Formation of a Corporation

1) Transferor: §351(a) - nonrecognition treatment applicable to the transferor if certain conditions are met (otherwise: §1001).

2) Corporation: Tax-free treatment to corporation issuing its shares. §1032.

3) Carryover tax bases to shareholder (shares) and to corporation (assets).
Section 351 Qualification Requirements

§351(a) - specific requirements:
  a) one or more persons must transfer;
  b) they must transfer "property";
  c) must be in exchange for "stock" of the issuing corporation - not "securities"; and,
  d) the transferor “group” must be in "control" immediately after the exchange (but not an “investment company”).

Tax objective for this treatment?

Ancillary Tax Rules for §351 Transfers

Basis  §358 - to shareholders - basis of stock shall be same as the basis for transferred property. Potential for double level of income taxation, i.e., to corporation & shareholder.

§362 - transferred basis for assets shifted into the corporation. Limit on built-in losses.

Holding period:  §1223(1) - transferor has a substituted holding period;  §1223(2) - carryover holding period to the corporation.
Slide 4

w1 wstreng, 8/22/2006
Incorporation Transaction
Multiple Transferors

Is § 351(a) exchange treatment available if:

a) Each party is a transferor of property (including the transferor of money).
b) Each party has received X corporation stock in the exchange.
c) The transferors (as a group) are in “control” of X corporation.
d) No transferor has received "boot" in the transaction.

Examples:

Cash Transfer by A: No gain realized.
   fmv basis for stock received.
Need to clarify that money is "property";
otherwise, less than 80% of the stock to transferors for § 351 purposes?

Inventory from B: Realized gain.
   Basis to B of stock received is increased.
   No tacked holding period - since inventory.
Example

Depreciated property from C:
Realizes loss on the land; but the loss is not recognized on this transfer.
Substituted basis under § 358(a).
Land is a capital asset – the holding period is tacked - § 1223(1).
Should C have sold the land to realize & recognize the loss for C’s tax purposes?

Example

Equipment Transfer by D:
Gain realized on the equipment transfer, but no gain recognition is required?
Depreciation recapture under §1245?
Provides that “such gain shall be recognized notwithstanding any other provision.”
But, see §1245(b)(3) - an exception in the §351 context. Depreciation recapture potential is preserved at the corporate level.
Example

Installment Obligation Transfer:
Disposition of an installment obligation occurs. §453B(a) requires the recognition of gain realized upon the disposition of an installment obligation. The amount realized is fmv; tax basis in the note is less.

Reg. § 1.453-9(c)(2) specifies that no gain recognition required upon the disposition of an installment obligation in a §351 transfer.

Example

Tax consequences to the corporation:
1) §1032 - no gain.
2) Tacked holding period(s) for the assets received - §1223(2) - but not for inventory.
3) Carryover tax basis for the assets received (§362): inventory; land (depreciated); equipment; installment note.
Example

C transfers:
Parcel 1: 10x FMV  15x basis (loss)
Parcel 2: 10x FMV  8x  basis (gain)
        20x             23x (3x net loss)

§362(e)(2) requires tax basis reduction by 3x.
Netting of gains and losses permitted.
Reduce basis of Parcel 1 from 15x to 12x.
Option to reduce C’s stock basis to 20x.

Issue:

Potential double taxation of inventory gain:
    gain to B on the stock sale.
    gain to the corporation on the inventory sale.

How prevent double gain (or double loss) if so desired?  Step-up the shareholder’s basis if the corporation realizes the gain. Step-down the shareholder's basis if the loss is recognized by corporation.
“Control” Requirement Defined

§§351(a) & 368(c) - requires:
  80% of voting power, and
  80% of total value of other stock.

If several transferors:
- an "integrated plan" is necessary
- need not transfer assets simultaneously
- must, however, transfer with "expedition consistent with orderly procedure."

