Incorporating a business or transferring property to a controlled corporation can be partly or wholly tax-free if certain technical rules are satisfied. If the transferor receives cash or property other than stocks and securities, gain must be recognized. If the transferee corporation issues too many securities and the structure of the corporation becomes “top-heavy” with debts, the IRS may contend that the securities are in fact equity. This means that the corporation cannot deduct the interest payments, and subsequent repayment of the securities can represent taxable dividends to the shareholders.

In studying the rules of transfers to controlled corporations, the student should have these objectives:

1. To learn and become familiar with the conditions necessary to transfer property to a controlled corporation.
2. To understand the effects of contributions to capital by both shareholders and nonshareholders.
3. To become familiar with the various rules applicable to debt in the capital structure and the effect of losses on the shareholders.

**STUDY HIGHLIGHTS**

**INCORPORATION IN GENERAL**

1. Two factors must be considered concerning the situs of incorporation once the decision to incorporate has been made. First, the various advantages and disadvantages of the alternative laws by state should be made. Second, the costs of incorporating by state should be compared, not only by state but also by country of origin.

2. Once the location of incorporation has been determined, the tax consequences should be examined. Under the general rule of § 1001, an exchange is treated as a taxable event. In 1921, Congress realized that treatment hampered the creation of a corporation since most transfers triggered gain recognition. Accordingly, under a continuity of interest principle, Congress made exceptions for most transfers to controlled corporations. In lieu of recognizing gain, deferral was allowed through the use of intricate and often complicated basis adjustments.

**SECTION 351: TRANSFERS TO CONTROLLED CORPORATIONS**

3. Generally, there is no gain or loss on the transfer of property to a corporation that, after the transfer, is controlled by the transferor. The concept behind this tax-free treatment is that there is a mere change in the form of operation to the corporate form and, therefore, no taxable event has occurred.

4. Only the transfer of property is eligible for nonrecognition. Thus, the transfer of services for stock will constitute a taxable event. The basis of the stock to the service shareholder is the amount of gain recognized.
5. Control means ownership of 80 percent or more of the voting stock and 80 percent or more of every class of nonvoting stock. If a shareholder transfers both property and services in exchange for stock, generally all of the stock received will be counted toward the control test. If, however, the shareholder transfers a nominal amount of property, only the stock received in exchange for the property will be counted toward the control test. Property is considered nominal if it is less than 10 percent of the value of services rendered.

6. Gain is recognized only if property, other than stocks, is received in the exchange. This other property is known as boot. If boot is received, the shareholder has gain but not in excess of the amount of cash and the fair market value of any other property received. In no case can the amount of recognized gain exceed the realized gain. In other words, the recognized gain is the lesser of the boot received or the realized gain. No loss is recognized. Prior to October 3, 1989, an exchange for stock or securities qualified for nonrecognition. The 1989 Reconciliation Act eliminated securities from the § 351 provisions.

Example. J and S, individuals, form F Corporation. J transfers property with an adjusted basis of $20,000, FMV of $65,000 for 50% the stock plus $5,000 in cash. S transfers property with an adjusted basis of $30,000, FMV of $60,000, for the remaining 50% the stock. Gain is not recognized by S on the transfer because it qualifies under § 351. J, however, must recognize the $5,000 of boot received. The basis of the stock to J is $20,000 while the basis of the stock to S is $30,000. F will have a basis of $25,000 in the property that is transferred by J and a basis of $30,000 in the property transferred by S.

7. The character of the gain recognized depends upon the nature of the property transferred. If a person transfers more than one asset to the corporation in a § 351 transaction, the boot must be allocated to each category of asset based upon the relative fair market values of those assets.

8. Under the general rule of § 357, a corporation's assumption of a liability is not treated as boot, nor does it prevent the exchange from qualifying under § 351. There are, however, two exceptions to the general rule: tax avoidance and liabilities in excess of basis.

9. The exception for tax avoidance applies to liabilities that are created shortly before incorporation in order to take cash out of the transaction. If tax avoidance is the motive, all liabilities are treated as boot.

10. Liabilities in excess of basis will trigger recognition to the extent that the liabilities exceed the aggregate basis of all properties transferred. This rule is designed to prevent a negative basis in the stock received in the exchange. An exception to the liability rule exists (i.e., no gain needs to be recognized) where the transferor is a cash basis taxpayer and the liability is an account payable that would normally create a deduction.

