CHAPTER 17

CORPORATIONS: ORGANIZATION AND CAPITAL STRUCTURE

SOLUTIONS TO PROBLEM MATERIALS

Question/ Problem	Topic	Status: Present Edition	Q/P in Prior Edition
1	Compare § 351 and § 1031 in terms of justification and effect	New	
2	Possible gain and/or loss recognition on a § 351 transfer	Unchanged	2
3	Definition of "property" in § 351 transfers	New	
4	Taxation of boot received	Unchanged	4
5	Effect of receipt of securities in exchange for transfer of property to a controlled corporation	Modified	5
6	Explain control requirement of § 351; effect of specific situations on control requirement	Unchanged	6
7	Issue ID	Unchanged	7
8	Charitable gift of stock shortly after § 351 exchange	Unchanged	8
9	Transfer of property for stock by two shareholders; transfer of services for stock by third shareholder	Unchanged	9
10	Shareholder who transfers property and services for stock as part of control group	Unchanged	10
11	Issue ID	Unchanged	11
12	Effect of debt on basis in corporate stock in a § 351 transfer	Unchanged	12
13	Gain recognition potential on transfer of mortgaged property in a § 351 transaction	Unchanged	13
14	Bona fide business purpose requirement in transfer of liabilities to a controlled corporation	Unchanged	14
15	Reason for the gain recognition rule of § 357(c)	Unchanged	15
16	Impact of various attributes on stock basis calculation	Unchanged	16

Question/ Problem	Topic	Status: Present Edition	Q/P in Prior Edition
17	When stock issued for services is deductible/not deductible	Modified	17
18	Basis rules for property acquired from a shareholder and from a nonshareholder	Unchanged	18
19	Advantages of utilizing debt in the capitalization of a corporation	Unchanged	19
20	Shareholder loan to corporation: business or nonbusiness bad debt?	New	
21	Tax treatment in selected situations where corporate stock has declined in value	Unchanged	21
22	Issue ID	Unchanged	22
23	Issue ID	Unchanged	23
24	Formation of corporation; gain or loss on transfer; transfer of property; basis	Unchanged	24
25	Formation of corporation; gain on transfer; basis of stock; basis of property	New	
26	Formation of corporation with transfer of property from several shareholders at different times	Unchanged	26
27	Transfer of property to a corporation after date of formation of corporation	Unchanged	27
28	Issue ID	New	
29	Transfer of property to existing corporation	New	
30	Formation of corporation; transfer of services for stock	Unchanged	30
31	Formation of corporation; transfer of services for stock	Unchanged	31
32	Property subject to liability in excess of basis transferred to corporation for stock	Modified	32
33	Issue ID	Unchanged	33
34	Stock received for services rendered	Unchanged	34
35	Stock received for services rendered	Unchanged	35
36	Contribution to corporation by nonshareholder	Unchanged	36
37	Investor losses; business versus nonbusiness bad debts	Unchanged	37
38	Reclassification of debt as equity	Unchanged	38
39	Section 1244 stock	Unchanged	39
40	Transfer of § 1244 stock to another individual	Unchanged	40
41	Section 1244 stock; determination of ordinary income	Modified	41
42	Reclassification of debt as equity; debt-equity ratio	Unchanged	42