Immediate Stock Disposition After Transfer

What if a disposition of the stock occurs immediately after its acquisition?

Cannot be disposed of pursuant to a pre-existing binding agreement.

Intermountain Lumber case

Issue: Tax basis of corporation's assets (i.e., Intermountain) for purposes of depreciation - to the acquirer; i.e., was the transfer of the assets to the corporation really a “sale”? 
Rev. Rul. 2003-51

Transfer of assets to 1st corporation for stock.
Transfer of stock of 1st corp to 2nd corp & transfer of assets to 2nd corp by another transferor.
Prearranged binding agreement.
The nontaxable disposition of 1st corp. stock after the 1st § 351 transaction does not violate the “control” requirement.

Transfers of “Property” and Services

Definition of "property": Stock received for "services" is not for property - §351(d).
What are services? Attorney; Promoter; Goods with installation/repair arrangement.
Effect on 80 % requirement of:
1) solely service provider - not a transferor.
2) both property and services - included in control group, but some stock may be gross income to the service provider/transferor.
**Solely for “Stock”**

“Stock” means an equity investment in the corporation and does **not** include:
1) stock rights or warrants
2) securities (i.e., long term debt), or
3) non-qualified preferred stock - §351(g).

---

**Example:**

A as transferor is entitled to §351 treatment: 50 of 60 shares. Exchanged basis in Newco stock. Tacked holding period under §1223(1) - assuming not inventory.

Corporation - §1032. No gain on issuance of shares & cost basis to A. Reg. §1.1032-1(d).

B's unrelated transfer - not under §351. B as the sole transferor. B is not part of the 80% group.)
Example, cont.

A & B transfer as part of an integrated plan. Both A & B each have Code §351 eligibility. B can take only preferred stock. But, must be qualified preferred - Code §351(g). Simultaneous exchanges not critical if linkage exists. Reg. §1.351-1(a)(1) specifies the transferors must proceed with an expedition consistent with orderly procedure.

Example, cont.

Integrated transaction; but subsequent transfer to daughter by A as a gift a few days after B's transfer. Transfer to D as a post-transfer transaction. Presumably not a binding commitment by A to dispose of these shares.
Example, cont.

Shares sold under a preexisting agreement.

If the transfer was an integral part of the incorporation?

What about a step transaction, and inclusion of transferees as part of the transferor group? No.

Example – Some shares for services (to manager)

Property transferors only own 350 of 500 shares & the control requirement (i.e., 80%) is not satisfied.

§351(d) specifies that stock for services is not considered as issued for property.

Property transferor to recognize all realized gain. Issue not relevant to transfer of cash.

Manager has compensation income - FMV of the stock after the Manager’s receipt?
**Example, cont.**

Manager pays cash for stock. Therefore, Manager is a member of the “control” group.

Property transferor can postpone gain recognition. If a promissory note is issued by Manager - is this "property"? Is issuance of stock for a note permitted under local (corporate) law? Consider the cash flow effect to Manager - salary less: (i) income tax, (ii) note payment, and (iii) note interest.

---

**Example, cont.**

Manager pays small amount for shares. Shares are worth much more and the shares are really for performance of future services. Manager is not a §351 “transferor” after examining the substance of the transaction. Therefore, property transferor is required to recognize all realized gain on the transfer. Manager: Ordinary income over cost.
Example, cont.

Manager pays more cash (not $1,000).

Assuming $1,000 per share, the cash transferred by the Manager might exceed 10 percent of value of the shares for services.

Manager is treated as a transferor - all stock is counted for the transfer rule; the property transferred by Manager will not be considered to be of "relatively small value". Property transfer - no gain recognized.

Example, cont.

Manager receives only some shares without restrictions and other shares subject to restriction - a Code §83 issue exists.

Are restricted shares counted for §351 purposes? If so, §351 qualification - if Manager’s shares. Are the shares treated as Treasury stock and not counted?

