieved of liabilities that exceed basis, does apply here. In this case, the total liabilities from which J was relieved, $7,000, exceeds the total basis of the property transferred, $6,000. (See Examples 21 and 22 and pp. 2-14 and 2-15.)

E does not recognize any gain or loss. Under § 357(c)(3), liabilities from which the taxpayer is relieved are considered liabilities only if their payment would be capitalized. As a result, routine deductible liabilities are ignored. (See Examples 23 and 24 and pp. 2-15 and 2-16.)

b. The corporation generally does not recognize any gain or loss on the issuance of stock or securities in exchange for property. However, in this case, it has issued stock in exchange for services. The corporation may treat the transfer of stock as if it paid cash for the services. Thus it is entitled to a deduction of $4,000. (See p. 2-18.)

c. The basis of stock and securities received in exchange for property under § 351 is generally a substituted basis as determined under § 358. In computing the shareholder's basis, liabilities—other than those which would give rise to a deduction when paid—are treated as boot. The basis of each shareholder's stock is computed below. (See Examples 26 and 27 and p. 2-17.)

		B	*C*	*D*	*E*
	Basis of property transferred	$ 9,000	$ 6,000	$ 6,000	$3,000
+	Gain recognized	2,000		1,000	
−	Boot received	(2,000)		(7,000)	
=	Basis of stock received for property	$ 9,000	$ 6,000	$ 0	$3,000
+	Basis of stock received for services		4,000		
			$10,000		

d. The corporation's basis of the property received in an exchange qualifying under § 351 is generally a carryover basis increased by any gain recognized by the shareholder as computed under § 362. (See Example 29 and p. 2-19.)

		B	*D*	*E*
	Basis of property transferred	$ 9,000	$6,000	$3,000
+	Gain recognized	2,000	1,000	
=	Basis of property to corporation	$11,000	$7,000	$3,000

e. The corporation would report income when it collects the receivables because it has a zero basis for such items. In addition, the corporation would be entitled to a deduction for the payment of the routine liabilities.

f. The corporation's gain on the sale would be $11,000 [$20,000 − ($11,000 original basis − $2,000 depreciation)]. Of this $11,000 gain, $6,000 would be recaptured as ordinary income under § 1245 and the $5,000 balance would be § 1231 gain. Note that the corporation not only must recapture the depreciation that it claimed of $2,000 but also the depreciation claimed by B which was not recaptured on the original exchange, $4,000 ($6,000 − $2,000). The recapture potential of the transferor carries over to the corporation to the extent the exchange is subject to § 351. (See p. 2-20.)

g. For purposes of the depreciation calculation, if prior to the contribution the property has been used in a trade or business, the corporation simply steps into the shoes of the transferor. The depreciation would be calculated in the same way that B normally computes it except that it must be allocated between B and the corporation for the year of the transfer. B could claim 4/12 of the annual depreciation while the corporation claims the remaining 8/12 which includes the month of the transfer, May. Note there is no short taxable year computation required when the property has been previously depreciated. (See Example 33 and p. 2-21.)

⋆ CHAPTER TWO ⋆

CORPORATE FORMATION AND CAPITAL STRUCTURE

SOLUTIONS TO TAX RETURN MATERIALS

2-48 This problem requires the preparation of the tax return of a newly formed corporation. As a result, the return covers not only the general mechanics used in preparing a corporate tax return, but also the rules governing basis for contributed property, organization expenses, depreciation of contributed property when there is a short taxable year, and allocation of depreciation between the contributor and the corporation.

Two other issues should be noted when assigning the problem:

- The improvements should be treated as nonresidential real property.
- Many students will note that the debits and credits do not balance, by $16,000. This occurs because no entry has actually been made to record ending inventory and cost of goods sold. The debit balance simply represents the remaining inventory.

Students commonly make errors on this problem relating to the following:

1. The short taxable year rules apply for depreciation purposes;
2. The basis of the stock carries over to the corporation for purposes of computing the corporation's gain on the sale;
3. The key-man insurance premium is not deductible;
4. Schedule M adjustments are not correct; and
5. The accrued bonus of $15,000 to Lisa Cutter is not deductible since she is considered a related party and the bonus was not paid by the close of the year.

The taxable income of the corporation is computed as follows:

Income:			
Sales		$ 600,000	
Cost of goods sold			
Beginning inventory	$ 0		
Purchases	300,000		
Ending inventory	(16,000)		
		84,000	
Gross profit		$ 316,000	
Other income:			
Dividends		2,000	
Gain on sale of stock ($38,000 − $8,000)		30,000	
Total income:			$ 348,000
Expenses:			
Compensation of officers		$ 60,000	
Salaries		45,000	
Repairs		6,500	
Taxes		20,500	
Interest		200	
Depreciation (Schedule 2)		21,139	
Advertising		8,600	
Other expenses (Schedule 3)		16,220	
Total deductions before contributions and dividends		$ 178,158	
Contributions			
Limitation: 10% ($348,000 − $178,158 = $169,842) (See Schedule 1)		+16,984	
Total deductions before dividends			(195,142)
Taxable income before dividends-received deduction:			$ 152,858
Dividends-received deduction ($2,000 × 70%)			(1,400)
Taxable income:			$ 151,458

Tax liability:

$50,000 × 15% = $ 7,500
$25,000 × 25% = $ 6,250
$25,000 × 34% = $ 8,500
$51,458 × 39% = $20,068
$42,318

Tax liability	$42,318
Prepayments	(48,000)
Tax overpayment	($5,682)

Under § 267, an accrual basis taxpayer can deduct an accrued expense to a related cash basis taxpayer only in the period in which the payment in included in the recipient's income. Here, Lisa is considered a related party since she owns more than 50 percent of the corporation (50% directly and 30% indirectly thru her mother, Tina). Therefore, the accrued bonus that has not been paid, $15,000, is not deductible currently, leaving $45,000 ($120,000 − $60,000 compensation to Lisa − $15,000 unpaid bonus) deductible.

Schedule 1. Contributions:

Contributions		$ 17,600
Taxable income before dividends received deduction and contribution ($348,000 − $178,158)	$ 169,842	
Ten percent limitation	× 10%	
Limit		(16,984)
Carryover		$ 616

Schedule 2. Depreciation. Note that because the company did not begin business until February, it has a short taxable year of 11 months. Thus, annual depreciation must be adjusted to reflect the short year for property other than real property.

Refrigeration equipment (7-year property):	
Cost	$15,000
Depreciation percentage (Appendix H)	×14.29%
	$ 2,143
Short taxable year (11/12)	×.9167
Depreciation	$ 1,965
Improvements and building:	
Improvements	$55,000
Building	15,000
Nonresidential real estate (no short year)	$70,000
Depreciation percentage (see Appendix H)	×2.247%
Depreciation	$ 1,573

Contributed equipment. Because the contributed equipment had previously been used in Jeff McMullen's business, the corporation steps into the shoes of McMullen and computes depreciation in the same manner that he would have. This annual amount must be allocated between the corporation and McMullen, with the corporation receiving the depreciation for the month of the transfer. Thus, the corporation is allowed 11/12 of the depreciation as shown below.

Carryover basis	$100,000
Statutory percentage (3rd year—see Appendix H)	× 19.20%
Annual depreciation	$ 19,200
Allocation between contributor and corporation (11/12)	×.9167
Depreciation	$ 17,601

Total depreciation:	
Refrigeration equipment	$ 1,965
Real property	1,573
Contributed equipment	17,601
Total depreciation	$21,139

Schedule 3. Other deductions:

Insurance			$ 9,000
Organization expenses*			
Legal	$5,500		
Accounting	3,000		
Incorporation fee paid to state	100		
Total	$8,600		
Expensed under § 248	(5,000)	5,000	
Balance	3,600		
Amortized over 180 months			
[11 months × ($3,600/180 = $20/month)		220	
Total			5,220
Miscellaneous			2,000
Total			$16,220

**Organization Expenses.* Section 248 permits both C and S corporations to deduct up to $5,000 of organization expenses incurred in the tax year in which business begins. The amount in excess of $5,000 is amortized over 180 months beginning in the month in which business begins. In this case, business begins in February and therefore 11 months of amortization is deducted.

Form **1120** Department of the Treasury Internal Revenue Service

U.S. Corporation Income Tax Return

For calendar year 2009 or tax year beginning Feb 1, 2009, ending Dec 31, 20 08
▶ See separate instructions.

OMB No. 1545-0123 **2009**

A Check if:
1a Consolidated return (attach Form 851) ☐
b Life/nonlife consolidated return ☐
2 Personal holding co. (attach Sch. PH) ☐
3 Personal service corp. (see instructions) ☐
4 Schedule M-3 attached ☐

Use IRS label. Otherwise, print or type.

Name: Slattery's Inc
Number, street, and room or suite no. If a P.O. box, see instructions.: 5432 Partridge Pl.
City or town, state, and ZIP code: Tulsa OK74105

B Employer identification number: 88-7654321
C Date incorporated: 02/01/2008
D Total assets (see instructions): $ 351,200.

E Check if: (1) ☐ Initial return (2) ☐ Final return (3) ☐ Name change (4) ☐ Address change

Income

Line	Description		Amount
1a	Gross receipts or sales 600,000. b Less returns and allowances c Bal ▶	1c	600,000.
2	Cost of goods sold (Schedule A, line 8)	2	284,000.
3	Gross profit. Subtract line 2 from line 1c	3	316,000.
4	Dividends (Schedule C, line 19)	4	2,000.
5	Interest	5	
6	Gross rents	6	
7	Gross royalties	7	
8	Capital gain net income (attach Schedule D (Form 1120))	8	30,000.
9	Net gain or (loss) from Form 4797, Part II, line 17 (attach Form 4797)	9	
10	Other income (see instructions—attach schedule)	10	
11	**Total income.** Add lines 3 through 10 ▶	11	348,000.

Deductions (See instructions for limitations on deductions.)

Line	Description		Amount
12	Compensation of officers (Schedule E, line 4) ▶	12	60,000.
13	Salaries and wages (less employment credits)	13	45,000.
14	Repairs and maintenance	14	6,500.
15	Bad debts	15	
16	Rents	16	
17	Taxes and licenses	17	20,500.
18	Interest	18	200.
19	Charitable contributions	19	16,984.
20	Depreciation from Form 4562 not claimed on Schedule A or elsewhere on return (attach Form 4562)	20	21,139.
21	Depletion	21	
22	Advertising	22	8,600.
23	Pension, profit-sharing, etc., plans	23	
24	Employee benefit programs	24	
25	Domestic production activities deduction (attach Form 8903)	25	16,220.
26	Other deductions (attach schedule) See Other Deductions Statement	26	195,143.
27	**Total deductions.** Add lines 12 through 26 ▶	27	152,857.
28	Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11	28	
29	**Less:** a Net operating loss deduction (see instructions) 29a		
	b Special deductions (Schedule C, line 20) 29b 1,400.	29c	1,400.

