Presentation:

Corporate Taxation
Chapter Two: Corporate Formation
Professors Wells

January 18, 2017

Key Statutory Provision: §351, §357, §358, §362, §368(c), §1032, §1223(1), §1223(2), §1245(b)(3), §118, §195, §212(3), §248
Fundamental income tax elements:

1) Transferor: §351(a) – nonrecognition treatment applicable to the asset transferor (if certain conditions are met); otherwise: §1001 gain recognition.

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

3) Carryover tax bases to shareholder (shares) and corporation (assets).
§351(a) – specific requirements:

a) One or more persons must transfer “property” to the corporation;

b) Transfer must be in exchange for “stock” of the issuing corporation – no “securities”; and,

c) The transferor “group” must be in “control” immediately after the exchange (but not be an “investment company”). What income tax objective for this treatment?

§351(b) – gain recognized to extent “boot received.”
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 – carryover 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.
Limitation to Transferee When Built-In Loss

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 exceeds total FMV.

Allocation proportionately of built-in loss to various corporate assets.

Possible election to reduce specific shareholder’s stock basis to fair market value & keep loss basis at corp. level. IRC §362(e)(3)(C).
Is §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 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.
Treatment to A: No gain realized & $25,000 basis for stock received.

Note: money is “property” – otherwise, only 75% (less than 80%) of the stock to transferors for §351 purposes. This is important for other transferors, not A.

Treatment to B: Realized gain of $5,000, but no gain recognized per §351. B’s stock basis is $5,000 per §358(a)(1). B has no tacked holding period since not a capital asset or §1231 property per §1223(1).

Treatment to C: Realizes $5,000 loss, but the loss is not recognized per §351. Substituted $25,000 basis for stock under §358(a). Holding period is tacked per §1223(1). Note corporation reduces basis per §362(e)(2). Should C have sold the land?
Treatment to D: $20,000 gain is realized, but no gain recognition is required per §351. No depreciation recapture under §1245 due to §1245(b)(3). Depreciation recapture potential is preserved at the corporate level.

Treatment to E: $18,000 gain realized (FMV $20,000/Basis $2,000), but none recognized per §351.

NOTE: §453B(a) generally requires the recognition of the gain upon the disposition of an installment obligation, but Treas. Reg. §1.453-9(c)(2) specifies that no gain recognition is required upon disposition of an installment obligation in a §351 transfer.
1) §1032 – no gain on stock issuance.

2) Tacked holding period(s) for the assets received except for inventory per §1223(2).

3. Carryover tax basis for the various assets received (§362)

   - Inventory: $5,000
   - Land: $20,000 (not 25,000)
   - Equipment: $5,000
   - Note: $2,000

[Note possible corporate election under §362(e)(2)(C)]
**FACTS**

Parcel 1: FMV = 10x Basis = 15x
Parcel 2: FMV = 10x Basis = 8x

**ANALYSIS**

1. §362(e)(2) requires 3x basis reduction. Netting of gains and losses is permitted. Reduce tax basis of Parcel 1 from 15x to 12x. Parcel 2 basis is 8x.

2. Alternative: C & X can jointly elect to reduce C’s stock basis to $20,000 and if so then X can keep full $15x basis in Parcel 1.
B’s Inventory Contribution

1. Substitute basis for B of $5,000 preserves $5,000 shareholder level gain for B.
2. Carryover $5,000 basis to X in inventory causes another $5,000 gain to X on corporation’s sale of inventory.

Implication: The “price” for allowing non-recognition/deferral of the realized gain is the potential doubling of that gain recognition later.
“Control” Requirement Defined

§§351(a) / §368(c) – requires “control” of
1. 80% of voting power, and
2. 80% of total value of all other stock.

“Immediately after the exchange”

If several transferors:
- An “integrated plan” is necessary
- Need not transfer all assets simultaneously
- Must, however, transfer with “expedition consistent with orderly procedure.”