§83(a) - no income until the restrictions lapse. §83(h). Function of the §83(b) election?
Example: Possible Multi-Class Structure

Venturer receives nonvoting preferred shares. If nonqualified preferred stock, should be received after the initial §351 transfers and in an unrelated transaction. Use debt? - to enable an interest expense deduction and repayment of the debt without dividend consequences. Operator - 51% to Operator & the remaining shares to manager? Lower the issue price and increase the incentive to Manager.

Treatment of “Boot” Received in Incorporation

§351(b); §358(a), (b)(1); §362(a).

Gain realized is to be recognized, but only to the extent of any “boot” received from corp. Basis limits the total amount of realized gain. Allocation of the boot is made (on a FMV basis) among the transferred assets. Tax character of the gain is determined by reference to the several asset(s) transferred.
Stock Basis Calculation when “Boot” is Received

§358(a) (Basis to the Distributee).
1) Tax basis of the transferred asset
2) Less: FMV of the boot received
3) Plus: Gain amount recognized
4) Equals: Basis to the transferee shareholder of the stock received.

Unrecognized gain remains in the stock.
Basis for the boot: Fair market value, since gain recognition occurring upon receipt.

Rev. Rul. 68-55

Determining the gain amounts, etc., when receiving boot (§351(b)):
1) Asset-by-asset allocation approach.
2) Allocation of the boot consideration on a relative fair market value of assets basis.
3) No loss recognition permitted; no netting.
4) Divided holding period for stock received.
5) Asset tax bases to corp. adjusted for boot.
Stockholder’s Holding Period - Corporation's Tax Basis

Shareholder’s holding period for stock:
split holding period for each share of stock, dependent upon each asset, including, if partially sourced to inventory, no tacked holding period for that portion.

Transferee corporation’s basis for various assets received: transferred basis, plus any boot/gain recognition allocable to each particular item of property.

Timing Considerations for Boot Gain Recognition

Installment gain treatment upon a boot transfer (e.g., corporate debt received)?
1) When must the gain be recognized?
2) What impact to the shareholder's stock basis under §358 for the stock received in the incorporation transaction?
3) What impact under §362(a) to the corporation's tax bases for these assets received? Cf., Crane case analysis re debt.
Example: Transferor A

Transferor A: Equipment: $22,000 FMV; 15,000 basis; 7,000 realized gain (all §1245).
Receives (i) stock & (ii) preferred stock (assuming not “nonqualified”) & (iii) 2,000 cash boot (gain). A's tax basis computation:

Adjusted basis - asset in 15,000
Less boot: 2,000
Plus: income (§1245): 2,000 = 15,000

Example, cont.

Allocation of the $15,000 shareholder basis between two types of stock (based on their relative fair market values):

3/4ths to common stock = 11,250
1/4th to preferred stock = 3,750
15,000

Corporation’s asset basis:
15,000 plus 2,000 gain recognized = 17,000
Example, cont. Transferor B
Boot Allocation Issue

$13,000 gain on inventory - $20,000 fmv.
$15,000 accrued loss on land - $10,000 fmv.
B receives: $15,000 in stock & $15,000 cash.
Boot is to be allocated based on the relative
FMVs of the two transferred assets.
Boot allocated to inventory is 20/30 times
$15,000 cash boot equals $10,000 gain.
Boot allocated to land is 10/30 times $15,000
equals $5,000 - no loss recognition.  Cont.

Example
Transferor B, cont.

B's basis in the stock:  Code §358(a)
7,000  inventory basis
25,000  land basis
less: 15,000  boot received
plus: 10,000  gain recognized
equals: 27,000  (32,000 less 5,000 cash).
Stock holding period is proportionate for
each share of stock received.
Example: Transferor C
Two types of boot received

- Land basis is $20,000 and FMV is $50,000.
- $30,000 realized gain on the transfer of land.
- Stock is received and two types of boot are received: cash & two year note (total 40k).
- All $30,000 gain is to be recognized (not $40,000) - see §351(b)(1). All gain is LTCG.
- Basis is allocated first to the non-recognition property.