Tax, Refundable Credits, and Payments

Line	Description		Amount
30	**Taxable income.** Subtract line 29c from line 28 (see instructions)	30	151,457.
31	**Total tax** (Schedule J, line 10)	31	42,318.
32a	2008 overpayment credited to 2009 32a		
b	2009 estimated tax payments 32b 48,000.		
c	2009 refund applied for on Form 4466 32c ( ) d Bal ▶ 32d 48,000.		
e	Tax deposited with Form 7004 32e		
f	Credits: (1) Form 2439 (2) Form 4136 32f		
g	Refundable credits from Form 3800, line 19c, and Form 8827, line 8c 32g	32h	48,000.
33	Estimated tax penalty (see instructions). Check if Form 2220 is attached ▶ ☐	33	
34	**Amount owed.** If line 32h is smaller than the total of lines 31 and 33, enter amount owed	34	
35	**Overpayment.** If line 32h is larger than the total of lines 31 and 33, enter amount overpaid	35	5,682.
36	Enter amount from line 35 you want: **Credited to 2010 estimated tax** ▶ Refunded ▶	36	5,682.

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Lisa Cutter — Signature of officer | 2-27-10 — Date | PRESIDENT — Title

May the IRS discuss this return with the preparer shown below (see instructions)? ☐ Yes ☒ No

Paid Preparer's Use Only

Preparer's signature: Sherry L. Hartman | Date: 2-27-10 | Check if self-employed ☐ | Preparer's SSN or PTIN

Firm's name (or yours if self-employed), address, and ZIP code: S. L. HARTMAN, P.C., 777 DOMINION DR., TULSA, OK 74105
EIN 74 8326198
Phone no. (905) 627-8110

For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11450Q Form **1120** (2009)

Form 1120 (2009) Slattery's Inc 88-7654321 Page 2

Schedule A **Cost of Goods Sold** (see instructions)

1	Inventory at beginning of year	1	0.
2	Purchases	2	300,000.
3	Cost of labor	3	
4	Additional section 263A costs (attach schedule)	4	
5	Other costs (attach schedule)	5	
6	**Total.** Add lines 1 through 5	6	300,000.
7	Inventory at end of year	7	16,000.
8	**Cost of goods sold.** Subtract line 7 from line 6. Enter here and on page 1, line 2	8	284,000.

9a Check all methods used for valuing closing inventory:

(i) ☒ Cost

(ii) ☐ Lower of cost or market

(iii) ☐ Other (Specify method used and attach explanation.) ▶

b Check if there was a writedown of subnormal goods ▶ ☐

c Check if the LIFO inventory method was adopted this tax year for any goods (if checked, attach Form 970) ▶ ☐

d If the LIFO inventory method was used for this tax year, enter percentage (or amounts) of closing inventory computed under LIFO | 9d |

e If property is produced or acquired for resale, do the rules of section 263A apply to the corporation? ☐ Yes ☐ No

f Was there any change in determining quantities, cost, or valuations between opening and closing inventory? If "Yes," attach explanation ☐ Yes ☐ No

Schedule C **Dividends and Special Deductions** (see instructions)

		(a) Dividends received	(b) %	(c) Special deductions (a) × (b)
1	Dividends from less-than-20%-owned domestic corporations (other than debt-financed stock)	2,000.	70	1,400.
2	Dividends from 20%-or-more-owned domestic corporations (other than debt-financed stock)		80	
3	Dividends on debt-financed stock of domestic and foreign corporations			
4	Dividends on certain preferred stock of less-than-20%-owned public utilities		42	
5	Dividends on certain preferred stock of 20%-or-more-owned public utilities		48	
6	Dividends from less-than-20%-owned foreign corporations and certain FSCs		70	
7	Dividends from 20%-or-more-owned foreign corporations and certain FSCs		80	
8	Dividends from wholly owned foreign subsidiaries		100	
9	**Total.** Add lines 1 through 8. See instructions for limitation			1,400.
10	Dividends from domestic corporations received by a small business investment company operating under the Small Business Investment Act of 1958		100	
11	Dividends from affiliated group members		100	
12	Dividends from certain FSCs		100	
13	Dividends from foreign corporations not included on lines 3, 6, 7, 8, 11, or 12			
14	Income from controlled foreign corporations under subpart F (attach Form(s) 5471)			
15	Foreign dividend gross-up			
16	IC-DISC and former DISC dividends not included on lines 1, 2, or 3			
17	Other dividends			
18	Deduction for dividends paid on certain preferred stock of public utilities			
19	**Total dividends.** Add lines 1 through 17. Enter here and on page 1, line 4 ▶	2,000.		
20	**Total special deductions.** Add lines 9, 10, 11, 12, and 18. Enter here and on page 1, line 29b ▶			1,400.

Schedule E **Compensation of Officers** (see instructions for page 1, line 12)

Note: *Complete Schedule E only if total receipts (line 1a plus lines 4 through 10 on page 1) are $500,000 or more.*

	(a) Name of officer	(b) Social security number	(c) Percent of time devoted to business	Percent of corporation stock owned (d) Common	(e) Preferred	(f) Amount of compensation
1	Lisa Cutter	444-33-2222	90.0 %	50.0 %	%	60,000.
	123 Any Drive		%	%	%	
	Tulsa, OK		%	%	%	
			%	%	%	
			%	%	%	

2	Total compensation of officers	60,000.
3	Compensation of officers claimed on Schedule A and elsewhere on return	
4	Subtract line 3 from line 2. Enter the result here and on page 1, line 12	60,000.

Form **1120** (2009)

Form 1120 (2009) Slattery's Inc 88-7654321 Page 3

Schedule J Tax Computation (see instructions)

1	Check if the corporation is a member of a controlled group (attach Schedule O (Form 1120)) ▶ ☐				
2	Income tax. Check if a qualified personal service corporation (see instructions) ▶ ☐			2	42,318.
3	Alternative minimum tax (attach Form 4626)			3	
4	Add lines 2 and 3			4	42,318.
5a	Foreign tax credit (attach Form 1118)	5a			
b	Credit from Form 8834, line 29	5b			
c	General business credit (attach Form 3800)	5c			
d	Credit for prior year minimum tax (attach Form 8827)	5d			
e	Bond credits from Form 8912	5e			
6	**Total credits.** Add lines 5a through 5e			6	
7	Subtract line 6 from line 4			7	42,318.
8	Personal holding company tax (attach Schedule PH (Form 1120))			8	
9	Other taxes. Check if from: ☐ Form 4255 ☐ Form 8611 ☐ Form 8697 ☐ Form 8866 ☐ Form 8902 ☐ Other (attach schedule)			9	
10	**Total tax.** Add lines 7 through 9. Enter here and on page 1, line 31			10	42,318.

Schedule K Other Information (see instructions)

		Yes	No
1	Check accounting method: **a** ☐ Cash **b** ☒ Accrual **c** ☐ Other (specify) ▶		
2	See the instructions and enter the:		
a	Business activity code no. ▶ 722110		
b	Business activity ▶ RESTAURANT		
c	Product or service ▶ FOOD		
3	Is the corporation a subsidiary in an affiliated group or a parent-subsidiary controlled group?		X
	If "Yes," enter name and EIN of the parent corporation ▶		
4	At the end of the tax year:		
a	Did any foreign or domestic corporation, partnership (including any entity treated as a partnership), trust, or tax-exempt organization own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of the corporation's stock entitled to vote? If "Yes," complete Part I of Schedule G (Form 1120) (attach Schedule G)		X
b	Did any individual or estate own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of the corporation's stock entitled to vote? If "Yes", complete Part II of Schedule G (Form 1120) (attach Schedule G)		X
5	At the end of the tax year, did the corporation:	Yes	No
a	Own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of stock entitled to vote of any foreign or domestic corporation not included on **Form 851,** Affiliations Schedule? For rules of constructive ownership, see instructions If "Yes," complete (i) through (iv).	X	

(i) Name of Corporation	**(ii)** Employer Identification Number (if any)	**(iii)** Country of Incorporation	**(iv)** Percentage Owned in Voting Stock

Form **1120** (2009)

Form 1120 (2009) Page 4

Schedule K *Continued*

		Yes	No
b	Own directly an interest of 20% or more, or own, directly or indirectly, an interest of 50% or more in any foreign or domestic partnership (including an entity treated as a partnership) or in the beneficial interest of a trust? For rules of constructive ownership, see instructions If "Yes," complete (i) through (iv).	X	

(i) Name of Entity	**(ii)** Employer Identification Number (if any)	**(iii)** Country of Organization	**(iv)** Maximum Percentage Owned in Profit, Loss, or Capital

		Yes	No
6	During this tax year, did the corporation pay dividends (other than stock dividends and distributions in exchange for stock) in excess of the corporation's current and accumulated earnings and profits? (See sections 301 and 316.)		X
	If "Yes," file **Form 5452,** Corporate Report of Nondividend Distributions. If this is a consolidated return, answer here for the parent corporation and on Form 851 for each subsidiary.		
7	At any time during the tax year, did one foreign person own, directly or indirectly, at least 25% of **(a)** the total voting power of all classes of the corporation's stock entitled to vote or **(b)** the total value of all classes of the corporation's stock?		X
	For rules of attribution, see section 318. If "Yes," enter: **(i)** Percentage owned ▶ ____ and **(ii)** Owner's country ▶ ____ **(c)** The corporation may have to file **Form 5472,** Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business. Enter the number of Forms 5472 attached ▶____		
8	Check this box if the corporation issued publicly offered debt instruments with original issue discount ▶ ☐ If checked, the corporation may have to file **Form 8281,** Information Return for Publicly Offered Original Issue Discount Instruments.		
9	Enter the amount of tax-exempt interest received or accrued during the tax year ▶ $ ____		
10	Enter the number of shareholders at the end of the tax year (if 100 or fewer) ▶ ____		
11	If the corporation has an NOL for the tax year and is electing to forego the carryback period, check here ▶ ☐ If the corporation is filing a consolidated return, the statement required by Regulations section 1.1502-21(b)(3) must be attached or the election will not be valid.		
12	Enter the available NOL carryover from prior tax years (do not reduce it by any deduction on line 29a.) ▶ $ ____		
13	Are the corporation's total receipts (line 1a plus lines 4 through 10 on page 1) for the tax year **and** its total assets at the end of the tax year less than $250,000?		X
	If "Yes," the corporation is not required to complete Schedules L, M-1, and M-2 on page 5. Instead, enter the total amount of cash distributions and the book value of property distributions (other than cash) made during the tax year. ▶ $		

Form **1120** (2009)

Form 1120 (2009) Slattery's Inc 88-7654321 Page **5**

Schedule L **Balance Sheets per Books**

Assets	Beginning of tax year (a)	(b)	End of tax year (c)	(d)
1 Cash				229,200.
2a Trade notes and accounts receivable				
b Less allowance for bad debts	( )		( )	
3 Inventories				16,000.
4 U.S. government obligations				
5 Tax-exempt securities (see instructions)				
6 Other current assets (attach schedule)				
7 Loans to shareholders				
8 Mortgage and real estate loans				
9 Other investments (attach schedule)				
10a Buildings and other depreciable assets			105,000.	
b Less accumulated depreciation	( )		(9,000.)	96,000.
11a Depletable assets				
b Less accumulated depletion	( )	FIRST YEAR	( )	
12 Land (net of any amortization)		CORPORATION		10,000.
13a Intangible assets (amortizable only)				
b Less accumulated amortization	( )		( )	
14 Other assets (attach schedule)				
15 Total assets				351,200.
Liabilities and Shareholders' Equity				
16 Accounts payable				45,000.
17 Mortgages, notes, bonds payable in less than 1 year				93,000.
18 Other current liabilities (attach schedule)				28,000.
19 Loans from shareholders				
20 Mortgages, notes, bonds payable in 1 year or more				
21 Other liabilities (attach schedule)				
22 Capital stock: a Preferred stock				
b Common stock			100,000.	100,000.
23 Additional paid-in capital				
24 Retained earnings—Appropriated (attach schedule)				
25 Retained earnings—Unappropriated				85,200.
26 Adjustments to shareholders' equity (attach schedule)				
27 Less cost of treasury stock		( )		( )
28 Total liabilities and shareholders' equity				351,200.

