Chapter 17

Corporations:
Organization and Capital Structure

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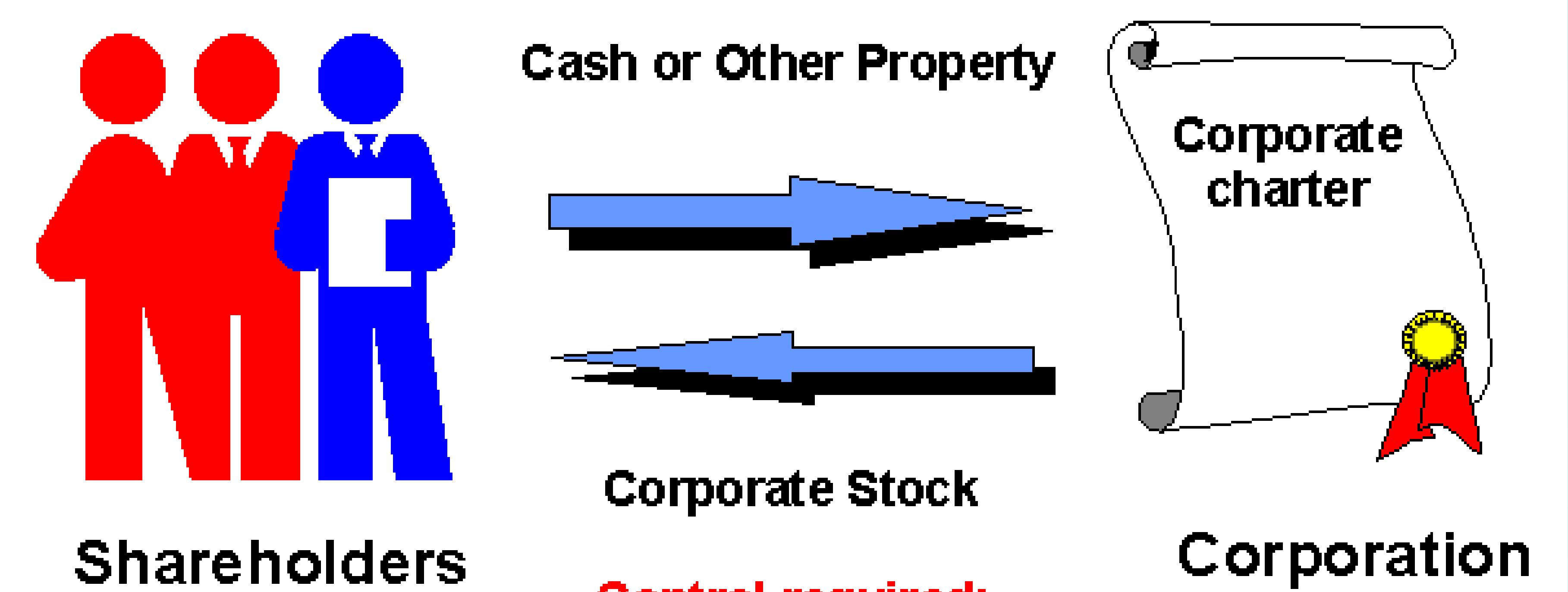
Corporation Formation Transaction



Control required: shareholders must own 80% after the transfer

Formation Example

Ron will incorporate his donut shop:

	Asset Tax Basis	Fair Mkt Value
Cash	$10,000	$ 10,000
Furniture & Fixtures	20,000	60,000
Building	40,000	100,000
Total	$70,000	$170,000

- Without §351: gain of $100,000.
- With §351: no gain or loss. Ron’s economic status has not changed.

Consequences of §351
(slide 1 of 2)

- In general, no gain or loss to transferors:
  - On transfer of <u>property</u> to corporation
  - In exchange for <u>stock</u>
  - IF <u>immediately after</u> transfer, transferors are in <u>control</u> of corporation

Consequences of §351
(slide 2 of 2)

- If boot (property other than stock) received by transferors
  - Gain recognized up to lesser of:
    - Boot received or
    - Realized gain
  - No loss is recognized

Issues re: Formation
(slide 1 of 7)

- Definition of property includes:
  - Cash
  - Secret processes and formulas
  - Unrealized accounts receivable (for cash basis taxpayer)
  - Installment obligations
- Code specifically excludes services from definition of property

Issues re: Formation
(slide 2 of 7)

- Stock transferred
  - Includes common and most preferred stock
    - Does not include nonqualified preferred stock which possesses many attributes of debt
  - Does not include stock rights or stock warrants
  - Does not include corporate debt or securities (e.g., corporate bonds)
    - Treated as boot