Transferor C, cont.

- When reporting on the installment method:
  - Basis 1st to the nonrecognition property (i.e., the X stock - $10,000).
  - Remaining $10,000 is excess basis to the boot.
  - Gross profit ratio $30,000 (10,000 for basis) $40,000 equals 3/4
  - 3/4 of 5,000 cash equals 3,750 current gain.
  - 3/4 of 35,000 = 26,250 - recognized in 2 years.
**Example: Transferor C cont. Stock basis**

C’s stock basis computation:
- Land basis: 20,000
- Less: boot received: 40,000
- Plus: gain recognized: 30,000
- Equals: 10,000

Treated as electing out of §453 installment re.

---

**Additional Example §453(i)**

C transfers depreciable equipment (instead of land):
- Same basis: 20,000
- Same FMV: 50,000
- Original cost: 50,000

 Entire $30,000 would be §1245 gain to be recaptured into income immediately.

Tax basis to the shareholder & corporation?
Assumption of Liabilities

Remember the Crane case: debt relief constitutes an “amount realized”.

§357(a) - the assumption of liability (or the taking of property subject to a liability) will:

(1) not constitute “boot”, and  
(2) not prevent §351 treatment.  

How take this into account? adjust tax basis, as required under §358(d). Reduce tax basis by treating the debt assumption as money.

Section 357(b) Exception

§357(b). Tax avoidance purpose limitation.  
A liability assumption is treated entirely as boot if the taxpayer's principal purpose in transferring some liability was the avoidance of federal income tax or was not for a bona fide purpose.  
Bona fides measured at the corporate level.  
Purpose: to avoid a pre-§351 cash bailout.
Section 357(c) Exception

§357(c). Liabilities in excess of tax basis of transferred property produce a gain amount. Total of liabilities in excess of total of asset bases triggers applicability of this provision. The excess is treated as gain from the sale or exchange of property. Exception for those liabilities deductible when paid. §357(c)(3). This enables avoiding a problem for cash basis taxpayers.

Peracchi case

Taxpayer contributes real estate to his corporation. The real estate is subject to debt in excess of its tax basis. The taxpayer also contributes his promissory note - face value in excess of §357(c) amount. Held: Note has a tax basis equivalent to face amount - eliminating the §357(c) problem. Note is either to be paid by the taxpayer or collected in corporation’s bankruptcy estate.
Alternative §357(c) Planning

Retention by the shareholder of the personal liability for the liability attached to the transferred asset. Does this enable the avoidance of the §357(c) effects? No (Tax Court).

What effect of entering into an agreement that the shareholder (not the corporation) will satisfy the debt?

Seggerman Farms Guarantor status

Taxpayers contributed assets subject to liabilities exceeding tax basis.

Taxpayers remained liable as guarantors.

Court of Appeals ruled §357(c) gain is to be recognized on the transfer.

Personal guarantee of shareholders is not the equivalent of primary liability.
### Example: Liabilities not Exceeding Basis

<table>
<thead>
<tr>
<th>Basis</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inv.</td>
<td>20,000</td>
</tr>
<tr>
<td>Land</td>
<td>20,000</td>
</tr>
<tr>
<td></td>
<td>40,000</td>
</tr>
</tbody>
</table>

Land (recourse) debt is 30,000; Stock issued is 20,000 (50 fmv less 30 debt).

No gain is to be recognized. Stock basis: 40,000 less 30,000 equals 10,000.

### Example – Liabilities Exceeding Basis

<table>
<thead>
<tr>
<th>Basis</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inv.</td>
<td>20,000</td>
</tr>
<tr>
<td>Land</td>
<td>5,000</td>
</tr>
<tr>
<td></td>
<td>25,000</td>
</tr>
</tbody>
</table>

Debt assumed is 30,000 (30 exceeds 25 basis).