Schedule M-1 **Reconciliation of Income (Loss) per Books With Income per Return**

Note: Schedule M-3 required instead of Schedule M-1 if total assets are $10 million or more—see instructions

1 Net income (loss) per books	85,200.	7 Income recorded on books this year not included on this return (itemize): Tax-exempt interest $	
2 Federal income tax per books	48,000.		
3 Excess of capital losses over capital gains			
4 Income subject to tax not recorded on books this year (itemize): See Line 4 Statement 12,000.	12,000.	8 Deductions on this return not charged against book income this year (itemize):	
5 Expenses recorded on books this year not deducted on this return (itemize):		a Depreciation $ 12,139.	
a Depreciation $		b Charitable contributions $	
b Charitable contributions $ 616.			
c Travel and entertainment $			
See Line 5 Statement 19,180.	19,796.	9 Add lines 7 and 8	12,139.
6 Add lines 1 through 5	164,996.	10 Income (page 1, line 28)—line 6 less line 9	152,857.

Schedule M-2 **Analysis of Unappropriated Retained Earnings per Books (Line 25, Schedule L)**

1 Balance at beginning of year		5 Distributions: a Cash	
2 Net income (loss) per books	85,200.	b Stock	
3 Other increases (itemize):		c Property	
		6 Other decreases (itemize):	
		7 Add lines 5 and 6	
4 Add lines 1, 2, and 3	85,200.	8 Balance at end of year (line 4 less line 7)	85,200.

Form **1120** (2009)

Slattery's Inc 88-7654321 1

Form 1120, Page 1, Line 26
Other Deductions Statement

Insurance	*9,000.*
Amortization	*5,220.*
Miscellaneous	*2,000.*
Total	*16,220.*

Form 1120, Schedule K, Corporation Ownership Information
Ques 5 Stmt

Name	ID No.
Lisa Cutter	*444-33-2222*

Form 1120, Page 4, Schedule M-1, Line 4
Ln 4 Stmt

Gain on sale of stock	*12,000.*
Total	*12,000.*

Form 1120, Page 4, Schedule M-1, Line 5
Ln 5 Stmt

Amortization (8,600 – 5,220)	*3,380.*
Life Insurance Premiums	*800.*
Accrued salary	*15,000.*
Total	*19,180.*

Form **4562** — Department of the Treasury, Internal Revenue Service (99)

Depreciation and Amortization
(Including Information on Listed Property)

▶ See separate instructions. ▶ Attach to your tax return.

OMB No. 1545-0172 — **2009** — Attachment Sequence No. **67**

Name(s) shown on return	Business or activity to which this form relates	Identifying number
SLATTERY'S INC.	RESTAURANT	88-7654321

Part I — Election To Expense Certain Property Under Section 179
Note: *If you have any listed property, complete Part V before you complete Part I.*

		Line	Amount
1	Maximum amount. See the instructions for a higher limit for certain businesses	1	$250,000
2	Total cost of section 179 property placed in service (see instructions)	2	
3	Threshold cost of section 179 property before reduction in limitation (see instructions)	3	$800,000
4	Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-	4	
5	Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see instructions	5	

6	(a) Description of property	(b) Cost (business use only)	(c) Elected cost

		Line	Amount
7	Listed property. Enter the amount from line 29	7	
8	Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7	8	
9	Tentative deduction. Enter the **smaller** of line 5 or line 8	9	
10	Carryover of disallowed deduction from line 13 of your 2008 Form 4562	10	
11	Business income limitation. Enter the smaller of business income (not less than zero) or line 5 (see instructions)	11	
12	Section 179 expense deduction. Add lines 9 and 10, but do not enter more than line 11	12	
13	Carryover of disallowed deduction to 2010. Add lines 9 and 10, less line 12 ▶	13	

Note: *Do not use Part II or Part III below for listed property. Instead, use Part V.*

Part II — Special Depreciation Allowance and Other Depreciation (Do not include listed property.**)** (See instructions.)

		Line	Amount
14	Special depreciation allowance for qualified property (other than listed property) placed in service during the tax year (see instructions)	14	
15	Property subject to section 168(f)(1) election CONTRIBUTED EQUIPMENT	15	17,601
16	Other depreciation (including ACRS) $100,000 X 19.2% X	16	

Part III — MACRS Depreciation (Do not include listed property.**)** (See instructions.)

Section A

		Line	Amount
17	MACRS deductions for assets placed in service in tax years beginning before 2009	17	
18	If you are electing to group any assets placed in service during the tax year into one or more general asset accounts, check here ▶ ☐		

Section B—Assets Placed in Service During 2009 Tax Year Using the General Depreciation System

(a) Classification of property	(b) Month and year placed in service	(c) Basis for depreciation (business/investment use only—see instructions)	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
19a 3-year property		REFRIG.EQUIP				$ 15,000
b 5-year property		15,000	7 YRS		DDB	X 14.29%
c 7-year property						1,965 X 1112
d 10-year property						SHORT
e 15-year property						YEAR
f 20-year property						
g 25-year property		GAS STATION	25 yrs.		S/L	
h Residential rental property		IMPROVEMENTS	27.5 yrs.	MM	S/L	
	2-05	70,000	27.5 yrs.	MM	S/L	$ 70,000
i Nonresidential real property			39 yrs.	MM	S/L	1,573 X 2.247%
				MM	S/L	

Section C—Assets Placed in Service During 2009 Tax Year Using the Alternative Depreciation System

(a) Classification of property	(b)	(c)	(d)	(e)	(f)	(g)
20a Class life					S/L	
b 12-year			12 yrs.		S/L	
c 40-year			40 yrs.	MM	S/L	

Part IV — Summary (See instructions.)

		Line	Amount
21	Listed property. Enter amount from line 28	21	
22	**Total.** Add amounts from line 12, lines 14 through 17, lines 19 and 20 in column (g), and line 21. Enter here and on the appropriate lines of your return. Partnerships and S corporations—see instructions	22	21,139
23	For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs	23	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 12906N Form **4562** (2009)

Form 4562 (2009) SLATTERY'S INC. Page 2

Part V **Listed Property** (Include automobiles, certain other vehicles, cellular telephones, certain computers, and property used for entertainment, recreation, or amusement.)

Note: *For any vehicle for which you are using the standard mileage rate or deducting lease expense, complete* ***only*** *24a, 24b, columns (a) through (c) of Section A, all of Section B, and Section C if applicable.*

Section A—Depreciation and Other Information (Caution: *See the instructions for limits for passenger automobiles.)*

24a Do you have evidence to support the business/investment use claimed? ☐ **Yes** ☐ **No** **24b** If "Yes," is the evidence written? ☐ **Yes** ☐ **No**

(a) Type of property (list vehicles first)	(b) Date placed in service	(c) Business/ investment use percentage	(d) Cost or other basis	(e) Basis for depreciation (business/investment use only)	(f) Recovery period	(g) Method/ Convention	(h) Depreciation deduction	(i) Elected section 179 cost
25 Special depreciation allowance for qualified listed property placed in service during the tax year and used more than 50% in a qualified business use (see instructions)						**25**		
26 Property used more than 50% in a qualified business use:								
		%						
		%						
		%						
27 Property used 50% or less in a qualified business use:								
		%				S/L –		
		%				S/L –		
		%				S/L –		
28 Add amounts in column (h), lines 25 through 27. Enter here and on line 21, page 1 . . .						**28**		
29 Add amounts in column (i), line 26. Enter here and on line 7, page 1							**29**	

Section B—Information on Use of Vehicles

Complete this section for vehicles used by a sole proprietor, partner, or other "more than 5% owner," or related person. If you provided vehicles to your employees, first answer the questions in Section C to see if you meet an exception to completing this section for those vehicles.

	(a) Vehicle 1		(b) Vehicle 2		(c) Vehicle 3		(d) Vehicle 4		(e) Vehicle 5		(f) Vehicle 6	
30 Total business/investment miles driven during the year (**do not** include commuting miles)												
31 Total commuting miles driven during the year												
32 Total other personal (noncommuting) miles driven												
33 Total miles driven during the year. Add lines 30 through 32												
	Yes	**No**	**Yes**	**No**	**Yes**	**No**	**Yes**	**No**	**Yes**	**No**	**Yes**	**No**
34 Was the vehicle available for personal use during off-duty hours?												
35 Was the vehicle used primarily by a more than 5% owner or related person?												
36 Is another vehicle available for personal use?												

Section C—Questions for Employers Who Provide Vehicles for Use by Their Employees

Answer these questions to determine if you meet an exception to completing Section B for vehicles used by employees who **are not** more than 5% owners or related persons (see instructions).

	Yes	**No**
37 Do you maintain a written policy statement that prohibits all personal use of vehicles, including commuting, by your employees?		
38 Do you maintain a written policy statement that prohibits personal use of vehicles, except commuting, by your employees? See the instructions for vehicles used by corporate officers, directors, or 1% or more owners . . .		
39 Do you treat all use of vehicles by employees as personal use?		
40 Do you provide more than five vehicles to your employees, obtain information from your employees about the use of the vehicles, and retain the information received?		
41 Do you meet the requirements concerning qualified automobile demonstration use? (See instructions.) . .		