11. The basis of the stock or securities received in the exchange is a substituted basis. However, if boot is also received, the basis is reduced by the amount of boot and increased by the gain recognized in the exchange. If several classes of stock are received, the bases of the property transferred must be allocated to the various classes of stock according to their relative fair market values. Liabilities that are assumed by the corporation on the transfer are treated like money received. Thus, the basis is reduced by the amount of the liabilities assumed. The following formula demonstrates:

\[
\text{Basis of assets transferred} - \text{Boot received} + \text{Gain recognized} - \text{Liabilities assumed} = \text{Basis in stocks and securities}
\]

\[
\text{Basis of assets transferred} = \$xxxx
\]
\[
- \text{Boot received} = - \text{xxxx}
\]
\[
+ \text{Gain recognized} = + \text{xxxx}
\]
\[
- \text{Liabilities assumed} = - \text{xxxx}
\]
\[
\text{Basis in stocks and securities} = \$xxxx
\]

This essentially is equal to the FMV of the stock received less the unrecognized gain on the § 351 transfer.
12. Ordinarily, the basis of property transferred to the corporation is a carryover basis equal to the transferor’s basis in the property and increased for any gain recognized by the shareholder on the exchange. The 2004 Jobs Act amended §362(e)(2) and provides that if the aggregate basis of the property transferred exceeds the value of such property (i.e., there is a built-in loss), the transferee corporation’s basis of the property is limited to the value of the property. Alternatively, §362(e)(2)(C) provides that if both the transferor and the transferee corporation elect, the limitation may be applied to the basis of the transferor’s stock instead of to the corporation.

Example. If N transfers Land (basis of $700,000 and FMV of $200,000) of P Corporation in a tax-free §351 transaction, then P must limit its carryover basis in the Land to $200,000 (its FMV). N will take a basis in the stock of $700,000. However, if both P and N elect, P can take a full substituted basis of $700,000 but N would be limited to a $200,000 outside basis in her stock.

13. Depreciation recapture under § 1245 and § 1250 is not triggered. Instead, the recapture potential shifts to the corporation and will be triggered when the corporation disposes of the property.

14. Investment tax credit recapture under § 47 may be triggered to the transferor if substantially all the assets are not transferred in the § 351 transfer. In any event, whether recapture is triggered or not on the transfer, the potential for recognition remains with the shareholder. Therefore, an early disposition of stock will trigger the recapture even though the asset itself was not sold by the corporation.

15. Under the tax benefit rule, the transferor may be required to recognize income. This will occur when stock is received for assets that have previously been expensed by the taxpayer (e.g., office supplies). The vulnerability to this rule can be recognized in the transfer of accounts receivables with reserves established for bad debts.

CONTRIBUTIONS TO CAPITAL

16. If a corporation receives a cash contribution to its capital, it can exclude the amount from gross income. If the payment is for some form of compensation, it can create a taxable event. The same rules apply for the transfer of property. However, basis adjustments to the shareholder vary.

17. A nonshareholder contribution may be excluded from gross income if the transfer is an inducement to continue business or incorporate rather than a payment for goods or services.

CORPORATIONS’ CAPITAL STRUCTURE

18. The transfer of debt versus stock by the corporation has certain advantages. Interest is deductible by the corporation and dividends are not. In addition, the shareholders can receive a return of principal tax-free. A payment in exchange for stock will create possible tax consequences. However, due to changes in § 351 imposed by the 1989 Tax Act, issuing debt for property becomes less attractive because of possible “boot” ramifications and subsequent tax consequences.

19. Under § 385, the Commissioner is authorized to prescribe Regulations that may classify debt as equity. The Service will contend that the debt is really equity if the debt instrument has too many features of stock. When this occurs, the IRS will deny the interest deduction and treat the interest payments as dividends. Although Regulations do not exist under § 385, and have not for over 20 years, the service still considers this section an important tool in combating thinly capitalized corporations.

