

Chapter Two - Formation of a Corporation

Fundamental federal income tax elements:

- 1) Transferor: §351(a) - nonrecognition treatment is applicable to the asset transferor (if certain conditions are met); otherwise: §1001 gain recognition on the asset transfers.**
- 2) Corporation: Tax-free treatment to corporation issuing its shares in the exchange. §1032.**
- 3) Carryover income tax bases (a) to shareholder (for shares) and (b) to corporation (for assets).**

Section 351 Qualification Requirements

p.56-7

§351(a) - specific requirements:

- a) one or more persons must transfer to corp.;**
- b) they must transfer “property”;**
- c) the transfer 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 be an “investment company”).**

What is the income tax objective for this treatment?

Ancillary Income Tax Rules for §351 Transfers p.57



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

Corporation: §362(a) - transferred basis for assets shifted into corporation. Limit on built-in losses.

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

Limitation to the Transferee when Built-in Loss p.58

Potential for duplication of economic loss.

IRC §362(e)(2) provides limit on transferee's “net built-in loss” when aggregate adjusted bases for properties transferred exceed their total FMV.

Allocation of the built-in loss to basis reduction is made proportionately to corporate loss assets.

Possible election to reduce the specific shareholder's stock basis to fair market value & keep the loss tax basis at the corp. level.

IRC §362(e)(2)(C).

Incorporation Transaction Problem

p.59

Is IRC §351(a) exchange treatment available?

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

Problem

p.59, cont.

Treatment to A: A has no gain realized.

\$25,000 basis for the stock received.

Need to clarify that money is “property” - otherwise, only 75% (less than 80%) of the stock is issued to “transferors” for §351 purposes and the control test is not satisfied.

Problem

p.59, cont.

Treatment to B: Realized gain of \$5,000.

Basis to B of stock received by B is \$5,000.

No tacked holding period for this stock - since inventory (not §1221/1231 property) is transferred.

Gain to B is postponed until the sale of B's stock.

X Corp. has inventory gain when the inventory is sold.

Problem

p.59, cont.

Treatment to C:

Realizes a \$5,000 loss on the land; but the loss is not recognized on this transfer.

Substituted \$25,000 basis for stock under §358(a).

But, is § 362(e)(2) applicable (to the corporation)?

Land is a capital asset – the holding period is tacked - §1223(1) when land held by X Corp.

Should C have sold the land to realize & recognize the loss for C's income tax purposes?

Problem

p.59, cont.

Treatment to D:

\$20,000 gain is realized on the equipment transfer, but no gain recognition is required.

Depreciation recapture applicable under §1245?
Code §1245 provides that “such gain shall be recognized notwithstanding any other provision.”

But, see §1245(b)(3) - an exception is provided in the §351 context. The depreciation recapture potential is preserved at the corporate level.

Problem

p.59, cont.

Treatment to E: Disposition of an “installment obligation” occurs. IRC §453B(a) requires the recognition of the gain upon the “disposition” of an installment obligation. The amount realized is \$20,000; tax basis in note is \$2,000 = \$18,000 gain.

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

Therefore, stock basis to the shareholder is \$2,000.

Problem, Part (b)

p.59

Tax consequences to the corporation:

- 1) §1032 - no gain on issuance of its stock.
- 2) Tacked holding period(s) for the assets received - §1223(2) - but not for the inventory received.
- 3) Carryover tax basis for the various assets received (§362): inventory - \$5,000; land - 20,000 (not 25,000) (see §362(2)(2)(A)) - but, possible election under §362(e)(2)(C)); equipment - 5,000; installment note - 2,000.

Problem, Part (c)

p.59

C transfers two properties:

Parcel 1:	10x FMV	15x basis (loss)
Parcel 2:	<u>10x</u> FMV	<u>8x</u> basis (gain)
	20x	23x total basis

3x net loss is realized.

§362(e)(2)(B) requires a tax basis reduction by 3x.

Netting of gains and losses is permitted to Corp.

Reduce tax basis of Parcel 1 from 15x to 12x.

Option to reduce C's stock basis to 20x.

Problem, Part (d)

p.59

Potential double taxation of inventory gain:

\$5,000 gain to B on the stock sale.

\$5,000 gain to corporation on inventory.

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 the corporation. Cf., partnership tax treatment when “inside gain” is realized (and to be recognized).