Note: *If your answer to 37, 38, 39, 40, or 41 is "Yes," do not complete Section B for the covered vehicles.*

Part VI **Amortization**

(a) Description of costs	(b) Date amortization begins	(c) Amortizable amount	(d) Code section	(e) Amortization period or percentage	(f) Amortization for this year
42 Amortization of costs that begins during your 2009 tax year (see instructions):					
43 Amortization of costs that began before your 2009 tax year				**43**	
44 **Total.** Add amounts in column (f). See the instructions for where to report				**44**	

Form **4562** (2009)

⋆ Contents ⋆

Chapter		Page
1.	Income Taxation of Corporations	**1-1**
2.	Corporate Formation and Capital Structure	**2-1**
3.	Corporate Distributions: Cash, Property, and Stock Dividends	**3-1**
4.	Corporate Distributions: Stock Redemptions and Partial Liquidations	**4-1**
5.	Complete Liquidations	**5-1**
6.	Penalty Taxes on Corporate Accumulations	**6-1**
7.	Corporate Reorganizations	**7-1**
8.	Consolidated Tax Returns	**8-1**
9.	Taxation of Partnerships and Partners	**9-1**
10.	Partnership Distributions, Dispositions of Partnership Interests, and Partnership Terminations	**10-1**
11.	S Corporations	**11-1**
12.	International Taxation	**12-1**
13.	State and Local Taxation	**13-1**
14.	Estate and Gift Taxation	**14-1**
15.	Income Taxation of Estates and Trusts	**15-1**
16.	Family Tax Planning	**16-1**
17.	Sources and Applications of Federal Tax Law	**17-1**
18.	Tax Practice and Procedure	**18-1**

Taxation Series

Instructor's Resource Guide and Test Bank to Accompany

Corporate, Partnership, Estate and Gift Taxation

2011 Edition

James W. Pratt
William N. Kulsrud

www.cengage.com/taxation/pratt

⋆ Contents ⋆

Chapter		Page
1.	Income Taxation of Corporations	1-1
2.	Corporate Formation and Capital Structure	2-1
3.	Corporate Distributions: Cash, Property, and Stock Dividends	3-1
4.	Corporate Distributions: Stock Redemptions and Partial Liquidations	4-1
5.	Complete Liquidations	5-1
6.	Penalty Taxes on Corporate Accumulations	6-1
7.	Corporate Reorganizations	7-1
8.	Consolidated Tax Returns	8-1
9.	Taxation of Partnerships and Partners	9-1
10.	Partnership Distributions, Dispositions of Partnership Interests, and Partnership Terminations	10-1
11.	S Corporations	11-1
12.	International Taxation	12-1
13.	State and Local Taxation	13-1
14.	Estate and Gift Taxation	14-1
15.	Income Taxation of Estates and Trusts	15-1
16.	Family Tax Planning	16-1
17.	Sources and Applications of Federal Tax Law	17-1
18.	Tax Practice and Procedure	18-1

CHAPTER TWO

CORPORATE FORMATION AND CAPITAL STRUCTURE

LECTURE OUTLINE

I. INTRODUCTION

In the interest of time, the professor might want to ignore this background material and start with transfers to controlled corporations.

A. Review advantages of incorporation.

Note. Before discussing the intricacies of § 351 and related provisions, it may prove useful to point out some tax and nontax advantages of the corporate form that serve as the motivation for incorporation. If some of the advantages of the corporate form were mentioned while discussing Chapter 1 or at this point, a brief review of these advantages could serve as a point of departure. One could then proceed on the basis that "we have decided to incorporate."

1. Tax advantages.
    a. Income splitting between owner and corporation.
        1. Income can be split between the owner and corporation such that it would be taxed at the lowest marginal rate.
        2. Splitting could be accomplished by paying the owner a salary, rents on property leased to the corporation, or interest on funds loaned to the corporation.
    b. Multiple corporations and income splitting.
        1. Income could be split between multiple corporations such that none of the corporations receive more than $50,000. By so doing, the top rate of tax paid would be 15 percent.
        2. Splitting must be done in light of the rules governing controlled groups. If ownership is arranged in the proper manner, the controlled group rules can be avoided.
        3. It was not uncommon before 1969 to find corporations with numerous subsidiaries, none of which earned more than the amount of the lowest bracket of income. This possibility still exists to a limited extent.
    c. Accumulating earnings.
        1. Earnings could be accumulated in the corporation to be taxed at corporate tax rates if lower than the shareholder's rate. Accumulations may be temporary, however, due to the accumulated earnings tax.
        2. The accumulated earnings tax provisions allow at least $250,000 ($150,000 for personal service corporations) to be accumulated before the tax becomes applicable Chapter 6. Thus, annual accumulations of $25,000 income could be taxed at the lowest corporate rate for as long as ten years.
    d. Dividend-received deduction.
        1. A taxpayer can incorporate his or her portfolio and reduce the amount of tax that must be paid on dividend income by utilizing the dividends-received deduction.
        2. This must be done in light of the personal holding company rules discussed in Chapter 6, but, with proper monitoring, this benefit can be obtained.
    e. Fringe benefits available only for employees.
        1. Certain fringe benefits are available only to employees and conversely unavailable to those who are not employees, most importantly sole proprietors, partners, and greater than 2 percent S corporate shareholders.

2. To obtain employee status and concomitantly desirable fringe benefits, the taxpayer must incorporate and operate as a C (regular) corporation. Some of the more valuable employee exclusions are for
   a. Meals and lodging;
   b. Health insurance premiums; and
   c. Group term life insurance premium payments.
   d. Participants in a corporate pension plan may borrow from the plan while loans from Keogh plans or to S shareholders are prohibited.
2. Nontax advantages include
   a. Limited liability;
   b. Free transferability of interest;
   c. Centralized management; and
   d. Continuity of interest.

B. At this point, a brief review of the process and costs of incorporation in your state may be appropriate.

II. GENERAL CONSIDERATIONS UPON INCORPORATION

A. Asset transfers.

1. To commence business operations, a corporation must have assets. Therefore, the first consideration involves the specific assets that should be transferred.
   a. It is unnecessary for incorporators to transfer to the corporation all of the assets it needs to operate.
   b. The corporation could simply lease assets or borrow funds to acquire assets.

Example. Leasing would be advantageous if depreciation would benefit the transferor more than it would the corporation (e.g., when the transferor is in a higher tax bracket). Note also that leasing and loaning can be used to siphon earnings out of the corporation without the penalty of double taxation.

B. The second consideration concerns the method used by the corporation to acquire the assets it will need to operate its business. It is obvious from the reading that taxes do not necessarily have to interfere with incorporation. A business can be incorporated tax-free. However, this might not be the most desirable course. As suggested above, not all assets need to be contributed outright in exchange for stock. The corporation could obtain the assets for debt and obtain all the attendant advantages of debt (e.g., the tax-free repayment of principal, the deductibility of interest, and a reason for accumulating earnings, but gain may be recognized since debt is now considered boot). Alternatively, some assets could be leased. Still other assets could be purchased from the transferor.

Note. At this point, instructors may wish to at least mention the purchase possibility, thus providing background for discussion of intentional avoidance of § 351 (e.g., to obtain the advantage of a step-up in basis at the cost of what historically has been a favorable capital gains tax), and, thus, the rationale for § 1239 (requiring characterization of income as ordinary on certain sales) and the denial of installment sale privileges between corporations and their shareholders.

III. TRANSFERS TO A CONTROLLED CORPORATION IN GENERAL

A. The transaction. A simple illustration of a transfer to a corporation (sometimes it is useful to diagram the transaction on the board or with a transparency) can be used to identify the considerations.

Example. If **J** decides to incorporate and simply transfers $ 1,000 cash to the corporation in exchange for stock, it is nothing more than a purchase. J has a basis in his stock of $1,000 and the corporation has $1,000 cash. On the other hand, if J transfers assets worth $1,000 and a basis of $100 in exchange for stock, a whole set of problems arises.

B. General rules governing exchanges (§1001). Absent a special rule, a transfer to a corporation in exchange for stock would be considered a taxable disposition. Note that this is what occurs if the transaction does not meet the nonrecognition provisions of § 351 (e.g., the 80% is failed, or the transferor contributes only services). *Note:* Many students do not understand the exact result if the transaction is taxable.

1. If the exchange is a disposition under § 1001, gain or loss normally must be recognized.

   Example. Referring to the illustration above, J realized a $900 gain ($1,000 — $100) that must be recognized unless a special rule provides otherwise.

2. Basis under § 1012 is cost.

   Example. Referring to the illustration above, J has a cost basis in his stock of $1,000 under § 1012. Similarly, the corporation has a basis of $1,000 for the asset.

3. Section 1001 could impede routine incorporations by making the exchange taxable.

C. Nontaxable transaction per § 351.

1. Practical considerations.
   a. Section 351 removes taxes as a factor in the choice of business form. As noted above, without a special rule, a routine incorporation would be a taxable transaction, and, thus, tax considerations would interfere with the taxpayer's choice of business form.
   b. Section 351 also eliminates artificial losses. Absent this rule, a taxpayer could contribute loss property to a corporation and recognize a loss even though the property remains under his or her control.
2. Theoretical considerations: continuity of interest.
   a. The theory for not recognizing gain or loss under § 351 is the same as for other nonrecognition provisions; that is, there has been a mere change in the form of ownership. The taxpayer has not liquidated his or her investment.
   b. For those who want to pursue the validity of this argument further, it can be pointed out that in some cases the nature of a transferor's interest could change dramatically (e.g., when one shareholder contributes equipment and the other contributes land). Note that each stockholder now owns an undivided interest in the assets contributed by the other, clearly altering the form of their investment. Despite this inconsistency, the Code ignores these problems and permits nonrecognition.

IV. SECTION 351: REQUIREMENTS FOR NONRECOGNITION

A. General rule.

1. Section 351(a). No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation, and, immediately after the exchange, such person or persons are in control.

   Note. This rule applies to contributions to newly organized corporations as well as existing corporations.

B. Mandatory tax consequences.

1. No gain or loss is recognized by the transferor.
2. No gain or loss is recognized by the corporation.
3. The corporation assumes the transferor's basis for property received (carryover basis).

4. The shareholder substitutes the basis of property transferred as his or her basis for stock received (substituted basis).

Example. These rules might be illustrated by referring back to the original example above involving J who transferred property worth $1,000 with a basis of $100 in exchange for stock. In such case, J would not recognize any of his realized gain of $900 ($1,000 — $100) and the basis in his stock would be $100. Similarly, the corporation recognizes no gain under § 1032 and its basis in the property would be $100. The gain not recognized is not excluded but merely deferred. The gain is preserved by assigning a basis to the assets such that, if they were sold for the value for which they were contributed, the deferred gains and losses would be recognized.

For example, if J's stock is sold for its value of $1,000, J recognizes a $900 gain due to his substituted basis of $100. Note, however, that the character of the asset does not transfer to J's stock and the gain would be capital gain. Thus, the possibility for converting ordinary income into capital gain exists. Of course, this arrangement is subject to IRS scrutiny and to the collapsible corporation rules.

It also might be noted that the corporation would recognize a $900 gain upon a subsequent sale of the property since it steps into the shoes of J, taking J's $100 basis. Students rarely have problems understanding the subsequent recognition of gain by the corporation or the shareholder gain when each is considered separately. However, they typically question the equity of taxing the gain twice; e.g., if the shareholder sold the stock and the corporation sold the property, in effect the gain attributable to the property is taxed twice. Steps could be taken to eliminate this possibility, e.g., legislation allowing an increase in the basis of the stock for any gain recognized by the corporation upon subsequent sale and vice versa. However, this adjustment could become cumbersome. Suffice it to say that this phenomenon is part of the double taxation trap that incorporation brings. It also suggests that appreciated property or property that may appreciate should never be contributed to the corporation.

C. Critical requirements for application.

1. Transfer of property. Only transferors of "property" are granted nonrecognition treatment.
2. The transfer must be in exchange "solely" for stock. This requirement allows nonrecognition treatment only if the transferor has not cashed in, i.e., only stock is received. Nevertheless, there is an exception for boot.
3. The transferors must be in control immediately after the exchange. This requirement ensures that nonrecognition is allowed only if the transferor has a continuing stake in the business; continuity of interest is maintained.