Question: What if a disposition of the stock occurs immediately after its acquisition?
### Transaction Steps

1. Shook transferred mill to S&W for 364 shares
2. Shook sold stock for Wilson note
3. Lender loaned $200,000 to S&W with Wilson (and Shook) guarantee

### Issue

What tax basis of corporation’s assets (i.e., Intermountain) for purposes of tax depreciation – to the acquirer; i.e., was the original transfer of the assets to the corporation really a “sale”?
Prearranged Plan As Follows:
1. X transfers business assets to X Subco for all X Subco stock
2a. X transfers X Subco stock to Y Subco for Y Subco stock
2b. Y transfers $30x of cash for Y Subco stock
3. Y Subco transfers assets plus the $30x of cash to X Subco

Holding: Good §351 transfers throughout. The nontaxable disposition of X Subco stock after Step #1 does not violate the “control” requirement because the transaction does not resemble a taxable sale.
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 an installation/repair arrangement.

Effect on the 80% requirement of:
1) Solely a service provider – 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.
1. Jan 2: A forms new and transfers assets for stock
2. March 2: B transfer assets to Newco for stock

A entitled to §351 treatment
1. A takes $10,000 basis in Newco stock.
2. A takes a tacked holding period under §1223(1) in its Newco stock (assuming not inventory).
3. Newco has no gain on issuance of its share per §1032 shares.
4. Newco takes a transferred basis under §362(a).

B’s Transfer: Not Entitled to §351 because not a joint transferor and not in control
1. B recognizes gain and takes a cost basis in Newco stock.
2. Newco recognizes no gain on issuance of Newco stock per Treas. Reg. §1.1032-1(d).
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 – 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.
Same as (b) – i.e., integrated transaction; but A transfers 25 shares to daughter on March 5 transfer as a gift **three days after** B’s transfer.

Result: Transfer to Daughter as a post-transfer transaction does not break control as long as no **binding commitment** by A to dispose of these shares.

What if A transfers the 25 shares to Daughter on January 5\(^{th}\) before B’s transfer?

Result: D is **not** a transferor for §351 purposes, so B’s transfer fails §351 and perhaps so does A’s transfer if A&B are joint transferors.
A sales 15 shares under pre-existing agreement to E.

Result: If the transfer was an integral part of the incorporation only 45 of the 60 shares (75%) were received under §351. A and B recognize gain on the exchange. E takes a cost basis for E’s shares.

Question: Could E be included as part of the transferor group under a step transaction analysis? No, E did not contribute to Newco.
“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” permitted (how defined?), but eliminated from §351 eligibility; or
3) Non-qualified preferred stock - §351(g). (How defined? See §351(g)(2)(A); debt-like).
Result: Transfers fail §351. Transferors (Nate and Venturer) only own 350 of 500 (70%) shares & the control requirement (i.e., 80%) is not satisfied. §351(d) specifies that stock for services is not considered as issued for property.

Consequences: Nate to recognize all realized gain. Manager has compensation income equal to FMV of stock. Venturer is not impacted since Venturer transferred cash.
REVISED FACTS:
Manager pays cash for stock. Therefore, Manager is a member of the “control” group.

RESULTS: Nate can postpone gain recognition. Manager’s P-note is considered “property.” [Further discussed in Peracchi]

Consider the cash flow effect to Manager - $80,000 salary less: (i) income tax, (ii) $30,000 note principal payment, and (iii) note interest expense.
REVISED FACTS:
Manager pays $1,000 cash for stock.

RESULTS: 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 realized gain on Nate’s transfer.

Manager: Ordinary income equal to the difference between the FMV of the stock and $1,000.
REVISED FACTS:
Manager pays $20,000 cash for stock.

RESULTS: Assuming $1,000 per share (total of $20,000) transferred by the Manager will exceed 10% of the value of the shares for services, then Manager will be respected as a transferor. Once Manager is treated as a transferor, all of Manager’s stock is counted. Distinction being drawn is that the property transferred by Manager (more than 10% of value of stock) is not considered to be of “relatively small value”. Thus, Nate recognizes no gain. But, Manager recognizes income on service-for-stock component (equal to difference of FMV of stock and property transferred).
REVISED FACTS:
Same as (d) except Manager receives 20 unrestricted shares and 130 restricted shares

RESULT:
Are the 130 shares counted for §351 purposes? Yes, if a §83(b) election in which cash all of manager’s shares are counted. However, if no §83(b) election, then the answer is unclear. Perhaps they are treated as Treasury stock until vested and thus not counted?