20. If a security becomes worthless at any time during the tax year, the loss is treated as having risen from the sale or exchange of a capital asset on the last day of the taxable year that worthlessness occurred. In most cases, the losses will be long-term capital losses.
21. Business bad debts that are totally or partially worthless may be deducted as ordinary losses. The loss of a nonbusiness bad debt can only be deducted if it is totally worthless, and then it is treated as a short-term capital loss.

22. For losses on the sale or exchange of small business stock, § 1244 allows an ordinary loss for as much as $50,000 per year ($100,000 on a joint tax return). The term small business stock refers to the amount of capitalization that may not be in excess of $1 million. If losses exceed $50,000 ($100,000 on a joint return), the remaining amount is treated as a capital loss subject to the capital loss limitations.

Example. S, a single individual, was the original owner of § 1244 stock with a basis of $110,000. If S sells half of his shares in one year for $3,000, he will recognize an ordinary loss of $50,000 and a net capital loss of $2,000 ([$3,000 - $55,000] less the ordinary loss of $50,000). If T sells his remaining stock the following year for $10,000, he will have an ordinary loss of $45,000 ($10,000 - $55,000).

23. In 1993, Congress created § 1202 which allows noncorporate investors to exclude 50 percent of the gain on the sale of qualified small business stock. Stock is considered qualified small business stock if it was issued after August 10, 1993 and meets special ownership requirement.

24. When qualified small business stock is received for property, other than money, the basis of the stock, for purposes of determining excludable gain, can be no less than the property’s value on the date of the contribution.
STUDY QUESTIONS

True or False

1. Section 351 applies to persons who transfer property or services to the corporation in exchange for stock or securities.

2. The purpose of § 351 is to grant deferral to those exchanges where there has been no substantive change in the transferor’s economic position.

3. Stock for services is included for the control test if property is also transferred that exceeds 10 percent of the value of stock received for services.

4. Control is defined as ownership of at least 80 percent of the total combined voting power.

5. Liabilities assumed by the corporation on the transfer of property are not considered boot for purposes of computing gain or loss.

6. Section 357(c) requires that the taxpayer recognize gain to the extent that the total liabilities exceed the total basis of assets transferred.

7. The holding period of any boot received on the exchange of property begins on the date of the exchange.

8. If a transferor recognizes gain on the exchange of property in a § 351 transfer, the basis of stock received is reduced so that such gain will not be recognized twice.

9. Under the tax benefit rule, if the value of the stock is equal to the net book value of the receivables, the transferor has not recovered the previous deduction and no income is recognized.

10. A corporation can deduct both payments of interest and certain dividends.

11. Corporation A received land valued at $80,000 from Town B as an incentive to the corporation to develop an industrial park on the land. The basis of the land to Corporation A is zero.

12. A transfer of money or property, or both, to a shareholder by a prospective shareholder in exchange for a controlling interest in that corporation is always a tax-free exchange.

13. Section 351 can apply only to the formation of a corporation.

14. If a taxpayer receives boot in the formation of a corporation, § 351 cannot apply.

15. Losses can never be recognized in a § 351 transaction.

16. Liabilities that are assumed in a § 351 transaction.

17. Under § 385, the IRS often tries to recharacterize equity in a closely held corporation as debt.

18. If a transferor satisfies the provisions of § 351, the application of § 351 is mandatory.

19. For purposes of § 351, services are considered property.

20. For transfers of property during the year, securities issued in exchange for appreciated property can create taxable gain to the transferor.
Multiple Choice

1. Individual E transferred the following assets and liabilities to Corporation M:

<table>
<thead>
<tr>
<th></th>
<th>Adjusted Basis</th>
<th>Fair Market Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Building</td>
<td>$35,000</td>
<td>$55,000</td>
</tr>
<tr>
<td>Mortgage on building</td>
<td>$48,000</td>
<td>$48,000</td>
</tr>
</tbody>
</table>

In exchange, E received 90 percent of M’s only class of stock outstanding. What is E’s recognized gain on the exchange before any capital gain deduction?

   a. $0.
   b. $3,000.
   c. $13,000.
   d. $17,000.
   e. $20,000.

2. L, an individual, formed Corporation T in 2009. L transferred a building with a basis of $5,000 and a fair market value of $10,000 and cash of $10,000 to Corporation T. Immediately after the transfer, L owned 100 percent of the stock in Corporation T. What is T’s basis in the building?

   a. $5,000.
   b. $10,000.
   c. $15,000.
   d. $20,000.
   e. $25,000.

