Corporation Formation Transaction

- Shareholders
- Cash or Other Property
- Corporate Stock
- Corporate charter

Control required: shareholders must own 80% after the transfer
Formation Example

Ron will incorporate his donut shop:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Tax Basis</th>
<th>Fair Mkt</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$10,000</td>
<td>$ 10,000</td>
</tr>
<tr>
<td>Furniture &amp; Fixtures</td>
<td>20,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Building</td>
<td>40,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Total</td>
<td>$70,000</td>
<td>$170,000</td>
</tr>
</tbody>
</table>

• 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 property to corporation
  – In exchange for stock
  – IF immediately after transfer, transferors are in control 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
(slid 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
(slidé 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):

<table>
<thead>
<tr>
<th>Purpose</th>
<th>Business</th>
<th>Business</th>
<th>No Business</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liability:</td>
<td>$80,000</td>
<td>$120,000</td>
<td>$120,000</td>
</tr>
<tr>
<td>Boot</td>
<td>None</td>
<td>$20,000</td>
<td>$120,000</td>
</tr>
<tr>
<td>Gain Recognized</td>
<td>None</td>
<td>$20,000</td>
<td>$50,000*</td>
</tr>
</tbody>
</table>

*(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
  - Liabilities transferred to corporation
  = 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
    + Gain recognized by transferor shareholder
  = Basis of assets to corporation
Basis in Stock in Last Example

<table>
<thead>
<tr>
<th>Business Purpose</th>
<th>Business Purpose</th>
<th>No Business Purpose</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liability:</td>
<td>$ 80,000</td>
<td>$120,000</td>
</tr>
<tr>
<td>Basis in assets</td>
<td>Transferred</td>
<td>$100,000</td>
</tr>
<tr>
<td>+ Gain recognized</td>
<td>None</td>
<td>20,000</td>
</tr>
<tr>
<td>- Liab. Transferred</td>
<td>(80,000)</td>
<td>(120,000)</td>
</tr>
<tr>
<td>Basis in stock</td>
<td>$ 20,000</td>
<td>-0-</td>
</tr>
</tbody>
</table>

Adjusted Basis of transferred assets: $100,000
Liabilities assumed by corp. (independent facts):
# Corporation’s Basis in Assets Received in Last Example

<table>
<thead>
<tr>
<th>Liabilities assumed by corp. (Independent facts):</th>
<th>Business Purpose</th>
<th>Business Purpose</th>
<th>No Business Purpose</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liability</td>
<td>$ 80,000</td>
<td>$120,000</td>
<td>$120,000</td>
</tr>
<tr>
<td>Basis of transferred assets:</td>
<td>$100,000</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Gain recognized by shareholder</td>
<td>None</td>
<td>20,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Basis to Corp.</td>
<td>$100,000</td>
<td>$120,000</td>
<td>$150,000</td>
</tr>
</tbody>
</table>
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 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
Thick 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
• 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
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
• 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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