D. Meaning of property.

1. The term *property* is not specifically defined in the Code but is broadly construed to embrace virtually everything but services. Thus, virtually all assets, including money, qualify as property.
2. Property includes installment obligations. The transfer of an installment note to a corporation does not trigger gain.
3. Property does not include services.
   a. It is not unusual for stock to be awarded for services. Stock is often given as compensation to an attorney or accountant upon formation when the corporation is cash poor and the individual is willing to take a stake in the business (particularly true in the technology business, i.e., Silicon Valley). The need for using stock as compensation also arises when a technical person with a process, equipment, or some other property joins forces with an investor and a manager. Both the technical person and the investor have property to contribute for their interest. However, the manager may have insufficient cash or other property to contribute. Yet he or she may demand an equity interest before contributing services and expertise. (Note that using restricted stock may be feasible if it is desirable to maintain the services of an individual.) In these or similar

situations, the organizers must observe the rules of §351 relating to service shareholders carefully if they want to avoid taxation. b. Services are not treated as property primarily because the contribution of services is not viewed as a contribution of capital in which the contributor has a continuing interest. Presumably, the exchange is more properly viewed as compensation for work performed followed by a purchase of stock. Thus, it should be subject to taxation under the rules of §§ 61 and 83 (relating to property received as compensation).

E. Control.

1. For control to exist, those that transfer property must own at least:
   a. 80 percent of the total combined voting power; and
   b. 80 percent of the total number of each class to another level, consider the consequences of nonvoting stock.

   The technical definition of control is rarely an issue since most of the time only one class of stock (e.g., common) is issued. (However, for those instructors who want to take the class to another level, consider the consequences where A gives property for common and B gives services for preferred.)
2. Control must exist immediately after the exchange.

   Example. Assume A and B have agreed to join together to form a corporation. Both will contribute assets in exchange for all of the stock. What if A transfers assets today and receives 80% the stock while B transfers assets tomorrow and receives the other 20%?'s transfer will qualify for nonrecognition since it is a part of a prearranged plan that will result in the transferors owning 80% the transfers have been made. But B's transfer must be timely. The Regulations indicate that the transfers will be aggregated only if the plan is carried out in an expeditious fashion. Note, however, that B may want to avoid § 351 to recognize losses and, consequently, delay her contribution. In such case, A would still qualify since he owned 100% his transfer.

   a. A prearranged plan must be carried out expeditiously.
   b. Control cannot be momentary or fleeting.

   Example. Subsequent transfers immediately after the exchange may disqualify the transfer if they are sufficient to cause the transferor to lose control. In *Wilgard Realty Co.,* the taxpayer acquired all of the stock of a new corporation and then gave away 75% to members of his family on the same day. The court said control existed since the taxpayer was free to dispose of his stock upon its receipt. Thus, as long as there is no binding obligation for a transferor to dispose of the stock upon receipt, he or she still has control. (See also Revenue Ruling 79-70 1979-1 C.B. 144 and *Fahs v. Florida Machine & Foundry Co.)*
3. When a shareholder performs services for stock, tax consequences may change.
   a. Contributions solely of services for stock.
      1. If a shareholder contributes *solely* services, his or her shares are not counted toward control but are included in the total number of shares outstanding.
      2. The receipt of stock in exchange for services is treated as compensation and is taxable to the service shareholder subject to § 83 concerning restricted stock.
   b. Contributions of both services and property for stock.
      1. If a shareholder contributes both property and services, all of the shares received are counted towards control, not just those that represent the value of the contributed property.
      2. The transferor is taxable on the amount of stock received for services in any event.
   c. Nominal transfers of property.
      1. Note that a strict interpretation of the above rule would permit the service shareholder's shares to be counted towards the 80 percent test even if he or she were to give only $1 of property.

2. The IRS is armed to address such a problem since the Regulations provide that nominal transfers of property are to be disregarded. The IRS has ruled that the contributed property must be at least 10 percent of the value of the services. 4. Property transfers for stock may be made after incorporation. Preexisting stock ownership is included to determine if control has been achieved.

> **Example.** Assume that B, an owner of the corporation, is willing to admit a new shareholder, C, if C will contribute certain desirable property she now holds. C will contribute the property for her interest only if she does not recognize gain. B may accommodate the prospective shareholder's wishes by contributing property so that his preexisting ownership can be counted toward control, and, thereby, achieve nonrecognition. However, the Regulations provide that in such cases nominal transfers of property should be disregarded. Revenue Procedure 77-37 indicates that the property's value must be equal to at least 10% the value of the stock and securities already owned by the transferor.

F. Solely for stock.

1. The exchange is nontaxable only if the shareholder receives stock. This requirement merely represents codification of the continuity of interest concept.
2. Definition of stock.
   a. Stock includes common, preferred, voting, and nonvoting stock.
   b. Stock does not include rights, warrants, options, or convertible bonds. These items are not included since the transferor does not receive an equity interest but only the right to obtain one, thus violating the continuity of interest concept.

V. TREATMENT OF BOOT

A. Gain is recognized to the extent of boot received. What if the shareholder receives property other than stock? Does this make the entire transaction taxable? Although § 351(a) provides nonrecognition only if the transferor receives solely stock, § 351(b) relaxes this rule requiring gain recognition only to the extent the transferor has "cashed in," clearly changing the form of his or her investment. Note that the gain not recognized is only deferred by virtue of the basis rules of § 358.

1. Section 1239.
   a. Income is ordinary on the transfer of depreciable property between a shareholder and his or her more than 50-percent-owned corporation.
   b. This rule was designed to prohibit the taxpayer from obtaining a step up in basis at the cost of a capital gains tax by selling the property to the corporation.
2. Section 267.
   a. This provision is generally inapplicable since losses are not recognized.
   b. However, if the transaction did not qualify under § 351, this provision would deny a deduction for losses between the taxpayer and his or her more than 50-percent-owned corporation.

B. Losses are not recognized even if boot is received.

C. Multiple asset transfers and boot received.

1. When several assets are transferred, the computations of gain recognized and basis become much more cumbersome.
2. As footnoted in the text, Rev. Rul. 68-55 provides that gain recognized is computed on an asset-by-asset basis with boot allocated ratably to each asset based on relative fair market values (FMVs).

VI. SHAREHOLDER'S BASIS AND HOLDING PERIOD (§§ 358 AND 1223)

A. Preservation of unrecognized gain.

1. The transferor's basis of stock is a substituted basis determined as follows.

   Basis of property transferred
   \+ Gain recognized
   − Boot received (includes relief of debt)
   = Basis of stock

   Note. If neither gain is recognized nor boot is received, the basis of the stock is the same as that of the property transferred. In effect, the tax attributes of the transferor are substituted for the new property. This ensures preservation of any deferred gain or loss. However, if gain is recognized, such gain need not be recognized again. Any recognized gain increases the basis of the stock and any other property received, thus reducing the amount of gain that must be subsequently recognized.

   The effect of the calculation is to allocate the basis of the transferred property (as increased by any gain) between the boot and the stock. The basis assigned to the boot is its FMV. This allocation is accomplished by subtracting the boot received from the total. The remainder of the basis is allocated to the stock.

   Example. Assume J transfers property worth $1,000 with a basis of $100 for stock worth $800 and cash of $200. He recognizes $200 of the $900 realized gain due to the boot received. His basis is the $100 in the transferred property increased by the $200 gain or a total of $300. This $300 basis is allocated between the boot and stock, $200 to the boot and the remaining $100 to the stock. If the stock is subsequently sold for its $800 value, J recognizes $700 gain ($800 — $100), which, when combined with the $200 gain on the original transfer, results in the total realized gain of $900.

2. Loss duplication rules. The basis of the stock may be limited to the value of the assets transferred under these rules. See the discussion of the corporation's basis for the assets transferred below
3. Basis of stock acquired by a service shareholder is its FMV (i.e., a cost basis).
4. Basis for boot is its FMV.

B. Holding period of stock and securities.

1. Holding period of transferred property tacks if the asset is:
   a. A capital asset, or
   b. Section 1231 property.
2. Otherwise the holding period begins on the day after the exchange.

VII. CORPORATION'S BASIS AND HOLDING PERIOD (§§ 362 AND 1223)

A. Preservation of unrecognized gain.

1. A corporation's basis is a carryover basis.
   a. Formula

   Transferor's basis in property transferred
   \+ Gain recognized by transferor
   = Corporation's basis

   This calculation builds any gain or loss not recognized by the shareholder on the exchange into the corporation's basis for later recognition.

Example. (Refer to the example involving J above.) J realizes a $900 gain of which $200 is recognized. In such case, the corporation's basis is $300 ($100 + $200). Thus, when the corporation sells the property for its $1,000 value, it will recognize $700 gain, the amount of gain that J deferred on the exchange.

b. Allocation of basis among assets received. In those cases where multiple assets are exchanged for stock and boot, the calculation becomes more difficult.

1. As noted earlier, gain recognized is determined under Rev. Rul. 68-55 by allocating the boot among the assets based on their relative FMVs.
2. Unfortunately, neither the Code, Regulations, nor rulings provide any clues concerning the manner in which the corporation allocates its aggregate basis (including any gain) to the assets received.
   a. This is not an issue when gain is not recognized since the transferor's basis simply carries over to the corporation intact.
   b. When gain is recognized, however, it is not clear how the aggregate basis should be allocated.

      Given that the purpose of the basis rules is to ensure that any gain deferred on the exchange is recognized when the asset is sold (and any gain that is recognized is not taxed again), it seems that the basis of each asset should be that of the transferor increased by any gain recognized attributable to such asset. [See *P. A. Birren & Son and Raginowitz* "Allocating Boot in § 351 Exchanges," 24 *Tax Law Review* 337 (1969).]

      Note. This problem is the subject of a research case at the end of this chapter.

2. The holding period of the transferor tacks to that of the corporation.
3. Loss duplication rules.
   a. Problem: Under the general rules used to determine the basis of the shareholder's stock and the basis of the transferred assets to a corporation, a transferor could double its losses on a single asset by transferring it to a corporation.
   b. Prevention: If the aggregate basis of all of the property transferred by a transferor exceeds the value of such assets, the aggregate basis of the loss assets under § 362(e)(2) is limited to their fair market value (i.e., there is a net built-in loss considering all of the assets transferred by that transferor).
      1. The basis of each loss asset is reduced by the loss asset's proportionate share of the total net built-in loss.
      2. Alternatively, if both the shareholder-transferor and corporate-transferee both elect, the transferor can reduce the basis of the stock rather than the corporation reducing the basis of the asset. The stock basis cannot exceed the value of the assets transferred.

B. Comparison between tax and financial accounting

1. For book purposes, the property is recorded at fair market value.

VIM. ASSUMPTION OF LIABILITIES BY CORPORATION (§ 357)

A. Relief of debt is not boot for purposes of gain recognition. However, the shareholder's basis in stock and securities must be reduced by the amount of the liability.

1. When the taxpayer's debt is assumed by another party, it is the economic equivalent of having received cash and paying off the debt. Consequently, the relief of debt is considered the receipt of boot.