§83(a) – no income until restrictions lapse.
§83(h). Function of the §83(b) election
REVISED FACTS:
Nate/Venturer receive preferred stock for current value of Newco and Manager pays nominal fair value for speculative value of common.

RESULT: As long as the preferred stock were not nonqualified preferred stock, then the transaction may work.
Gain realized is to be recognized, but only to the extent of any “boot” received from corp.

Tax 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) – Tax basis for 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.

Unrecognized gain remains in the stock.

Basis for the boot: Fair market value, since gain recognition occurring upon its receipt.
### Determining the gain amounts, etc., when receiving boot (§351(b)):

1. **Asset-by-asset allocation approach**
2. **Allocation of boot on a relative FMV basis.** Gain recognized to the extent of boot (3x and 5x). No loss recognition or netting
3. **Divided holding period for shares.** See Rev. Rul. 85-164
4. **Asset tax bases to corp. adjusted for boot**

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Asset I</th>
<th>Asset II</th>
<th>Asset III</th>
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<tbody>
<tr>
<td><strong>Fair market value of asset transferred</strong></td>
<td>$110x</td>
<td>$22x</td>
<td>$33x</td>
<td>$55x</td>
</tr>
<tr>
<td><strong>Percent of total fair market value</strong></td>
<td></td>
<td>20%</td>
<td>30%</td>
<td>50%</td>
</tr>
<tr>
<td><strong>Fair market value of Y stock received in exchange</strong></td>
<td>$100x</td>
<td>$20x</td>
<td>$30x</td>
<td>$50x</td>
</tr>
<tr>
<td><strong>Cash received in exchange</strong></td>
<td>10x</td>
<td>2x</td>
<td>3x</td>
<td>5x</td>
</tr>
<tr>
<td><strong>Amount realized</strong></td>
<td>$110x</td>
<td>$22x</td>
<td>$33x</td>
<td>$55x</td>
</tr>
<tr>
<td><strong>Adjusted basis</strong></td>
<td>40x</td>
<td>20x</td>
<td>25x</td>
<td></td>
</tr>
<tr>
<td><strong>Gain (loss) realized</strong></td>
<td>($18x)</td>
<td></td>
<td>$13x</td>
<td>$30x</td>
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</tbody>
</table>

Under section 351(b)(2) of the Code the loss of 18x dollars realized on the exchange of Asset Number I is not recognized. Such loss may not be used to offset the gains realized on the exchanges of the other assets. Under section 351(b)(1) of the Code, the gain of 13x dollars realized on the exchange of Asset Number II will be recognized as short-term capital gain in the amount of 3x dollars, the amount of cash received. Under sections 351(b)(1) and 1245(b)(3) of the Code, the gain of 30x dollars realized on the exchange of Asset Number III will be recognized as ordinary income in the amount of 5x dollars, the amount of cash received.
Shareholder’s holding period for stock:
Split holding period for each share of stock, dependent upon each asset.

Transferee corporation’s basis for various assets received: transferred basis, plus any boot/gain recognition allocable to each particular item of property.
Installment gain treatment upon a boot transfer (e.g., corporate debt received)?

1) **When** must the gain be recognized?
   1) **Answer:** General rule is immediate gain recognition if cash or property received as boot. But, if a corporate note is received and installment sale treatment is applicable, then §453 may allow deferral of gain to when payments received.

2) **What impact to the shareholder’s stock basis under §358 for the stock received in the incorporation transaction?** Current increase.