Issues re: Formation

(slide 3 of 7)

- Transferors must be in control immediately after exchange to qualify for nontaxable treatment
  - To have control, transferors must own:
    - 80% of total combined voting power of all classes of stock entitled to vote, plus
    - 80% of total number of shares of all other classes of stock

Issues re: Formation
(slide 4 of 7)

- "Immediately after" the exchange
  - Does not require simultaneous transfers if more than one transferor
  - Rights of parties must be outlined before first transfer
  - Transfers should occur as close together as possible

Issues re: Formation
(slide 5 of 7)

- After control is achieved, it is not necessarily lost upon the sale or gift of stock received in the transfer to others not party to the initial exchange
- But sale might violate §351 if prearranged

Issues re: Formation

(slide 6 of 7)

- Transfers for property and services
  - May result in service provider being treated as a member of the 80% control group
    - Taxed on value of stock issued for services
    - Not taxed on value of stock received for property contributions
  - Service provider should transfer property having more than “a relatively small value”

Issues re: Formation
(slide 7 of 7)

- Subsequent transfers to corporation
  - Tax-free treatment still applies as long as transferors in subsequent transfer own 80% following exchange

Assumption of Liabilities

(slide 1 of 2)

- Assumption of liabilities by corp DOES NOT result in boot to the transferor shareholder for gain recognition purposes
  - Liabilities ARE treated as boot for determining basis in acquired stock
  - Basis of stock received is reduced by amount of liabilities assumed by the corp

Assumption of Liabilities
(slide 2 of 2)

- Liabilities are NOT treated as boot for gain recognition unless:
  - Liabilities incurred for no business purpose or as tax avoidance mechanism
    - Boot = Entire amount of liability
  - Liabilities > basis in assets transferred
    - Gain recognized = Excess amount (liabilities - basis)

Formation with Liabilities Example (slide 1 of 2)

Property transferred has:

Fair market value	=	$150,000
Basis	=	100,000
Realized Gain	=	50,000

Formation with Liabilities Example (slide 2 of 2)

Liabilities assumed by corp. (independent facts):

	Business Purpose	Business Purpose	No Business Purpose
Liability:	$80,000	$120,000	$120,000
Boot	None	$ 20,000	$120,000
Gain Recognized	None	$20,000	$ 50,000*

*(Gain is lesser of $50,000 realized gain or boot)

Basis Computation for §351 Exchange (slide 1 of 2)

- Shareholder's basis in stock:

Adjusted basis of transferred assets

\+ Gain recognized on exchange

\- Boot received

\- <u>Liabilities transferred to corporation</u>

= Basis of stock received by shareholder

Basis Computation for §351 Exchange (slide 2 of 2)

- Corporation's basis in assets:

Adjusted basis of transferred assets

+ <u>Gain recognized by transferor shareholder</u>

= Basis of assets to corporation

Basis in Stock in Last Example

Adjusted Basis of transferred assets: $100,000

Liabilities assumed by corp. (independent facts):

	Business Purpose	Business Purpose	No Business Purpose
Liability:	$ 80,000	$120,000	$120,000
Basis in assets			
Transferred	$100,000	$100,000	$100,000
+ Gain recognized	None	20,000	50,000
- Liab. Transferred	(80,000)	(120,000)	(120,000)
Basis in stock	$ 20,000	-0-	$ 30,000

Corporation's Basis in Assets Received in Last Example

Liabilities assumed by corp. (Independent facts):

	Business Purpose	Business Purpose	No Business Purpose
Liability:	$ 80,000	$120,000	$120,000
Basis of transferred assets:	$100,000	$100,000	$100,000
Gain recognized by shareholder	None	20,000	50,000
Basis to Corp.	$100,000	$120,000	$150,000

Holding Period

- Holding period of stock received
  - For capital assets or §1231 property, includes holding period of property transferred to corporation
  - For other property, begins on day after exchange
- Corp's holding period for property acquired in the transfer is holding period of transferor

Capital Contributions (slide 1 of 3)

- No gain or loss is recognized by corp on receipt of money or property in exchange for its stock
  - Also applies to additional voluntary pro rata contributions of money or property to a corp even though no additional shares are issued

Capital Contributions (slide 2 of 3)

- Capital contributions of property by nonshareholders
  - Not taxable to corporation
  - Basis of property received from nonshareholder is -0-

Capital Contributions (slide 3 of 3)