Gain recognized is 5,000; Stock - 20k FMV.

Stock basis: 25,000 less 30,000, plus 5,000 (gain to be recognized) equals 0 basis.
**Example**

**Tax Character of 5,000 Gain**

What tax character of A's recognized gain?

Reg. §1.357-2(b). Allocate the §357(c) gain between the transferred assets based on the relative fair market property values (without consideration of the debt).

<table>
<thead>
<tr>
<th>Asset</th>
<th>Value 1/10</th>
<th>Percentage</th>
<th>Gain Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>10,000/50,000</td>
<td>20%</td>
<td>1,000</td>
</tr>
<tr>
<td>Land</td>
<td>40,000/50,000</td>
<td>80%</td>
<td>4,000</td>
</tr>
</tbody>
</table>

**Example:**

**Tax Basis Allocation**

1) If allocating the entire gain to the land (since the land is the only appreciated asset):

- **inventory**: 20,000
- **land**: 5,000 - plus 5,000 gain = 10k recognized and total basis for land is $10,000.

2) If allocation is on the basis of asset FMVs:

- **inventory**: 21,000 (20,000 plus 1,000)
- **land**: 9,000 (5,000 plus 4,000)
Example: Avoiding Gain Recognition

Avoiding gain recognition:
1) Transfer into Corp: (a) $5,000 cash or (b) any other asset with an adjusted basis of at least $5,000.
2) Remain personally liable on at least $5,000 of the mortgage.
3) Transfer a personal promissory note for $5,000 to the corporation.

Example: Liabilities assumed

Building is transferred - basis $100,000; fair market value - $400,000; subject to $80,000 first mortgage; borrowed $10,000 on the building two weeks before incorporation of Y; and, issuance by Y of $310,000 in stock.

Code §357(b) is applicable - assuming no bona fide business purpose for the borrowing for personal reasons immediately prior to incorporation transfer. Bailout amount? cont
Example, cont.:

Basis in the Y stock would be determined as follows:

- Transferred tax basis of the building: $100,000
- Less: $90,000 liabilities assumed
- Plus: $90,000 gain recognized
- Equals: $100,000

Example, cont. – Bank borrowing

Cash - bank to Y Corp, then to shareholder. B will only recognize the $10,000 cash boot. B’s basis in the Y Corp stock would be:

- $100,000 transferred basis of building
- Less: $80,000 liabilities assumed
- Less: $10,000 cash received
- Plus: $10,000 gain recognized
- Equals: $20,000 basis for stock
Incorporation of a Going Business

Transferred assets might include:
- Land & Building (depreciated)
- Machinery & equipment
- Goodwill
- Accounts receivable and inventory
- Previously deducted supplies

Assumed liabilities might include long term debt, accounts payable, contingent liabilities.

Hempt Brothers

Facts: $662,000 in zero basis accounts receivable transferred to a new corporation in exchange for stock.

1) IRS claims partnership's zero basis in the receivable carried over to corporation - corp. realizing income upon collection.
2) Corporation contended receivables were not “property” & transfer to corporation was an "assignment of income".
Rev. Rul. 95-74
Environmental liabilities

§357 effect of potential future liabilities.
Parent drops assets into sub - possible environmental liabilities (CERCLA).
These liabilities are assumed by subsidiary.

1) These potential liabilities are not “liabilities” for §357(c)(1) (and §358(d)).
2) Liabilities assumed by the sub are deductible (or to be capitalized) when paid (by the cash basis taxpayer).