“Control” Requirement Defined

p.60

§§351(a) & 368(c) – requirement in the exchange:

80% of voting power, and

80% of the total value of all other stock.

If several transferors to corporation:

- an “integrated plan” is necessary**
- need not transfer all assets simultaneously**
- must have transfers with “expedition consistent with orderly procedure.” Reg. §1.351-1(a)(1).**

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 (then not received in the “exchange”). Intermountain Lumber case - p.61 (binding obligation to transfer ½ of shares issued).

Issue: What tax basis of corporation's assets (i.e., Intermountain, the acquirer) for purposes of tax depreciation; i.e., was the original transfer of the assets to the corporation really a taxable “sale”?

Rev. Rul. 2003-51 p.65

Holding Co. Structure

Transfer of assets to 1st corporation for stock.

Then: (1) Transfer of stock of 1st corp to 2nd corp
& (2) transfer of assets to 2nd corp by another transferor & (3) transfer of all assets to lower tier sub.

Prearranged binding agreement.

But: The nontaxable disposition (not a “sale”) of 1st corp. stock after the 1st §351 transaction does not violate the “control” requirement.

Problem 1(a)

p.66

Code § 351 Eligibility

A as transferor is entitled to §351 treatment:

50 of 60 shares. Exchanged basis of \$10,000 in Newco stock. Tacked holding period under §1223(1) - assuming not inventory.

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

B's (unrelated) transfer - not under §351. B as the sole transferor. B owns only non-voting preferred (and is not part of the 80% group) & 9,000 gain and stock cost basis of 10,000. No gain to Corp.

Problem 1(b)

Integrated plan

p.66, 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, it must be qualified preferred stock - cf., Code §351(g).

Simultaneous exchanges are not critical if linkage exists. Reg. §1.351-1(a)(1) specifies the transferors must proceed with an expedition consistent with orderly procedure.

Problem 1(c) p.66,cont.

Post §351 Gift Transfer

- 1) Same as (b) - i.e., integrated transaction; but March 5 transfer to daughter by A as a gift three days after B's transfer. Transfer by A to D as a post-transfer transaction. Presumably not a binding commitment by A to dispose of these shares & control test satisfied. See state contract law?
- 2) January 5 transfer to D - 3 days after A's transfer. Related? D (holding 50% of common) is not a transferor for §351 purposes. B's transfer fails §351 eligibility. OK for A – if no linkage to B.

Problem 1(d) p.66,cont.

Shares sold under a preexisting agreement.

If the transfer was an integral part of the incorporation only 35 of the 50 voting shares (70%) were received under §351. See *Intermountain*.

What about a “step transaction,” and inclusion of E as part of the transferor group? No – E is not a transferor.

A and B must recognize gain on the exchange.

E would take a cost basis for E's shares.

Transfers of “Property” and Services

p.66

Definition of “property”. Stock received for “services” is not in return for property - §351(d).

What are “services”? Attorney; Promoter; Goods provided with an installation/repair arrangement.

Effect on measurement for 80% requirement on:

- 1) solely a service provider – is not a “transferor.”
- 2) both property (more than *de minimis*) & services - included in control group, but some stock may be gross income to the service provider/transferor.

Solely for “Stock”

p.68

“Stock” means an equity investment in the corporation and does not include:

- 1) stock rights or warrants (defined?)
- 2) securities (i.e., long term debt). Previously “securities” (how defined?) were permitted, but eliminated from enabling §351 eligibility; or
- 3) non-qualified preferred stock - §351(g).

How defined? See §351(g)(2)(A); put & call features, or debt-like characteristics.

Problem a

Incorporation Planning

p.70

Transferors (Nate & Venturer) only own 350 of 500 (70%) shares & the control requirement (i.e., 80%) is not satisfied. Manager receives the other 30%.

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

Nate must recognize all realized gain. Issue is not relevant to Venturer since transferring cash.

Manager has compensation income – what FMV of the stock after the Manager's receipt of her shares?

Problem b

Cash for Stock

p.70

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

Nate can then postpone his gain recognition. §351.

**If a promissory note is issued - is this "property"?
Is issuance of stock for a promissory note permitted
under local (corporate) law? Use an escrow?**

**Consider the cash flow effect to Manager - \$80,000
salary, less: (i) her income tax, (ii) \$30,000 note
principal payment, and (iii) note interest expense.**

Problem c p.70

Limited Cash for Mgr. Stock

Manager pays \$1,000 for 150 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, Nate is required to recognize all his realized gain on the Java transfer.