3. On June 30, 2008, K purchased a truck. On March 31, 2009, he transferred it to Corporation E in exchange for 90 percent of the outstanding stock of Corporation E plus $2,000 cash. As of December 31, 2009, what is Corporation E’s holding period?

   a. 3 months.
   b. 6 months.
   c. 9 months.
   d. 12 months.
   e. 18 months.

4. Which of the following is not taken into account when determining if a gain or loss should be recognized on the transfer of property to a corporation in exchange for a controlling interest in stock of the corporation?

   a. Ownership of at least 80 percent of the total combined voting power of all stock entitled to vote.
   b. Ownership of at least 80 percent of the total number of shares of all other classes of stock.
   c. Receipt of money in addition to stock.
   d. Fair market value of property transferred.
   e. Mortgage on property assumed by the corporation.
5. Z, an individual, transferred a lift truck with an adjusted basis of $20,000 and fair market value of $30,000 to Corporation E. In exchange, Z received 80 percent of E’s outstanding voting stock with a $24,000 fair market value, $5,000 cash, and a trailer with a fair market value of $1,000. What is Z’s recognized gain on the exchange?

a. $0.
b. $1,000.
c. $5,000.
d. $6,000.
e. $10,000.

6. During 2009, G Corporation, in need of additional factory space, exchanged 10,000 shares of its common stock with a par value of $100,000 for a building with a fair market value of $120,000. On the date of the exchange the stock had a market value of $130,000. For 2009, how much and what type of gain or loss should G Corporation report on this transaction?

a. No gain or loss.
b. $10,000 capital loss.
c. $20,000 capital gain.
d. $20,000 § 1231 gain.
e. $30,000 capital gain.

7. T transferred land worth $50,000 to his controlled corporation for stock in the corporation worth $20,000 and $20,000 cash. The basis of the property to him was $15,000, and it was subject to a $10,000 mortgage, which the corporation assumed. How much gain must T report?

a. $10,000.
b. $20,000.
c. $30,000.
d. $35,000.
e. None of the above.

8. B and W decide to form a corporation on January 2 of the current year. B contributes a building, in which he has an adjusted basis of $10,000, worth $25,000 on the market. W contributes $25,000 in cash to the corporation. In exchange for these properties, the corporation issues its entire capital stock equally to B and W. What is the basis of the building to the corporation?

a. $10,000.
b. $15,000.
c. $25,000.
d. $35,000.
e. None of the above.

9. Referring to problem 8, what is B’s basis in his shares of corporate stock?

a. $0.
b. $10,000.
c. $17,500.
d. $25,000.
e. None of the above.
2-8 Corporate Formation and Capital Structure

Problems 10 through 12 are related.

G and B decided to form a corporation. On July 1, 2009, G transferred a building to the new corporation. Her adjusted basis in this building was $27,000, and its FMV was $50,000. B contributed $40,000. In addition, the corporation paid G $10,000 in cash. There were no other stockholders.

10. Which of the following represents the amount of gain that G must report on her 2009 return?
   a. $0.
   b. $3,000.
   c. $13,000.
   d. $23,000.
   e. None of the above.

11. What is the basis of the building to the new corporation?
   a. $0.
   b. $27,000.
   c. $37,000.
   d. $50,000.
   e. None of the above.

12. What is G’s basis in the corporate shares of stock?
   a. $0.
   b. $17,000.
   c. $27,000.
   d. $37,000.
   e. $50,000.

13. S owns equipment having a fair market value of $15,000. The equipment originally cost him $24,000 and he claimed depreciation of $14,000. S transferred the equipment to his 100 percent controlled corporation in exchange for $2,000 in cash and stock worth $13,000. What is the taxable gain to S?
   a. $0.
   b. $1,000.
   c. $2,000.
   d. $5,000.
   e. None of the above.

14. In a § 351 transaction, what is the minimum amount of stock all parties to the transaction must own to qualify for a nontaxable transaction?
   a. 50%.
   b. 51%.
   c. 80%.
   d. 81%.
   e. 100%.
15. 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.

16. 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.

17. 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.