   Note. In *Hendler* (in the context of a reorganization), the Service argued that this approach should apply, and won. But it was a hollow victory. The ruling meant that corporations would be able

to increase their basis by gain that could not be taxed because such years were closed. Consequently, the IRS pleaded to Congress for help. Congress responded by enacting the predecessor to § 357(a), which provides that the assumption of debt by the corporation would not be considered boot for purposes of gain. However, to preserve the gain, the liability was treated as boot for basis purposes. Under § 358 discussed above, the shareholder's basis in the stock and securities is reduced by the amount of the liability [except where such liabilities are ignored under § 357(c)(3)].

B. Exception: Section 357(b) prevents liability bailouts. Absent this provision, the transferor could borrow against the property on the eve of the transfer, effectively receiving boot, yet he or she would not be required to recognize gain.

1. Liabilities are treated as boot if the principal purpose:
    a. Were to avoid tax; or
    b. If there were no bona fide business purposes.
2. If either one is present, all liabilities are treated as boot.
    a. Normally a valid business purpose will be found if the liability arose in the ordinary course of the taxpayer's business prior to incorporation.
    b. However, if the taxpayer used the borrowed funds for personal purposes knowing that the corporation would be assuming the indebtedness, a tax avoidance motive may be found.
    c. Perhaps the most important factor to be considered in determining whether the liability is tainted is the amount of time lapsing between borrowing and transferring the debt.
        1. If this period is short and the borrowed funds are put to personal use, an improper motive probably will be attributed to the shareholder.
        2. Absent this rule, a taxpayer would have the corporation assume his or her personal debts prior to incorporation. Subsequent payment of these debts is the equivalent of paying taxable dividends to the transferor who subsequently pays off the liability. By having the corporation assume the debt, double taxation can be avoided.
        3. Note that if the taxpayer transfers a liability as part of an exchange, he or she is required to state this on his or her return, detailing the circumstances.
3. If one liability is tainted, all liabilities are treated as boot, even those for which there is a valid business purpose.

C. Exception: Section 357(c) prevents a negative basis.

1. Gain is recognized to the extent liabilities transferred exceed basis. The need for this requirement can be seen in a simple illustration.

    Example. If **J** transfers his property worth $1,000 with a $100 basis to the corporation which assumes a liability of $300 encumbering the property, he would recognize no gain under the general rule of § 357(a) since liabilities are not boot. However, his basis under § 358 would be $100 less the liability of $300, or a negative $200. Assume the value of the stock received was equal to the net value of the property transferred, or $700 ($1,000 — $300), and the stock was subsequently sold for this amount. Assuming the basis was a negative $200, the taxpayer would recognize the deferred gain of $900. Nevertheless, the concept of negative basis generally is not recognized. Consequently, to avoid the negative basis issue, the taxpayer must recognize gain to the extent the liabilities exceed the basis. Regulation §1.357-2(b) suggests that the character of the gain is determined by the character of the assets transferred. When multiple assets are transferred, the gain is allocated to the assets according to their relative FMVs. This approach is questionable, particularly when there are realized gains on some assets and realized losses on others.
    a. For purposes of determining the amount of gain recognition, total liabilities are compared to the *total* basis of all assets transferred.
    b. The shareholder's basis in the stock received will always be zero in this situation.
2. For a *cash basis* transferor, liabilities do not include accounts payable that would give rise to a deduction when paid by the corporation.

a. Prior to enactment of § 357(c)(3), cash basis taxpayers incorporating their businesses often had to recognize gain because liabilities exceeded the basis of the assets transferred. This occurred because the bulk of the assets transferred was unrealized receivables for which the taxpayer had a zero basis.
b. In addition, the term *liability* generally was construed broadly by the Tax Court as embracing all types of liabilities, including those not yet recorded by the cash basis taxpayer. Consequently, as numerous cases suggest, several taxpayers inadvertently fell prey to § 357(c).
c. Although the appellate courts constructed several unique arguments (and the Tax Court ultimately relented) to provide the taxpayer relief, confusion and controversy still reigned.

1. Congress responded with enactment of § 357(c)(3).
2. Under this provision, the term *liability* is limited to those liabilities that, when paid by the corporation, would not result in a deduction.
   a. Thus, notes payable are treated as liabilities since payments on them simply represent repayment of principal.
   b. In addition, payment of an account payable that is a capital expenditure (e.g., architect's fee that would have to be capitalized as part of the cost of an asset or an item to be included in inventory) would not be deductible, and the payable is treated as a liability.

   Note. These payables are not treated as liabilities for purposes of computing *gain or basis.*

d. Not considered liability for gain purposes [§ 357(c)(3)].
e. Not considered liability for basis purposes [§ 358(d)(2)].

Example. Assume J transfers his property worth $1,000 with a basis of $100 along with accounts payable of $300 for stock worth $700. No gain is recognized assuming the liabilities give rise to deductions when paid by the corporation. In addition, J's basis is $100 ($100 + $0 gain – $0 liabilities). Assuming J sells the stock for $700, his gain is $600 rather than $900. The effect of ignoring the liabilities is to give J a deduction of $300 even if the liabilities are not paid by the corporation.

3. If §§ 357(b) (relating to tax avoidance) and (c) apply, § 357(b) controls.

IX. RECAPTURE OF DEPRECIATION AND CREDITS

A. Depreciation.

1. Depreciation is not recaptured on an exchange qualifying for nonrecognition treatment under § 351 (except to the extent of any gain recognized). However, the potential carries over to the corporation.
2. The corporation is liable for recapture of depreciation that was claimed both by the transferor and by the corporation.
3. Any gain recognized on the transfer is recaptured and treated as ordinary to the extent of any potential recapture.

B. Credits.

Note: The treatment of unearned credits is rarely an issue since the repeal of the investment credit. However, rehabilitation credits are subject to recapture.

1. There is no recapture of an unearned credit on the exchange if this is merely a change in form.
2. The contributing shareholder must recapture the credit on subsequent dispositions.

Note. Any credit to be recaptured must be recaptured by the contributing shareholder while depreciation is recaptured by the corporation.

a. Mere change in form is deemed to occur if:
   1. The property is retained in the same trade or business;
   2. The transferor retains a substantial interest in the corporation;
   3. Substantially all the assets necessary to operate the business are transferred to the corporation; and
   4. The property takes a carryover basis.

b. Thus, recapture may occur if:
   1. The corporation sells the asset;
   2. A shareholder reduces his or her interest (in *Soares,* the transferor exchanged a partnership interest of 48 percent for 7.22 percent interest that was not considered substantial); or
   3. Insufficient assets are transferred. In Rev. Rul. 76-514, a doctor transferred all of the assets of his practice except a building (no doubt retained to siphon earnings out of the corporation to him or his children in trust). The Service ruled that he had not transferred substantially all of the assets.

X. TAX BENEFIT RULE AND OTHER JUDICIAL DOCTRINES (NOT DISCUSSED IN TEXT)

A. *Tax benefit rule.* If an amount has been deducted and a later event occurs that is inconsistent with the rationale for the deduction, the deduction is offset by inclusion of income equal to the deduction.

Examples. Consider a taxpayer that has expensed supplies based on the assumption that they would be used in the immediate future. If the taxpayer transfers those supplies to the corporation and receives value (e.g., stock or boot) for them, in effect she has received a refund of her expenditure. Thus, she must give back the deduction by including the amount previously expensed in income.

The classic case in this area is *Nash,* where the taxpayer transferred accounts receivable for which a reserve had been established. The IRS asserted that the taxpayer's receipt of stock was a taxable recovery of the reserve, i.e., the taxpayer received the full face value of the receivables and the reserve was no longer necessary. The Supreme Court disagreed, stating that the taxpayer had received only the net value of the receivables.

B. Assignment of income.

1. Although this issue is not considered in the text, it is an issue that some might want to examine.
2. When a cash basis taxpayer transfers unrealized receivables to a corporation, the question arises as to which taxpayer should properly report the income when receivables are collected.

Example. This question arose in *Hempt Brothers,* where the taxpayer, a cash basis partnership, transferred $662,820 of receivables for which it had no basis. Because the statute of limitations had run out on the receivables in the year of the exchange, the taxpayer argued that the receivables were not property, and, thus, could not be transferred to the corporation tax-free. Instead, the taxpayer argued that the corporation had purchased them at cost and the partnership had failed to report the gain, which now could not be taxed due to the statute of limitations. Because the corporation's basis was cost, so the argument went, no income was recognized on their collection. The court rejected this ingenious argument indicating that the term *property* embraced receivables. Not to be denied, the taxpayer also argued that the IRS was attempting to tax the wrong taxpayer; i.e., there had been an assignment of income. The court agreed, indicating that there had been an assignment of income. However, it felt that this doctrine must give way to the Congressional desire to facilitate the incorporation of ongoing businesses without interference of the tax laws. Thus, it ruled that § 351 was controlling and the corporation was taxable as it collected the receivables. The IRS has since

agreed with this approach where there is a valid business purpose for the transfer, and it is apparent that the taxpayer is not attempting to assign income. Thus, the corporation normally will report the income from receivables. Similarly, it will be granted a deduction for the payment of any payables transferred. (See Rev. Rul. 80-198.)

C. Clear reflection of income *(not discussed in text).*

1. Another judicial doctrine that is not discussed in the text concerns the so-called clear reflection of income doctrine.
2. Under this doctrine, income and expenses may be allocated between taxpayers to ensure that each taxpayer's income is clearly reflected.

Example. Rev. Rul. 80-198 refers to the court's decision in *Rooney* to illustrate how this doctrine might be applied. In that case, a farming operation was incorporated after all the expenses had been incurred to produce the crops but before the crops had been sold. In effect, the transferor had deducted all the expenses while shifting all the income to the corporation. The Ninth Circuit held that the expenses could be allocated under § 482 to the corporation to be matched against the income. Accordingly, the Service may argue that if any receivables are transferred to the corporation, payables should be transferred as well.

XI. DEPRECIATION OF CONTRIBUTED PROPERTY

A. Depreciation.

1. For property previously placed in service (or currently being used by an ongoing business), the transferee corporation steps into the transferor's shoes.
   a. If the transferor had been using MACRS, the corporation merely steps into the shoes of the transferor, continuing to depreciate the property as if it were still held by the transferor.
   b. In the year of the transfer, the annual depreciation is allocated between the transferor and the corporation with the corporation receiving the depreciation for the month of the transfer. Thus, if five-year property is transferred in the third year, depreciation would be computed using the third-year percentage and depreciation for the following year would be computed using the fourth-year percentage.
   c. The limited expensing provision (§ 179) is not available since the property is not purchased by the corporation.
   d. If the basis is increased because of gain recognized, the corporation may treat this additional amount as if it were newly purchased property.
2. Short taxable year adjustments are required for property other than real property.
   a. A short taxable year exists if the taxpayer is not in business the entire taxable year.
   b. Depreciation is allowed for only $^{1}/2$ the number of months during which the corporation is in business.

   Example. If the corporation is in business for eight months, 4/12 of the amount of depreciation computed in the normal fashion is allowed. Since the half-year convention is reflected in the depreciation percentages, the given rate must be multiplied by 8/12. Any depreciation not deducted by the close of the final recovery period is deductible in the following year.

3. For real property not previously used or newly purchased, the appropriate table is used reflecting the mid-month convention. For this purpose, it is assumed that the corporation was in business a full 12 months.