3) **Delayed impact under §362(a) to the corporation’s tax bases for these assets received.** Prop. Treas. Reg. §1.454-1(f)(3).
1) First to the nonrecognition property.
2) Any remaining (i.e., excess) basis allocated to the boot to limit gain realized amount.
3) If installment note received (as boot) allocation of any remaining basis is made under the installment method, i.e., proportionately.
   (Gain recognition timing affects corp’s basis).
Problem: Transferor A

Transferor A
1. 7,000 realized gain; $2,000 recognized
2. A’s tax basis computation: 15 (A/B) – 2 (Boot) + 2 (gain rec.) = 15
3. A’s Basis Allocation (relative FMV)
   3/4th c.s. = 11,250
   1/4th Pfd. = 3,750
   15,000

X Corporation
1. Tax basis in A asset 15,000 plus 2,000 gain recognized = 17,000
2. X takes a tacked holding period per §1223(2)
4. A has tacked holding period per §1223(1)
Transferor B
1. 13 realized gain & $3 realized loss;
2. Boot allocated 10 to inventory / 5 to land
3. Gain recognized of 10
4. Stock basis (7+13+10 gain -15 boot=15) per §358
5. Stock holding period proportionate based on assets contributed.

X Corporation
1. Tax basis in B asset (7+10 gain+13=30)
2. Note: $30 aggregate basis doesn’t exceed $30 FMV; therefore, no built-in loss/§362(e)(2) applicability.
Transferor C

30 realized gain;
Boot of 40

$30 gain rec. on installment basis
  Year 1 (5 cash x 30 gain/40 pmts = $3,750)
  Year 3 (35 note paid x 30 gain/40 pmts = $26,250)

Stock basis (20+30 gain -40 boot =10)
Holding period is tacked per §1223(1)

X Corporation
Tax basis in C asset
Year 1: 20,000+3,750 = $23,750
Year 3: $23,750+$26,250 = $50,000
Problem (b) §453(i)

Section 453(i) requires all $30,000 of realized gain to be recognized and does not allow installment reporting for §1245 gain.

Transferor C
Stock Basis:
20+30 gain -40 boot=10

X Corporation
1. Tax basis in C asset
Year 1: 20,000+30,000=$50,000
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.
§357(b). Tax avoidance purpose limitation.

A liability 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).
§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 asset bases triggers applicability of this provision.

The excess is treated as gain from the sale or exchange of the property.

Exception for those liabilities deductible when paid. §357(c)(3). This enables avoiding a gain problem for cash basis taxpayer (i.e. accounts payable).
How solve this liabilities exceeding basis problem – to avoid gain recognition at incorporation time?

- Contribute cash to equalize
- Contribute high-basis debt-free property
- Contribute a promissory note in an amount at least equal to the “negative basis” (see Perrachi)
- Remain personally liable on the debt. §357(d).
FACTS: Perrachi contributes real estate to wholly-owned corporation ("NAC"). Real estate 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: Shareholder’s Personal Note has a tax basis equivalent to face amount – eliminating the §357(c) problem. The Shareholder Note is either to be paid by the taxpayer or collected in the corporation’s bankruptcy estate. The Perrachi Note is not a “sham” (p.91). See IRS stipulation that the note contribution has a business purpose.
Alternative §357(c)
Planning – Retain Liability?

p. 95. 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 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 debt (including shareholder’s promissory note).
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 in a guarantee agreement?
### Problem 1(a) – Liabilities Not Exceeding Basis

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<th>FMV</th>
<th>Recourse Debt</th>
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<tbody>
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<td>Inv.</td>
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<tr>
<td>Land</td>
<td>20,000</td>
<td>40,000</td>
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<tr>
<td></td>
<td>40,000</td>
<td>50,000</td>
<td>&lt;30,000&gt;</td>
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</table>

Stock issued for 20,000.

**Result:** No gain is to be recognized.

A Stock Basis: $40,000 - 30,000$ debt = $10,000$ excess per §358(d)(1).
### Problem 1(b)
**Liabilities Exceeding Basis**

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<tr>
<td>Land</td>
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<td>20,000</td>
</tr>
<tr>
<td></td>
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</table>

Debt assumed exceeds basis.