18. In a § 351 transaction, how is depreciation recapture treated?

   a. Depreciation recapture disappears.
   b. All potential depreciation recapture is transferred to the corporation.
   c. All depreciation recapture is assigned to the remaining business assets of the transferor.
   d. Depreciation recapture is triggered to the extent of recognized gain; any unrecovered recapture is transferred to the corporation.
   e. All depreciation recapture is recognized on the transfer of the underlying property.

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

   a. “plain vanilla” preferred.
   b. nonvoting preferred.
   c. nonparticipating preferred.
   d. nonvoting common.
   e. stock rights and warrants.
20. Which of the following code sections is used to assist in determining a shareholder’s stock basis resulting from a § 351 transfer?
   _____ a. § 357.
   _____ b. § 358.
   _____ c. § 362.
   _____ d. § 368.
   _____ e. § 1014.

Fill In the Blanks

1. Section 351 precludes any gain or loss on the transfer of _______ in exchange for _______ of the corporation.

2. The transfer of services in exchange for stock will always be _______, and the basis to the transferor will always be _______ _______ _______.

3. Consideration received, other than stock, in a § 351 transaction is referred to as _______.

4. Liabilities transferred in excess of the transferor’s basis will always trigger gain in order to prevent _______ basis in the stock of the corporation.

5. Debt versus stock becomes a tax issue in a closely held corporation because _______ paid is deductible and _______ paid are not deductible.

6. Business bad debts are treated as _______ losses, whereas nonbusiness bad debts are treated as _______.

7. Small business stock is often referred to as _______ stock.

8. Losses on small business stock are treated as _______ losses as long as they do not exceed _______ per taxpayer.

Code Section Recognition

For each of the following Code sections, try to match the response that most properly identifies the underlying provision.

1. § 166 a. small business stock
2. § 351 b. transferred liabilities
3. § 357 c. bad debts
4. § 358 d. corporate transferee’s basis
5. § 362 e. tax-free transfer rules
6. § 1244 f. transferor shareholder’s basis
SOLUTIONS TO STUDY QUESTIONS

True or False

1. False. Services are not included.

2. True.

3. True.

4. False. Must include at least 80 percent of nonvoting stock as well.

5. True.

6. True.

7. True.

8. False. Gain increases the basis of stock received.


10. False. Dividend payments are never deductible to the corporation.

11. True.

12. False. Transfers between shareholders are not a qualifying exchange for purposes of § 351.

13. False. It applies to all transfers of stocks and securities that satisfy the provisions—not just formations.

14. False. It must recognize the lesser of the boot received or the gain recognized if the remaining provisions of § 351 are met.

15. True. Under § 351(c) losses are never recognized.

16. True. The only exceptions are provided for in §§ 357(b) and (c).

17. False. The IRS generally recharacterizes debt as equity.

18. True. Section 351 is not an elective provision. Accordingly, if the requirements are met, the provision applies.

19. False. Services are specifically excluded from the definition of property under § 351(d).

20. True. These were changes imposed by the Tax Act of 1989.
Multiple Choice

1. b. Liability in excess of basis ($48,000 - $45,000).
2. a. Transferor’s basis.
3. e. § 1223(2).
4. d.
5. d. Cash ($5,000) + FMV trailer ($1,000).
6. a.
7. b. $20,000 of cash (boot).
8. a. Transferor’s basis.
9. b. Substituted basis.
10. e. $10,000 of cash (boot).
11. c. Transferor’s basis = gain ($27,000 = $10,000).
12. c. ($27,000 = $10,000 - $10,000 + $27,000).
13. c. The boot ($2,000).
14. c. Eighty percent or more.
15. d. The $4,000 realized gain is deferred until the stock is sold.
16. a. $9,000 basis + $11,000 gain - $20,000 liability = 0.
17. c. § 1032 allows the corporation to escape taxation.
18. d. Depreciation recapture is only recognized to the extent that gain is recognized.
19. e. Not the same as ownership.
20. b.
Fill In the Blanks

1. Property; stock.

2. Taxable; fair market value.


4. Negative.

5. Interest; dividends.

6. Ordinary; short-term capital losses.

7. § 1244.

8. Ordinary; $50,000.

Code Section Recognition

1. c.

2. e.

3. b.

4. f.

5. d.

6. a.