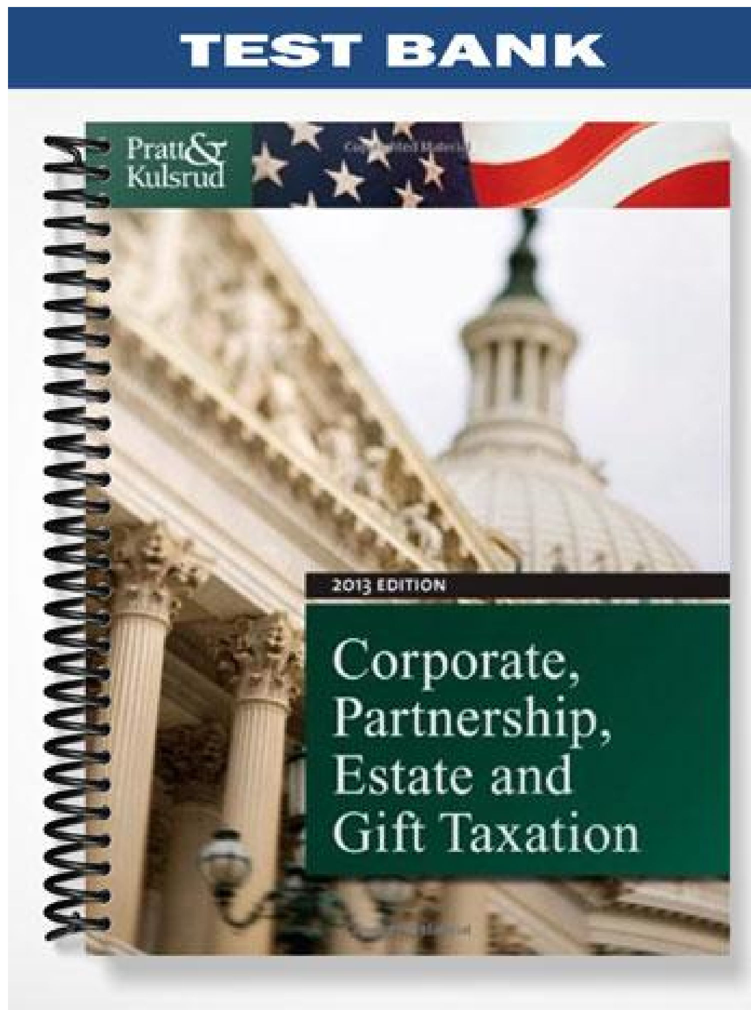
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2

Corporate Formation and Capital Structure

Solutions to Tax Research Problems

TAX 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.

2-50 **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.

2-53 **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 10 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.

2

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. Both b. and c. 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 CDs 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.** 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.

______ **55.** 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

______ **56.** 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.

______ **57.** 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

______ **58.** 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

______ **59.** 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

______ **60.** N Corporation was formed by L in 2003, 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

______ **61.** 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

______ **62.** 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

______ **63.** 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

2

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 pp. 2-11 and 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. 2-9 and 2-10.)
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 p. 2-13.)
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 p. 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. 2-15 and 2-16.)

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 22.1 and 2.2, Examples 25 and 29, and pp. 2-16, 2-18 and 2-19.)

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. 2-18 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. 2-29 through 2-31.)

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. 2-6.)

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 transferors are to be nontaxable, a person that contributes only services can receive at most 20 percent of the stock. (See Example 9 and p. 2-7.)

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 p. 7.)

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. 2-8 and 2-9.)

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. 2-21 through 2-23.)

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 p. 2-7.)

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 Example 16 and 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. 2-6.)

41. d. Stock rights and warrants do not qualify as stock, since they only give a *right* to obtain an equity interest. (See p. 2-6.)

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. 2-6 and 2-11.)

43. d. Choice a. is false because a transferor can receive solely 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 pp. 2-10 and 2-14.)

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. 2-12.)

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 or aggregate basis of the property transferred,

$145,000 ($45,000 + $100,000). 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. 2-12 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 Section 357(c)(2)(A)) and p. 2-14.)

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. 2-16 and 2-17.)

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 pp. 2-16 and 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. 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.)

55. 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.)

56. 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.)

57. 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.)

58. **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. 2-27 and 2-28.)

59. **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.)

60. **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 2-32.)

61. **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.)

62. **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.)

63. **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.)

2

Corporate Formation and Capital Structure

Comprehensive Problems

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

1. 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 to Comprehensive Problems

1. **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. 2-7.)

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. 2-21.)

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.)

2

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	
10 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 (seven-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 2011 or tax year beginning Feb 1, 2011, ending Dec 31, 20 11

▶ See separate instructions.