Gain recognized is 5,000 per §357(c)

B’s Stock Basis: 25,000 - 30,000 debt + 5,000 gain = zero per §358(a) & (d).
Problem 1(c)  
Tax Character of 5,000 Gain  p.98

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<th>Basis</th>
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<td>Inv.</td>
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<tr>
<td>Land</td>
<td>5,000 20,000</td>
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</tr>
<tr>
<td></td>
<td>25,000 40,000</td>
<td>50,000 &lt;30,000&gt;</td>
</tr>
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</table>

What tax **character** of A’s recognized gain?

Reg. §1.357-2(b). Allocate the §357(c) gain of $5,000 between the transferred assets based on the relative **fair market values** (without consideration of the debt or tax basis).

- **Inventory** 10,000/50,000  
  20% = 1,000 gain (ordinary)
- **Land** 40,000/50,000  
  80% = 4,000 gain (LTCG)  
  5,000
Problem 1(d)  
Tax Basis Allocation  

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

<table>
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<tr>
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<tbody>
<tr>
<td>Inv.</td>
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<tr>
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<tr>
<td></td>
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<td>&lt;30,000&gt;</td>
</tr>
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</table>

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

If allocation is on the bases of asset FMV:

Inventory 21,000* (20,000 plus 1,000)
Land 9,000 (5,000 plus 4,000)

*But §362(d)(1)
### 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 **primarily** liable on at least $5,000 of the mortgage. §357(d)

3) Transfer a personal promissory note for $5,000 to the corporation (e.g., Peracchi).

### Table:

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**Problem 2(a)**

**Liabilities Assumed**

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<td></td>
<td></td>
<td>&lt;80,000&gt;</td>
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<tr>
<td>2d Mortgage (2 weeks b/4 contribution)</td>
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<td>&lt;10,000&gt;</td>
</tr>
</tbody>
</table>

**FACTS:** Building is transferred subject to $80,000 first mortgage & $10,000 second mortgage incurred two weeks before incorporation of Y for Y stock.

**RESULT:** Code §357(b) is applicable – assuming no bona fide business purpose for the incremental $10,000 borrowing.

1. **Boot consequences:** The full **90,000 is boot** (not just the $10,000).
2. **B Basis in Stock:** 100+90-90=100 per §358(a) & (d).
FACTS: Bank Lends to Y Corp which then pays the cash to B.

RESULT: §357(b) is not applicable
1. B recognizes gain only on the $10,000 cash boot.
2. B’s Stock Basis (100-80+10-10=20) per §358(a) & (d).
Transferred assets might include:

- Land & Building (depreciated)
- Machinery & Equipment
- Goodwill
- Accounts Receivable & Inventory
- Previously Deducted Supplies

Assumed liabilities might include long term debt, accounts payable, contingent liabilities.
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”.
FACTS: Parent drops assets into sub – with possible environmental liabilities (CERCLA). These liabilities are assumed by subsidiary.

ISSUE: What impact does §357 have on potential future liabilities.

RESULT:
1) These potential (contingent) 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).

Caveat: §357 may apply in abuse situation such as §482, “tax benefit rule” scenario. Note the Hillsboro case (p.112).
FACTS: Architect deducted supplies and has contingent liability.

RESULT:
1. Liabilities do not exceed tax basis due to §357(d)(2) and (c)(3).
2. Architect’s Stock basis: $60,000 - 30,000 = 30,000 per §358(a) & (d)
Problem (b)  
Cash Basis Taxpayers p.109

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 without income recognition. The corporation has income when the 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.
Deduction allowed to the corporation with respect to contributed accounts payable which were assumed as long as no tax avoidance purpose.

Yes, deduction to the transferee of the accounts payable is permitted under Code §162 when accounts payable are paid – unless evidence exists of tax avoidance or the distortion of income.
Problem (d) Partial Transfer p.109

Payment of the accounts payable but transfer of the accounts receivable to the corporation.