Manager: Ordinary (compensation) income (\$149,000?) over the \$1,000 cost.

Problem d

p.70

More than 10% Cash for Stock

Manager pays \$20,000 cash (not \$1,000).

Assuming \$1,000 per share, the \$20,000 transferred by the Manager will exceed 10% of value of the shares for services. But, \$130,000 is compensation.

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." What stock value?

Nate - no gain recognized since 80% control group.

Problem e p.70

Delayed Stock Delivery

Manager receives only 20 shares without restrictions and another 130 shares are subject to restriction - a Code §83 issue exists.

Are the 130 shares counted for §351 purposes?

If so, §351 qualification - with Manager's shares. If not counted: are the 130 shares treated as Treasury stock and, therefore, not counted for §351 purposes?

§83(a) - no income until the restrictions lapse.

§83(h). Function of the §83(b) election? Cash available to pay her taxes?

Problem f Possible Multi-Class Structure p.70

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

Tax basis limits the total amount of realized gain for the transferor into the corporation.

Allocation of the boot is made (on a FMV basis) for tax purposes among the transferred assets.

Tax character of the gain is determined by pro rata reference to the several asset(s) transferred.

Stock Basis Calculation when “Boot” is Received

§358(a) - Tax basis to shareholder for the distributed stock:

- 1) Tax basis of the asset transferred to corp.
- 2) Less: FMV of the boot received
- 3) Plus: Gain amount recognized
- 4) Equals: Basis to the transferee shareholder of the stock received from transferee corp.

Any unrecognized gain remains in the stock.

Tax basis for the boot: Fair market value, since full gain recognition occurs upon receipt. §358(a)(2)

Allocating the boot gain

Multiple asset transfers; Determining the several gain amounts, etc., when receiving boot (§351(b)):

- 1) Asset-by-asset allocation, i.e., separately.**
- 2) Allocation of the boot consideration on the basis of the relative fair market values of assets.**
- 3) No loss recognition permitted; no netting.**
- 4) Divided holding period for each share received.**
- 5) Asset tax bases to the corp. are adjusted for the boot gain recognized & the loss not recognized.**

Stockholder's Holding Period - Corporation's Tax Basis p.75

- 1) 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 of each share. Rev. Rul. 85-164.
- 2) Transferee corporation's basis for various assets
received: (1) transferred basis, plus (2) any
boot/gain recognition allocable to each particular
item of property.

Timing Considerations for Boot Gain Recognition p.76

Installment gain (§453) treatment upon a boot transfer (e.g., stock received, plus corporate debt)?

- 1) The shareholder's gain is to be recognized later.
- 2) What impact to the shareholder's stock basis under §358 for the stock received in the incorporation transaction? Current basis increase.
- 3) Delayed impact under §362(a) to the corporation's tax bases for these assets received?
Cf., Crane case analysis re debt (nonrecourse).

Tax Basis Allocation When Boot is Installment Debt

Allocation of shareholder's tax basis – page 77-78.

- 1) First to the nonrecognition property (i.e., stock).
- 2) Any remaining (i.e., excess) tax basis is then allocated to boot to limit the gain realized amount.
- 3) If an installment note is received (as boot) -- allocation of any remaining basis is made under the installment method, i.e., proportionately.

(Shareholder's gain recognition timing affects the corp's §362 basis for the assets transferred to it.).

Problem: Transferor A

p.79

Transferor A: Equipment: \$22,000 FMV;
15,000 basis; 7,000 realized gain (all §1245).

Receives (i) common stock, (ii) preferred stock (not “nonqualified”), & (iii) \$2,000 cash boot (gain).

A's tax basis computation for (combined) stock:

Adjusted basis	15,000
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Less boot (cash):	2,000
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Plus: income (§1245):	2,000	=	15,000
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continued

Transferor A, continued

p.79

Allocation of the \$15,000 shareholder basis between two types of stock (based on their relative fair market values – 15 & 5 = 20 FMV):

3/4ths to common stock = 11,250

1/4th to preferred stock = 3,750
15,000

Corporation's tax basis for A's asset received:

15,000 plus 2,000 gain recognized = 17,000

(22-17 = 5 gain yet to be recognized)

Transferor B

p.79

Boot Allocation Issue

\$13,000 gain on inventory - \$20,000 fmv.