- Capital contributions of cash by nonshareholder
  - Must reduce basis of assets acquired during 12 month period following contribution
  - Any remaining amount reduces basis of other property owned by the corp
    - Applied in the following order to depreciable property, amortizable property, assets subject to depletion, and other remaining assets

Debt Vs. Equity
(slide 1 of 2)

- Debt
  - Corporation pays interest to debt holder which is deductible by corporation
  - Interest paid is taxable as ordinary income to individual or corporate recipient
  - Loan repayments are not taxable to investors unless repayments exceed basis

Debt Vs. Equity
(slide 2 of 2)

- Equity:
  - Corporation pays dividends which are not deductible
  - Taxable as ordinary income to recipient to extent corp has E & P
    - Corporate shareholder may receive dividends received deduction

Reclassification of Debt As Equity

- If corp is "thinly capitalized", i.e., has too much debt and too little equity
  - IRS may argue that debt is really equity and deny tax advantages of debt financing
  - If debt has too many features of stock, principal and interest payments may be treated as dividends

Thin Capitalization Factors
(slide 1 of 2)

- Debt instrument documentation
- Debt terms (e.g., reasonable rate of interest and definite maturity date)
- Timeliness of repayment of debt
- Whether payments are contingent on earnings

Thin Capitalization Factors
(slide 2 of 2)

- Subordination of debt to other liabilities
- Whether debt and stock holdings are proportionate
- Use of funds (if used to finance initial operations or to acquire capital assets, looks like equity)
- Debt to equity ratio

Losses on Investment in Corporation (slide 1 of 5)

- Stock and security losses
  - If stocks and bonds are capital assets, losses from worthlessness are capital losses
    - Loss is treated as occurring on last day of tax year in which they become worthless
    - No loss for mere decline in value

Losses on Investment in Corporation (slide 2 of 5)

- Stock and security losses
  - If stocks and bonds are not capital assets, losses from worthlessness are ordinary losses (e.g., broker owned)
  - Sometimes an ordinary loss is allowed for worthlessness of stock of affiliated company

Losses on Investment in Corporation (slide 3 of 5)

- Business versus nonbusiness bad debts
  - General rule: Losses on debt of corporation treated as business or nonbusiness bad debt
  - If noncorporate person lends as investment, loss is nonbusiness bad debt
    - Short-term capital loss
    - Only deductible when fully worthless

Losses on Investment in Corporation (slide 4 of 5)

- Business versus nonbusiness bad debts (con't)
  - If corporation is lender, loss is business bad debt
    - Ordinary loss deduction
    - Deduction allowed for partial worthlessness
    - All bad debts of corporate lender qualify as business bad debts

Losses on Investment in Corporation (slide 5 of 5)

- Business versus nonbusiness bad debts (con't)
  - Noncorporate lender may qualify for business bad debt treatment if:
    - Loan is made in some capacity that qualifies as a trade or business, or
    - Shareholder is in the business of lending money or of buying, promoting, and selling corporations

§1244 stock
(slide 1 of 4)

- Treatment of §1244 stock:
  - Ordinary loss treatment for loss on stock of "small business corporation" (as defined)
  - Gain still capital gain

§1244 stock
(slide 2 of 4)

- §1244 stock:
  - Total amount of stock at initial issuance cannot exceed $1,000,000 (based on basis of property contributed, less liabilities assumed by company)

§1244 stock
(slide 3 of 4)

- Annual loss limitation:
  - $50,000 or
  - $100,000 if married filing joint return
  - Any remaining loss is a capital loss
- Only original holder of §1244 stock qualifies for ordinary loss treatment
  - Sale or contribution of stock results in loss of §1244 status

§1244 stock
(slide 4 of 4)

- If §1244 stock is issued for property with basis > fair market value
  - For determining ordinary loss, stock basis is reduced to fair market value on date of exchange

Gain From Qualified Small Business Stock (slide 1 of 2)

- Noncorporate shareholders may exclude 50% of gain from sale or exchange of such stock
  - Must have held stock for > 5 years and acquired stock as part of original issue
  - 50% exclusion can be applied to the greater of:
    - $10 million, or
    - 10 times shareholder's aggregate adjusted basis of qualified stock disposed of during year

Gain From Qualified Small Business Stock (slide 2 of 2)

- Qualified Small Business Corp
  - C corp with gross assets not greater than $50 million on date stock issued
  - Actively involved in a trade or business
    - At least 80% of corporate assets are used in the active conduct of one or more trade or businesses

If you have any comments or suggestions concerning this PowerPoint Presentation for West's Federal Taxation, please contact:

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