Possible Code §351 Abuse Situations

1) Applicability of the "assignment of income" doctrine.
2) Code §482 is used to appropriately allocate income among taxpayers (e.g., cannot accelerate deductions and deflect related income to corporation).
3) Tax benefit rule - deduction of the cost of property prior to its transfer to Corp.
Example: Cash basis taxpayer

Collection of zero basis accounts receivable:
1) Taxpayer not taxed because the A/Rs are "property" under §351 and can be assigned to the corporation without income recognition. The corporation is taxed when the A/Rs are collected (cash basis taxpayer).
2) The “assignment of income” doctrine does not apply if a valid business purpose exists for the transfer of the accounts receivable.

Example: Accounts payable assumed

Deduction by corporation of accounts payable which were assumed?
Yes, deduction to the transferee of the accounts payable is permitted under §162 when they are paid - unless evidence exists of tax avoidance or the distortion of income.
Example, cont.

Payment of the accounts payable but transfer of the accounts receivable.
Is the “assignment of income” doctrine applicable in this situation?
Evidence of tax avoidance or the distortion of income existent here?
What relevance of §446(b)?

Example

Payment of the accounts payable but transfer of the accounts receivable.
But, taxpayer as an **accrual basis** taxpayer.
Receivables would have been included.
Payables would have been deducted & an assumed liability to Corp.
**Accounting Method?**

Limitations of the choice of accounting method? See §448. A “qualified personal service corporation” - see §448(b)(2) & (d)(2) - and accrual method is not required. Is the calendar year required? Yes, see §441(i)(2).

**Contingent Liability Tax Shelters**

*Black & Decker Corp v. U.S.*

Motion for Summary Judgment

Is basis in stock of sub to be reduced by the contingent liabilities assumed by the sub?

Held: no; deduction to the subsidiary & capital loss to parent corp when selling stock. See §358(h) basis limitation to FMV of the stock received.
**Intentional Avoidance of Code §351**

Code §351 is **not** an elective provision.

Objectives when seeking to avoid §351:

1) Enable a loss deduction (ordinary?).
2) Step up the tax basis for depreciation.

Techniques for avoiding Code §351:

1) Immediately breaking 80% control.
2) **Sale** of an asset to the corporation (including installment sale treatment).

---

**Contributions to Capital - p. 116**

Code §§118(a) & 362(a)(2), (c).

1) No receipt of stock for property to corp.
2) No gain recognized; but, increase to shareholder of tax basis for stock by the cash and adjusted basis of property transferred.
3) This contribution is excludable from gross income of the transferee corporation.
4) Transferred tax basis to the corporation for the assets received.
**Commissioner v. Fink**

Controlling shareholder surrenders some shares to corporation, but retains control.

What deductibility (ordinary loss?) of the tax basis for the surrendered shares?

Held: voluntary surrender of some shares constitutes a contribution to the capital of the corporation. Objective: enhance corp.

No immediately deductible loss actually sustained during the taxable year.

---

**Organizational Expenses - Deduction Available?**

Code §195, §212(3) & §248

§248 – deduction & 180 months amortization deduction for organizational expenses.

§248(b) - defining organizational expenses:

legal fees for drafting the articles of incorporation, but not the costs for issuing or selling the stock.

§195 – start-up expenditures deductible.
Examples:

a) Fees paid for appraisals of A's proprietorship.
A's personal cost and not an expense of the incorporation. An expense of acquiring the stock and added to the tax basis for the stock.

b) Fee paid by the corporation. Treated as a liability of Shareholder A which is assumed by corporation and subject to §357.

Example, cont.

i) Drafting the articles of incorporation - §248 election enables an expense deduction & amortization. Reg. §1.248-1(b)(2).

ii) Deeds, etc. - constitute costs of the specific assets to be added to basis of assets.

iii) Application to issue stock - not considered organizational expense; also, not otherwise deductible or amortizable. Reg. §1.248-1(b)(3)(i).
Example, cont.

iv) §212(3) not available since not applicable to corporations.
Not a §162(a) expense, but should be includible in the organizational expenses under Code §248 and amortizable.

v) Buy-sell agreement - organizational expense under Code §248?? and, therefore, amortizable?