\$3,000 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 the \$15x cash boot – equals \$10x gain (20x less 10x).

Boot allocated to land is $10/30$ times \$15,000 equals \$5,000 - but, no loss recognition. *Cont.*

Transferor B, p.79, cont.

B's basis in the stock: Code §358(a)

7,000 inventory basis

13,000 land basis = 20,000 total

less: 15,000 boot received

plus: 10,000 gain recognized (of 15,000)

equals: 15,000 (20,000 less 5,000 cash).

Stock holding period is proportionate for each
share of stock received. *Cont.*

Transferor B, p.79, cont.

Corporation's basis for assets received:

Code §362

1) Inventory $7,000 + 10,000$ gain = 17,000

2) Land 13,000

Note: \$30,000 aggregate basis does not exceed the \$30,000 fair market value and, therefore, no built-in loss/§362(e)(2) applicability.

Transferor C p.79

Two types of boot received

Land basis is \$20,000 and FMV is \$50,000.

\$30,000 realized gain on C's transfer of land.

Stock (10x) is received & two types of boot are received: (1) 5x cash & (2) a two year 35x note (total 40x boot).

All \$30,000 gain is to be recognized (not \$40,000) - see §351(b)(1). All gain is LTCG (land).

Basis is allocated first to the non-recognition property (10x of 20x to stock).

continued

Transferor C p.79,cont.

When reporting on the installment method:

Basis 1st to the nonrecognition property

(i.e., the X stock – the first \$10,000 of \$20,000).

Remaining \$10,000 is excess basis to the boot.

Gross profit ratio 30,000 (10,000 for basis)

40,000 - $\frac{3}{4}$ as gain

$\frac{3}{4}$ of the 5,000 cash equals 3,750 current gain.

$\frac{3}{4}$ of 35,000 note = 26,250 - recognized in 2 years.

Transferor C p.79,cont. Shareholder's stock basis

C's stock basis computation:

Land basis:	20,000
Less: boot received:	40,000
Plus: gain recognized:	<u>30,000</u>
Equals:	10,000

Shareholder treated as electing out of §453 installment treatment for shareholder tax basis purposes (and FMV basis for shares is 10,000).

Transferor C p.79,cont. Corporation's basis for land

Corp's land basis computation:

Land basis:	20,000
Plus: gain recognized:	<u>3,750 (on note)</u>
Equals:	23,750

When note is paid (two years later) tax basis for land is increased by \$26,250 to \$50,000.

Problem (b)

p.79

§453(i) Applicability

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 (10x for stock) & corporation – 50x (20x + 30x gain) for equipment?

Assumption of Liabilities

§357

p.80

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 the tax basis by treating the debt assumption as money received.

Section 357(b) Exception if a “Tax Avoidance Purpose”

§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” (i.e. borrowing against property immediately before an incorporation transfer).

Section 357(c) Exception if Liabilities Exceed Total Basis

§357(c). Liabilities in excess of tax basis of the transferred property produce a gain amount.

Total of the liabilities in excess of the total of the asset bases triggers applicability of this provision.

The excess is treated as gain from the sale or exchange of property. What tax character?

Exception for those liabilities deductible when paid.

§357(c)(3). This enables avoiding a gain problem for cash basis taxpayers (i.e., accounts payable).

The Excess Liabilities Problem

p.83

How solve this “liabilities exceeding total tax basis” problem – to avoid gain recognition at the time of the incorporation (e.g., when assuming payables)?

- Contribute cash to equalize debt & tax basis
- Contribute high-basis debt-free property
- Contribute a promissory note in an amount at least equal to the “negative basis”
- Remain personally liable on the debt property?

Peracchi case p.84

Promissory Note & Tax Basis?

Taxpayer contributes real estate to his corporation.
Real estate subject to debt in excess of its tax basis.

The taxpayer also contributes his promissory note -
face value of note in excess of the §357(c) amount.

Held: The note has a tax basis equivalent to the face
amount - eliminating the §357(c) problem.

The note is either to be paid by the taxpayer or
collected in the corporation's bankruptcy estate.

The note is not a “sham” (p. 92). See IRS
stipulation re business purpose existing (p. 92).