XII. CORPORATE GAIN OR LOSS ON ISSUANCE OF STOCK

A. *Section 1032. A* corporation recognizes no gain or loss on issuance of its own stock (including treasury stock) for property or services.

B. *Rev. Rul. 62-217.* A corporation may deduct the value of stock issued as compensation for services if a payment of cash in lieu of stock would have been deductible.

XIII. CONTRIBUTIONS OF CAPITAL (NO EXCHANGE OF STOCK)

A. Contributions by shareholders.

1. Cash contributions.
    a. A corporation excludes all contributions from gross income, if the contributions are not compensation.
    b. The contributing shareholder increases the basis in his or her stock.
2. Property contributions.
    a. A corporation excludes all contributions from gross income if the contributions are not compensation.
    b. The contributing shareholder increases the basis in his or her stock by the basis of the property contributed.
    c. The corporation's basis is the same as the transferor's basis.
3. Forgiveness of corporate indebtedness. If the corporation owes money to a shareholder, forgiveness of the debt by the shareholder is normally treated as a nontaxable contribution to capital rather than a cancellation of indebtedness income.

B. Contributions to capital by nonshareholders. Such contributions are normally made by civic groups such as the Chamber of Commerce, local governments, and other nonshareholders that hope to benefit indirectly from the contributions. For example, a city may give a corporation land on which to relocate with the hope of generating jobs.

1. The corporation excludes the contribution from gross income.
    a. This treatment is allowed as long as the contribution is an inducement rather than compensation.
2. Basis of property contributed or acquired with contributed cash.
    a. The corporation's basis for contributed property is zero. This treatment prohibits the corporation from obtaining tax benefits (e.g., depreciation) as well.
    b. Cash contributions.
        1. Property acquired with such cash has a zero basis.
        2. If cash is not used to acquire property, the corporation must reduce the basis of property it owns, with the basis of depreciable property being reduced first.

XIV. INTENTIONAL AVOIDANCE OF § 351

A. Reasons for avoiding § 351. Although most taxpayers seek nonrecognition treatment when making transfers to a corporation, some reasons for making the transfer taxable are listed below.

1. Recognize loss.
2. Step up in basis. With proper planning the step up may be obtained at a cost of capital gains tax that might be deferred using the installment sale rules.
3. Ensure capital gain treatment for appreciation.

Example. Assume that J's property, worth $1,000 with a $100 basis, is land that he intends to develop. If he contributes it to a corporation, develops it, and then sells it, the $900 of appreciation may be treated as ordinary income since the corporation takes a carryover basis of $100. To ensure capital gain treatment on the $900 of predevelopment appreciation, he could sell the property to the corporation for $1,000. The basis of the property would then be increased to $1,000 and any subsequent ordinary income would be measured from a basis of $1,000 rather than $100. To accomplish this, however, J must make the transaction taxable, and, thus, avoid § 351 (and the related carryover-basis provisions of § 362 that would give the corporation a $100 basis), which is not elective but mandatory if the transfer satisfies its requirements. The IRS often argues that § 351 applies in such situations. In addition, Congress has given the IRS several other weapons to combat this scheme: §1239, causing any gain recognized on a sale of depreciable property between a shareholder and his or her more than 50 percent owned corporation to be treated as ordinary income; §453(e), which prohibits installment sale treatment of sales between a shareholder and his or her more than 50 percent owned corporation; and § 453(i), requiring recapture of all depreciation in the year of the disposition despite the fact that the installment sales method is elected. Moreover, if the transferor attempts to recognize a loss, § 267 disallows the deduction of losses between a shareholder and his or her more than 50 percent owned corporation. An excellent case illustrating what can be accomplished with proper planning is *Jolanda Bradshaw,* as long as the taxpayer is not too greedy, as was the case in *Burr Oaks Corp.*

B. Avoiding § 351.

1. Sale.
   a. Instead of a § 351 exchange, a taxpayer might structure the transfer as a sale.
   b. Problems with debt.
      1. Typically, the transaction is carried out with all the formalities of a sale with the shareholder receiving corporate notes, thus enabling installment sale treatment.
      2. In such case, however, the Service may assert that the notes are stock (if the corporation is thinly capitalized) and attempt to apply § 351. See *Aqualane Shores,* as described in the text.
2. Receive boot on the exchange.
   a. Boot makes an exchange taxable even under §351.
   b. Use of debt.
      1. Although the transfer is characterized as a § 351 exchange, any debt received by the transferor would be treated as boot and the desired treatment would be obtained.
      2. Even with debt, the taxpayer risks these notes being treated as stock.
3. Fail § 351 requirements.
   a. Violate control requirement with prearranged disposition of stock following transfer.

C. Additional pitfalls.

1. *Section 1239* requires that gain recognized on a sale of depreciable property (in the hands of the buyer) between a shareholder and his or her more than 50 percent owned corporation is to be treated as ordinary income.
2. *Section 453(e)* denies installment sale treatment of sales between a shareholder and his or her more than 50 percent owned corporation.
3. *Section 453(i)* requires recapture of all depreciation in the year of disposition despite the fact that the installment sales method is elected.
4. *Section 267* disallows the deduction of losses between a shareholder and his or her more than 50 percent owned corporation.

CAPITAL STRUCTURE OF THE CORPORATION

XV. Introduction. One of the most important decisions to be made by those who create a new corporation concerns the capital structure of the business. How will the corporation raise the capital necessary to carry out its operations? Most corporations simply issue stock in exchange for money, property, or services. Stock can come in a variety of forms. It may be common or preferred. In addition, there may be different classes of common or preferred, each of which differs with respect to voting rights, dividend preferences, liquidation privileges, etc. Moreover, the corporation is not restricted to using stock to attract its needed capital. It can borrow the necessary capital either from shareholders or from outsiders. The form of borrowing can vary much like stock. The corporation can issue notes, bonds, convertibles, or nothing at all. However, if debt is exchanged for appreciated property, the transferor must recognize gain.

Decisions regarding the proper mix of debt and equity are often motivated by tax factors. This is not to say that nontax factors are ignored. Obviously, the prudent manager does not want to burden his or her corporation with debt so excessive as to risk insolvency. Nor does he or she want to saddle the corporation with a poor credit rating, a likely prospect if the debt-to-equity ratio is beyond reason. Nevertheless, the tax treatment afforded debt so heavily favors it over equity that debt normally is a significant part of the capital structure.

XVI. STOCK VS DEBT: COMPARATIVE ADVANTAGES AND DISADVANTAGES.

A. Appreciated property exchanged for debt.

1. Transferor must recognize gain if any is realized.

2. No effect if no gain is realized.

B. Interest vs. dividends.

1. Interest is deductible while dividends are not.
2. Debt enables the avoidance of double taxation. The significance of this cannot be over-emphasized.

   Example. Assume the business is going to pay a return to those who provide its capital. From the corporation's view and that of its owners, it is much less expensive to pay tax-deductible interest payments than nondeductible dividends. Assuming a corporation pays taxes at a 40%, it takes about $1.67 of income to pay $1 of dividend.

3. Paying dividends may be more advantageous than making deductible payments notwithstanding the double taxation problem because dividends are taxed at a maximum rate of 15%.

C. Repayment vs. redemption.

1. Repayment of debt principal (which is treated as an exchange) is normally tax-free.
2. A sale of stock back to the corporation (i.e., a redemption) is often treated as a dividend and, thus, subject to double taxation.
3. This distinction is extremely significant when the corporation is closely held, since a sale to the corporation may be the only option.

D. Loss on sale or worthlessness.

1. A loss on worthless securities (stock and debt) generally is treated as a capital loss.
2. A loss on stock may be ordinary under § 1244.

E. Accumulated earnings tax. The accumulated earnings tax discussed in Chapter 6 is a penalty tax imposed in addition to the regular tax when the corporation has been used for tax avoidance purposes. It is

designed to prohibit shareholders from using the corporate form to shield income from higher individual rates by accumulating earnings rather than distributing them. However, the provision allows accumulation of earnings *for reasonable needs.*

1. Earnings can be accumulated to retire debt.
   a. Accumulation within the corporation (and, thus, under the shield of lower rates) to retire debt is considered a reasonable need of the business.
   b. As a result, the presence of debt can serve as a defense against the accumulated earnings tax.
2. Earnings can be accumulated to redeem stock. This purpose is not considered a reasonable need of the business unless a shareholder has died.

F. Transferability and control.

1. Debt can be given to others to shift income (e.g., to children) without losing control.
2. Stock can be used in the same fashion only if it is nonvoting.

G. Fixed vs. flexible obligation.

1. Debt requires fixed payments of interest and principal. Such payments could be a burden, tying up future earnings.
2. Stock requires neither payments of dividends nor retirement of principal and, thus, is flexible.

XVII. CHARACTERIZATION: IS THE INSTRUMENT STOCK OR DEBT?

A. Given the advantages of debt, it is not surprising that many taxpayers would just as soon have virtually the entire capital structure of the corporation consist of debt. The Service is sensitive to this possibility, however, and has often rejected the taxpayer's characterization. Instead, the Service has ignored the label given to the instrument by the taxpayer and made its own determination. When the purported debt is recharacterized as equity, the creditor now turned shareholder can find the consequences disastrous.

B. Consequences of the recharacterization of debt to equity.

1. Interest payments become nondeductible dividends.
2. Tax-free principal payments become nondeductible dividends.

C. Factors to be considered.

Note. Unfortunately, whether a particular instrument is debt or equity is not easily resolved. Plumb has written a treatise of over 300 pages on the problem from which one can only conclude that the ultimate determination depends on a variety of factors, none of which is conclusive. As pointed out in the early case of *O.P.P. Holding,* the problem seems to be one of risk. A shareholder is "an adventurer in the corporate business." He or she takes risks and profits commensurately. A creditor "in compensation for not sharing in the profits, is to be paid independently of the risk of success, and gets a right to dip into capital when the payment date arrives." Although the court eloquently states the issue, it provides little objective guidance for resolving the conflict. The critical factors enunciated by the courts over the years are summarized below.

1. Form of the obligation.
   a. So-called straight debt normally has an unconditional promise to pay, a specific term, a stated and reasonable interest rate, and is payable in all events.
   b. Although such form does not control, instruments that contain all the characteristics normally associated with debt are far less vulnerable to reclassification than so-called hybrid instruments

that have equity features, e.g., debt with interest payments contingent on earnings, convertible to stock, or with voting rights. 2. Debt/equity ratios.

   a. A high debt-to-equity ratio is a red flag and suggests that some, or even all, of the risk is being borne by the creditors.
   b. In such case, repayment of the debt is so linked with the fortunes of the business, because there are no other sources for payment, that the debt represents risk capital.

      Example. A ratio greater than 4:1 is probably suspect under the Supreme Court's decision in *Kelly*. However, a ratio of 3:1 was held to be excessive in *Schnitzer* while much higher ratios have not. Still another issue is how this ratio should be computed. What debt should be included? Should only shareholder debt be included for this purpose? What about accounts payable, or should debt be restricted to only long-term liabilities? In computing equity should fair market value or historical cost be the appropriate measure?