Is the “assignment of income” doctrine applicable in this situation? IRS may think so because the separation of A/P from A/R in a single business looks to have been done for tax avoidance reasons particularly if Design needs the cash ultimately to be contributed to run. Consequently, the IRS may attempt to apply assignment of income to put A/P and A/R into same hands. See §446(b) (“clear reflection of income”). Hempt Bros. dealt with transfer of entire business in incorporation.
Architect as an **accrual basis** taxpayer. Receivables would have been included in GI and Payables would have been deducted by Architect and represent an assumed liability to Design Corp.

**Stock basis:** 60 plus 60 = 120 less 100 debt = 20 basis (and no §357(c) gain).

<table>
<thead>
<tr>
<th></th>
<th>Basis</th>
<th>FMV</th>
<th>Debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>A/R</td>
<td>60,000</td>
<td>60,000</td>
<td></td>
</tr>
<tr>
<td>A/P</td>
<td></td>
<td></td>
<td>70,000</td>
</tr>
<tr>
<td>Supplies</td>
<td>-0-</td>
<td>20,000</td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>60,000</td>
<td>120,000</td>
<td></td>
</tr>
<tr>
<td>Debt</td>
<td></td>
<td></td>
<td>30,000</td>
</tr>
<tr>
<td></td>
<td>120,000</td>
<td>200,000</td>
<td>100,000</td>
</tr>
</tbody>
</table>

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

Is the calendar year required? Yes, see §441(i)(2).
Contingent Liability Tax Shelters & §358(h) p.109

Black & Decker Corp v. U.S.

436 US 431 (4th Cir. 2006) addressed question of whether tax basis in stock of sub to be reduced by the contingent liabilities assumed by the sub?

Held: No, so by implication does this mean that the subsidiary gets deduction when liability is fixed & capital loss to parent corp. when selling stock? Case remanded to consider sham transaction arguments.

1. Judicial Response:
Disallowed Coltec stock loss of $379.5 million on economic substance grounds. See Coltec Industries, Inc. v. United States, 54 F.3d 1340 (Fed. Cir. 2006).

2. Congressional Response:
Enacted §358(h) which now limits shareholder basis limitation to the lesser of substitute basis or FMV of the stock received.
### Comparison of §362(e)(2) and §358(h)

<table>
<thead>
<tr>
<th>§362(e)(2)</th>
<th>p.59</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Provides limit on transforee’s “net built-in loss” when aggregate adjusted bases for properties transferred exceeds total FMV.</td>
<td></td>
</tr>
<tr>
<td>2. Allocation proportionately of built-in loss to various corporate assets.</td>
<td></td>
</tr>
<tr>
<td>3. Possible election to reduce specific shareholder’s stock basis to fair market value &amp; keep loss basis at corp. level. §362(e)(3)(C).</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>§358(h)</th>
<th>p.82 n.72</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Shareholder basis in stock exceeds FMV of stock, then basis must be stepped-down (but not below FMV) for any transferred liability that was not taken into account under §358(d) [think contingent liability].</td>
<td></td>
</tr>
<tr>
<td>2. Impact is on shareholder basis, not corporate basis.</td>
<td></td>
</tr>
</tbody>
</table>
Contributions to Capital

Code §§118(a) & 362(a)(2), (c).

1) **No** receipt of stock for property sent to corp.

2) No gain is to be recognized; but, an *increase to shareholder of tax basis* for stock by the cash and adjusted basis of property transferred.

3) This contribution is excludable from the gross income of the transeree corporation.

4) Transferred tax basis to the corporation for the assets received.
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: voluntary surrender of some shares 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.
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.
3) Freeze capital gain potential.

Techniques for avoiding Code §351:
1) Immediately breaking 80% control.
2) **Sale** of an asset to the corporation (with §453 installment sale treatment).
Organizational Expenses – Is a Deduction Available?

Code §195, §212(3) & §248

§248 - $5,000 deduction & 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 deductible, with 180 month amortization for remainder,
a) $3,000 fees paid for appraisals of A’ 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 the corporation and is subject to §357 liability treatment.
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 the tax basis of these assets.

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

iv) §212(3) deduction treatment is 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 §248 and therefore amortizable.