Alternative §357(c) Planning – Retain Liability?

P. 95. Retention by the shareholder of the personal liability for that liability which is attached to the transferred asset. Does this enable the avoidance of the §357(c) effects? No avoidance. (Tax Court).

What effect of entering into an agreement that the shareholder (not the corporation) will satisfy the debt (e.g., guarantee agreement)? Court position: guarantees are not the same as a direct debt (including the shareholder's promissory note).

See next slide.

Seggerman Farms

Footnote 83, p.96

Taxpayers contributed assets subject to liabilities exceeding tax basis.

But, taxpayers remained liable as guarantors of these liabilities.

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

Personal guarantee of the shareholders is not the equivalent of primary liability. Correct result?

What are the terms of a guarantee agreement relating to continued indebtedness?

Problem 1(a) - Liabilities not Exceeding Basis

p.98



	Basis	FMV
Inventory	20,000	10,000
Land	<u>20,000</u>	<u>40,000</u>
	40,000	50,000

Land (recourse) debt is 30,000 & X Corp. (as transferee) takes land subject to this debt.

Stock is issued for 20,000 (50 fmV less 30 debt).

No gain is to be recognized (basis exceeds liability).

Stock basis: 40,000 less 30,000 debt = 10,000 excess.

Problem 1(b) – Liabilities Exceeding Basis

p.98



	Basis	FMV
Inv.	20,000	10,000
Land	<u>5,000</u>	<u>40,000</u>
	25,000	50,000

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

Gain to be recognized is 5,000; Stock = 20x FMV.

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

Problem 1(c) p.98

Tax Character of 5,000 Gain

What is the tax character of A's recognized gain?

See Reg. §1.357-2(b).

Allocate the §357(c) gain of \$5,000 between the transferred assets based on their relative fair market values (without consideration of the debt or tax basis for the several properties).

Inventory	10,000/50,000	20% = 1,000
Land	40,000/50,000	80% = <u>4,000</u>
		5,000

Problem 1(d)

p.98

Tax Basis Allocation

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

inventory 20,000 basis

land 5,000 - plus 5,000 gain = 10k

Gain recognized and total basis for land is \$10,000.

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

inventory 21,000 (20,000 plus 1,000)

land 9,000 (5,000 plus 4,000)

Problem 1(e)

p.98

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. ?? probably not.**
- 3) Transfer a personal promissory note for \$5,000 into the corporation (e.g., Peracchi).**

Problem 2(a)

p.98

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 (400 less 80 and less 10).

Code §357(b) is applicable - assuming no bona fide business purpose for the borrowing for personal reasons immediately prior to incorporation transfer. Bailout amount? 90x (not 10x).

Cont.

Problem 2(a), cont.

p.98

B's 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 basis

Problem 2(b)

Only Cash Boot

p.98

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

p.99



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 **p.99**

Accounts Receivable to Corp.

Facts: \$662,000 in zero basis “accounts receivable” transferred to a new corporation in exchange for stock in a §351 transaction.

- 1) IRS claims partnership's zero basis in the receivable is carried over to corporation - corp. realizing income upon collection of receivable.**
- 2) Corporation contended receivables were not “property” & the transfer to the corporation was an “assignment of income” &, therefore, gain recognition occurred to the transferor.**

Environmental liabilities

§357 effect of potential future liabilities.

Parent drops assets into sub – with possible environmental liabilities (CERCLA).

These liabilities are assumed by a subsidiary.

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

Possible Code §351 Abuse Situations

P.106

- 1) Applicability of the “assignment of income” doctrine to cause income to the transferor.
- 2) Code §482 can be used to appropriately allocate income among related taxpayers (e.g., cannot accelerate deductions and deflect related income to the corporation).
- 3) “Tax benefit rule” - deduction of the cost of property prior to its transfer to Corp. Recovery of deduction by transferor? Note Hillsboro (p. 108).

Problem (a)

p.109

Incorporation Transfers

Possible income tax consequences:

Is gain to be recognized by transferor? No.

Do the assumed liabilities exceed tax basis?

No, consider §357(c)(3) (70,000 not “liabilities”).

Liability (bank loan) assumed of \$30,000 (not 100x)
& is less than the \$60,000 total tax basis.

Tax basis for the shares received by shareholder:

\$60,000 less 30,000 debt assumed = \$30,000

Stock holding period is partially tacked.