3. Proportionality.
   a. If shareholders hold debt in the same proportion as stock (e.g., J owns 60% the stock and 60% the debt while K owns the other 40% the debt and stock), this encourages close scrutiny by the Service.
   b. The theory is that the so-called creditors have no economic incentive to act as creditors because their share of the pie on liquidation would be the same regardless of whether they enforce their obligations, i.e., if J did, so would K. Thus, the required debtor-creditor relationship would not exist.
   c. Proportionality is not conclusive, however, particularly in the case of a sole shareholder.
4. Subordination.
   a. Although this has been a factor in some decisions, it seems that subordination is more of a reality in a closely held setting.
   b. It becomes significant when other factors such as proportionality and a high debt-to-equity ratio also exist.

D. Section 385 and proposed regulations.

In 1969, it was reported to Congress that the percentage of debt in the capital structure of corporations had reached 51 percent, a 50 percent jump from its 34 percent level in 1954. In addition, Congress was informed that in 1968, there were more acquisitions of large companies, those with assets of $250 million or more, than in the previous 20 years. Also in 1968, of companies with assets of $10 million or more (these controlled about 7/8 of corporate manufacturing assets and profits at that time), approximately one in thirteen was acquired in that year. In light of these statistics, Congress became alarmed about what it perceived to be the dangers of conglomerates, primarily the possibilities for the consolidation of power and the elimination of competition.

Part of the takeover phenomenon was attributable, at least in part, to the deduction granted for interest. Typically, when a corporation wanted to acquire another corporation, it might purchase the target's stock from its shareholders by using their own debt. The significance of this was noted by one commentator as follows *(James S. Eustice,* "Corporations and Corporate Investors," 25 *Tax Law Review* 512(1970)):8

> Of prime importance to the success of a debt-financed purchase of stock was the deductibility of interest on the purchase money obligation by the buyer corporation. If stock had been issued, dividends thereon were not deductible. Thus, the government (through tax deductibility of credit costs) became a significant joint venturer with purchasing corporations in the takeover game. In addition to this favorable tax break for interest costs, buyers could also extract debt service funds from their newly purchased subsidiaries at a maximum tax cost of only 7.2 percent (due to the 85 percent [now 70 or 80 percent] dividends received deduction of § 243); moreover, if consolidated returns were filed, intercorporate dividends were wholly tax-free.

> The bootstrapping possibilities of this technique soon became obvious. The opportunity to acquire corporate property essentially out of its own funds, coupled with the tax advantages of deductibility for interest costs on the purchase money debt, added up to a most attractive financial package.

From a tax perspective, the problem of interest deductibility was exacerbated because many of the acquisitions were not made with straight debt but with so-called hybrid securities, i.e., securities that had both debt and equity features such as convertible bonds. Congress apparently believed that to allow corporations and their investment bankers to treat such instruments as debt was essentially giving away the store. It should be emphasized that the more debt that a corporation uses, the greater the possibility that it will pay no income tax. As some commentators have noted, the net result is that the corporate tax is avoided, and for all intents and purposes there is no corporate tax.

To cool the fires of the takeover phenomenon, Congress enacted § 385 along with § 279. Section 385 gave the Service the authority to write its own rules to clarify the distinction between debt and equity. Despite much fanfare regarding the significance of this action, the IRS did not issue Proposed Regulations until March 1980, 11 years later.

Final regulations were issued with much publicity in December, 1980, to become effective after April 30, 1981. However, this date was postponed twice and extensive amendments were made including a new effective date. In 1982, many investment bankers began designing securities that took maximum advantage of the proposed § 385 regulations governing hybrid securities. Many of these securities derived a major portion of their value from their equity features but yielded fully tax-deductible "interest" payments. In the fall of 1982, Goldman, Sachs & Company underwrote a $45 million private placement of "adjustable rate convertible notes" (ARCNs) for NICOR, which technically qualified as debt under the regulations but as a practical matter were equity. The IRS addressed this situation in Rev. Rul. 83-98, issued in July, 1983. This ruling completely ignored the proposed regulations and evaluated the instruments using traditional criteria. At this point, it became quite clear that the Treasury had realized that the regulations had not gone far enough. Less than one month after the ruling, the Treasury proposed to withdraw the final regulations. In July 1983, the regulations were withdrawn before they ever became effective. It now appears that this project has been shelved permanently as other more palatable solutions to the problems are sought.

XVIII. CHARACTER OF INVESTOR'S LOSS ON CORPORATE INVESTMENT

Despite the overwhelming optimism that normally surrounds the creation of a new corporation, design of the capital structure of the corporation should consider the downside. What happens if the investment goes sour? In this case, an investment in stock that qualifies for special treatment under § 1244 is more desirable than debt.

A. Worthless securities.

1. Defined as stock, stock rights, bonds, and debentures.
2. Treated as capital loss arising from a hypothetical sale on the last day of the taxable year in which it became worthless.

B. Bad debts (e.g., shareholder advances not evidenced by a note).

1. *Business bad debts* are treated as ordinary losses, fully deductible against ordinary income.
2. *Nonbusiness bad debts* are treated as short-term capital losses. Hence, the deduction for a nonbusiness bad debt is limited to $3,000 plus capital gains.
3. Which is it, business or nonbusiness bad debt?

Example. Litigation on this issue has been extensive, but the classic case cited by most courts concerns the escapades of Mr. Whipple. Whipple was a wheeler dealer. He had made sizable cash *advances* to one of several enterprises he owned, the Mission Orange Bottling Co., a corporation that

he had formed in Lubbock, Texas. During 1951-53, the company made no payments of interest, rent, or salary to him despite the fact that he had provided certain promotional and managerial services for it. Whipple claimed that these activities constituted a trade or business and consequently deducted $57,000 owed to him as a business bad debt. According to the Supreme Court, "devoting one's time and energies to the affairs of a corporation is not of itself and without more, a trade or business of the person so engaged. Though such activities may produce income, profit or gain in the form of dividends or enhancement in the value of an investment, this return is distinctive to the process of investing as distinguished from the trade or business of the taxpayer himself. When the only return is that of an investor, the taxpayer has not satisfied his burden of demonstrating that he is engaged in a trade or business." Because Whipple had received no remuneration from the company, the Court denied him business bad debt treatment, and he was stuck with a short-term capital loss of $57,000. (One only hopes that he had some capital gains.)

The *Whipple* decision did provide a basis for business bad debt treatment, however, when the taxpayer's return was not solely limited to dividends, appreciation, etc. If the taxpayer can establish that the purpose of the advances was to protect a business relationship such as that of employer—employee (and, therefore, protect a salary) or supplier—customer, then business bad debt treatment may be granted.

Yet, the Supreme Court, in *Generes,* established a severe obstacle in this regard indicating that the taxpayer's dominant motive for the advances must be protection of his or her job. In that case, the Court denied favorable treatment for a taxpayer who had loaned more than $150,000 to a family corporation that employed him for a salary of only $12,000. This decision has caused many commentators to dismiss the issue saying that it is virtually impossible for a shareholder to avoid nonbusiness bad debt treatment if he or she sustains a loss in a creditor capacity.

Nevertheless, occasionally a victory is seen. This issue is commonly litigated before a jury.

4. Section 1244 stock.
   a. Background.

      1. Sole proprietors, partners, and S corporate shareholders can deduct their losses as ordinary deductions as they occur.
      2. Prior to 1958, the shareholder of a regular C corporation was at a relative disadvantage since he or she had to treat any losses as capital losses when the stock was sold or became worthless. This seemed inappropriate to Congress, particularly when the owner of a small business chose to use the corporate form for nontax reasons. Accordingly, relief was provided in a limited fashion in 1958 with the addition of § 1244.

   b. Treatment.

      1. Loss on sale or worthlessness is ordinary loss up to $50,000 ($100,000 if joint return) annually.
      2. Any loss in excess of this limit is capital loss.
      3. This loss can add to or create an NOL.
      4. Treatment is available only for certain taxpayers.
         a. Section 1244 treatment is available only to individuals or partnerships (not estates, trusts, or corporations) that were the original holders of the stock.
         b. It is not available to the transferee of the original holders, i.e., donees, beneficiaries, purchasers, or others.

5. Section 1244 stock is defined as follows:
   a. Common or preferred stock in a domestic corporation;
   b. Issued for money or property (other than stock or securities) and not services; and
   c. Is a Small Business Corporation at the time of issue.
      1. The aggregate amount of money and other property received by the corporation for stock, as a contribution to capital, does not exceed $1 million, including all previous issues.
   d. Gross receipts test when loss sustained.

1. For five taxable years ending before the year in which the loss was sustained, the corporation must have been an operating company, i.e., it must have derived more than 50 percent of its aggregate gross receipts from sources other than passive investment income items.
2. This prohibits taxpayers from incorporating their investment activities and obtaining ordinary loss treatment for investments that would have created capital losses had they held them directly.
3. This test does not apply, however, if for the same period the aggregate amount of deductions of the corporation exceeds the aggregate amount of its gross income.

XIX. QUALIFIED SMALL BUSINESS STOCK

A. Individual taxpayers are allowed to exclude 50% of the gain on the sale or other disposition of qualified small business stock. Stock generally is considered qualified small business stock if the following conditions are met:

1. The corporation issuing the stock is a domestic C corporation on the date the stock is issued.
2. The taxpayer is the original owner of the stock.
3. At the time the stock was issued, the gross assets of the corporation did not exceed $50 million.
    a. Gross assets are the sum of cash plus the fair market value of contributed property measured at the time of contribution plus the adjusted basis of other assets.
    b. For purposes of determining whether the $50 million threshold is surpassed, a parent-subsidiary controlled group (using a 50 percent test rather than an 80 percent test) is treated as one corporation.

B. 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:

1. 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 assets is the reputation or skill of one or more of its employees.
2. Banking, insurance, financing, leasing, investing
3. Farming
4. Businesses involving the production or extraction of products eligible for depletion.
5. Business of operating a hotel, motel, or restaurant.

C. The corporation generally cannot own:

1. 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).
2. Portfolio stock or securities with a value that exceeds 10 percent of the corporation's total assets in excess of its liabilities.

D. The effect of this provision is to impose a maximum tax of 14 percent (50% x 28% maximum capital gain rate) on the gains from such investments, a far lower rate than the 39.6 percent that may apply to other types of income received by the taxpayer.

E. This provision applies to stock issued after August 10, 1993.

F. AMT preferences. Seven percent of the exclusion (3.5% of the entire gain) is a tax preference item.

G. The new provision limits the amount of gain eligible to be excluded on the sale of a particular corporation's stock. The maximum amount of gain that may be excluded on the sale of one corporation's stock is the larger of:

1. $10 million reduced by previously excluded gain on the sale of such corporation's stock.
2. 10 times the basis of all qualified stock of the corporation that the taxpayer sold during the tax year.

H. In determining the taxpayer's net capital gain and losses, any gain excluded on the sale of QSBS is not taken into account.

I. Basis of small business stock. When qualified stock is received for property other than money or stock in a tax-free exchange under § 351, the basis of the stock received *for purposes of determining the amount eligible for exclusion* is no less than the fair market value of the stock at the time of acquisition [§ 1202(i)].

J. If a gain is recognized on the sale of QSB stock, it may be deferred if the sales proceeds are reinvested in other QSB stock. In such case, the basis of the new stock is its cost reduced by the deferred gain.