OMB No. 1545-0123 **2011**

A Check if:	TYPE OR PRINT	
1a Consolidated return (attach Form 851) ☐	Name: Slattery's Inc	B Employer identification number: 88-7654321
b Life/nonlife consolidated return ☐	Number, street, and room or suite no. If a P.O. box, see instructions.: 5432 Partridge Pl.	C Date incorporated: 02/01/2012
2 Personal holding co. (attach Sch. PH) ☐	City or town, state, and ZIP code: Tulsa OK 74105	D Total assets (see instructions): $ 351,200.
3 Personal service corp. (see instructions) ☐		
4 Schedule M-3 attached ☐	E Check if: (1) ☐ Initial return (2) ☐ Final return (3) ☐ Name change (4) ☐ Address change	

Income

Line	Description	Sub-line	Sub-amount	Line	Amount
1a	Merchant card and third-party payments. For 2011, enter -0-	1a	600,000.		
b	Gross receipts or sales not reported on line 1a (see instructions)	1b			
c	Total. Add lines 1a and 1b	1c	600,000.		
d	Returns and allowances plus any other adjustments (see instructions)	1d			
e	Subtract line 1d from line 1c			1e	
2	Cost of goods sold from Form 1125-A, line 8 (attach Form 1125-A)			2	284,000.
3	Gross profit. Subtract line 2 from line 1e			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	Sub-line	Sub-amount	Line	Amount
12	Compensation of officers from Form 1125-E, line 4 (attach Form 1125-E) ▶			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 Form 1125-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	
29a	Net operating loss deduction (see instructions)	29a			
b	Special deductions (Schedule C, line 20)	29b	1,400.		
c	Add lines 29a and 29b			29c	1,400.

Tax, Refundable Credits, and Payments

Line	Description	Line	Amount
30	**Taxable income.** Subtract line 29c from line 28 (see instructions)	30	151,457.
31	Total tax (Schedule J, Part I, line 11)	31	42,318.
32	Total payments and refundable credits (Schedule J, Part II, line 21)	32	48,000.
33	Estimated tax penalty (see instructions). Check if Form 2220 is attached ▶ ☐	33	
34	**Amount owed.** If line 32 is smaller than the total of lines 31 and 33, enter amount owed	34	
35	**Overpayment.** If line 32 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 2012 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.

Signature of officer	Date	Title
Lisa Gutter	2-27-11	PRESIDENT

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

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
	Sherry L. Hartman	2-27-11		

Firm's name ▶ S. L. HARTMAN, P.C. — Firm's EIN ▶ 74 8326198

Firm's address ▶ 777 DOMINION DR., TULSA, OK 74105 — Phone no. (905) 627-8110

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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		see instructions	
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.

Form **1120** (2011)

Form 1120 (2011) Slattery's Inc 88-7654321 Page **3**

Schedule J **Tax Computation and Payment** (see instructions)

Part I–Tax Computation

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 30 (attach Form 8834)	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	
9a	Recapture of investment credit (attach Form 4255)	9a			
b	Recapture of low-income housing credit (attach Form 8611)	9b			
c	Interest due under the look-back method—completed long-term contracts (attach Form 8697)	9c			
d	Interest due under the look-back method—income forecast method (attach Form 8866)	9d			
e	Alternative tax on qualifying shipping activities (attach Form 8902)	9e			
f	Other (see instructions—attach schedule)	9f			
10	**Total.** Add lines 9a through 9f			10	42,318.
11	**Total tax.** Add lines 7, 8, and 10. Enter here and on page 1, line 31			11	

Part II–Payments and Refundable Credits

12	2010 overpayment credited to 2011			12	
13	2011 estimated tax payments			13	
14	2011 refund applied for on Form 4466			14	( )
15	Combine lines 12, 13, and 14			15	
16	Tax deposited with Form 7004			16	
17	Withholding (see instructions)			17	
18	**Total payments.** Add lines 15, 16, and 17			18	
19	Refundable credits from:				
a	Form 2439	19a			
b	Form 4136	19b			
c	Form 3800, line 17c and Form 8827, line 8c	19c			
d	Other (attach schedule—see instructions)	19d			
20	**Total credits.** Add lines 19a through 19d			20	
21	**Total payments and credits.** Add lines 18 and 20. Enter here and on page 1, line 32			21	

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? If "Yes," enter name and EIN of the parent corporation ▶		X
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)		

Form **1120** (2011)

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Schedule K **Other Information** *continued* (see instructions)

		Yes	No
5	At the end of the tax year, did the corporation:		
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) below.	X	

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

		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) below.	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 1c 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. ▶ $ ______		
14	Is the corporation required to file Schedule UTP (Form 1120), Uncertain Tax Position Statement (see instructions)?		
	If "Yes," complete and attach Schedule UTP.		
15a	Did the corporation make any payments in 2011 that would require it to file Form(s) 1099 (see instructions)?		
b	If "Yes," did or will the corporation file all required Forms 1099?		

Form **1120** (2011)

Form 1120 (2011) *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** (2011)

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
2011
Attachment Sequence No. 179

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.*

1	Maximum amount (see instructions)	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
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 2010 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 2012. 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.)

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

17	MACRS deductions for assets placed in service in tax years beginning before 2011	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 2011 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 2011 Tax Year Using the Alternative Depreciation System

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.)

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** (2011)

Form 4562 (2011) SLATTERY'S INC. Page **2**

Part V **Listed Property** (Include automobiles, certain other vehicles, 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 2011 tax year (see instructions):					
43 Amortization of costs that began before your 2011 tax year				**43**	
44 **Total.** Add amounts in column (f). See the instructions for where to report				**44**	

Form **4562** (2011)