Problem (b)

p.109

Cash basis taxpayers

Collection of zero basis accounts receivable:

- 1) Architect is not taxed because the A/Rs are "property" under §351 and can be assigned to the corporation (Design) without income recognition. The corporation has income when the “zero basis” A/Rs are collected (i.e., a 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 to Corp.

Problem (c) p.109

Accounts payable assumed

Is deduction by the corporation of accounts payable which were assumed permitted?

Yes, deduction to the transferee of the accounts payable is permitted under Code §162 when accounts payable are paid by transferee - unless evidence exists of tax avoidance or the distortion of income by transferor.

Environmental remediation costs – deduction or capitalization of amount paid is permitted.

Problem (d) Only Partial Transfer

p.109

Payment of the accounts payable (deduction) by transferor but transfer of the accounts receivable (income) to the corporation.

Is the “assignment of income” doctrine applicable in this situation? Is evidence of tax avoidance or the distortion of income existent here? Probably.

What relevance of §446(b) (“clear reflection of income”)? Or, §482. Architect includes income when accounts receivable are collected?

Problem (e)

p.109

Accrual Basis Transferor

Payment of the accounts payable by Transferor but transfer of the accounts receivable to Corporation. But, assume Architect is an accrual basis taxpayer.

Receivables previously would have been included in Architect's GI. Payables would have been deducted & an assumed liability to Corp.

Stock basis: $60 \text{ plus } 60 = 120 \text{ basis less } 100 \text{ debt} = 20 \text{ net basis (and no } \S 357(c) \text{ gain)}.$

Problem (f)

Accounting Method

p.109

1) Limitations of the choice of accounting method? See §448.

Design probably a “qualified personal service corporation” - see §448(b)(2) & (d)(2) – and, the accrual method is not required.

2) Accounting period. Is the calendar year required? Yes, see §441(i)(2).

Contributions to Capital - p.110

- 1) No receipt of stock for the property contributed to corporation by the existing shareholder.
- 2) No gain is to be recognized; but, an increase to shareholder of tax basis for his stock by the cash and adjusted basis of property transferred to corp.
- 3) This contribution is excludable from the gross income of the transferee corporation. §118(a).
- 4) Transferred tax basis to the corporation for the assets received from shareholder. §362(a)(2), (c).

Commissioner v. Fink, p.110

Loss Deductibility?

Controlling shareholder surrenders some shares to corporation, but retains control (72% to 68%).

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

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

No immediately deductible (ordinary) loss actually sustained during taxable year. Reallocate tax basis.

Intentional Avoidance of Code §351 p.111

Code §351 is not an elective provision.

Objectives when seeking to avoid §351:

- 1) Enable a loss deduction (ordinary?).
- 2) Step up a property's tax basis for depreciation.
- 3) Freeze accrued value as potential capital gain.

Techniques for avoiding Code §351:

- 1) Immediately breaking 80% control.
- 2) Sale of an asset to the corporation (with possible §453 installment sale treatment). P.111.

Organizational Expenses - Is a Deduction Available?

P. 112 Code §195, §212(3), & §248

§248 – \$5,000 deduction (with phase-out) & 180 months amortization 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 – \$5,000 “start-up expenditures” are deductible (but phase-out), with 180 month amortization for remainder.

Problems

Appraisal Fees

p.113

a) \$3,000 fees paid for appraisals of A's proprietorship (property). A's personal cost and not an expense of the incorporation. An expense of acquiring the stock and added to the shareholder's tax basis for the stock.

b) Fee paid by the corporation. Treated as a liability of Shareholder A which is assumed by the corporation and is subject to §357 liability treatment. Probably 357(b) &(c) not applicable.

Problem c

p.113

Document Preparation

- i) Drafting the articles of incorporation
 - §248 election enables an expense deduction (\$5000) & then amortization. Reg. §1.248-1(b)(2).
- ii) Deeds, etc. - constitute costs of the specific assets & to be added to the tax basis of these assets.
- iii) Application to issue stock - not considered an organizational expense; also, not otherwise deductible or amortizable. Frozen into franchise cost. Reg. §1.248-1(b)(3)(i).

continued

Problem c

p.113

- iv) IRS ruling request - §212(3) deduction treatment is not available since this provision is not pertinent 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 organizational expense?