CHECK FIGURES

24.a.	$6,000.
24.b.	$30,000.
24.c.	$36,000.
24.d.	$9,000.
24.e.	$45,000.
24.f.	$54,000.
24.g.	$0.
24.h.	$15,000.
24.i.	$15,000.
24.j.	$0.
24.k.	$30,000.
25.a.	$0.
25.b.	$180,000.
25.c.	$140,000.
25.d.	$0.
25.e.	$264,000.
25.f.	$120,000 equipment; $4,000 patent.
25.g.	No change.
25.h.	No change.
26.a.	None recognizes gain.
26.b.	$410,000.
26.c.	Clyde's transfer should be independent of the others.
27.	$570,000 recognized gain.
29.	$510,000 recognized gain.
30.a.	Ann $0; Bob $15,000.
30.b.	Ann $150,000; Bob $45,000.
30.c.	$150,000 basis in property Ann transferred; $30,000 basis in property Bob transferred; $15,000 basis in organization costs.
31.	Both Ann and Bob recognize gain.
32.	Paul zero basis; Swift basis $105,000.
34.a.	Sara no gain; Jane income $15,000.
34.b.	$25,000 in property from Sara; $10,000 in property from Jane; deduction of $15,000 for services.
35.a.	$15,000.
35.b.	$10,000; capitalize.
36.a.	$0.
36.b.	$0.
36.c.	$0 basis for property.
36.d.	$25,000 basis for property.
39.	Ordinary loss $50,000; long-term capital loss $40,000.
40.	Long-term capital loss $20,000.
41.a.	$50,000.
41.b.	$25,000.
41.c.	$5,000 ordinary loss; $25,000 capital loss.

DISCUSSION QUESTIONS

1. Both § 351 and § 1031 provide for nonrecognition of gain or loss for certain transfers which otherwise would be taxable. The principle behind the nonrecognition of gain or loss is the concept of continuity of the taxpayer's investment. As there is no real change in the taxpayer's economic status, gain or loss should be postponed until such a change occurs (i.e., a sale to or a taxable exchange with outsiders). In addition, this approach can be justified under the wherewithal to pay concept discussed in Chapter 1. pp. 17-2 and 17-3

2. Gain is recognized on a § 351 transfer if the transferor receives "boot" in the exchange (i.e., money or property other than stock). Gain is recognized to the extent of the lesser of the gain realized or the boot received (the amount of money and the fair market value of the other property received). The nature of any gain recognized is characterized by reference to the type of asset transferred. Loss is never recognized. pp. 17-3 and 17-4

3. The definition of property for purposes of § 351 is comprehensive. As one would expect, cash and fixed assets are included in the term. But in addition, unrealized receivables of a cash basis taxpayer, secret processes and formulas, as well as secret information in the general nature of a patentable inventory, are considered to be property. However, services rendered are specifically excluded from the definition of property. pp. 17-4 and 17-5

4. Under § 357(c), the release of liabilities in excess of the basis of assets transferred can *create* gain. Otherwise, the receipt of boot does not trigger gain recognition unless a gain is realized. pp. 17-4 and 17-10

5. Yes. Securities, as well as cash and other property, constitute boot under § 351. p. 17-5

6. The control requirement specifies that the person or persons transferring property to the corporation must own, immediately after the transfer, stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total *number* of shares of all other classes of stock of the corporation. Control may apply to a single person or to several taxpayers if they are all parties to an integrated transaction. p. 17-6

    a. If a shareholder renders services to the corporation for stock, the control requirement can be lost as to the other shareholders. The shareholder rendering services, absent any additional transfer of property for stock, cannot qualify under § 351 because services rendered are not "property." For example, if Adam transfers property to Brown Corporation for 50% of the stock and Bonnie receives 50% of the stock for services rendered, the transaction is taxable to both Adam and Bonnie. Bonnie is not a member of the group transferring property, and Adam receives only 50% of the stock. The post-control requirement is not met. Example 8

    b. If a shareholder renders services *and* transfers property to the corporation for stock, the shareholder is treated as a member of the transferring group although taxed on the value of the stock received for services. Consequently, in part a. above, if Bonnie also transferred property, the transaction would qualify under § 351. To be a member of the group and to aid in qualifying all transferors under the 80% test, the person contributing services must transfer property having more than a relatively small value in relation to the services he or she performed. pp. 17-7 and 17-8

c. If a shareholder has only momentary control of the stock of the corporation after the transfer, these shares do not count in determining control if the plan for ultimate sale or other disposition of the stock existed before the exchange. p. 17-7 and Example 7

d. If a long period of time elapses between the transfers of property by different shareholders, the control requirement may be lost as to the later transfers because there is no transferring group. The Regulations affirm that an exchange involving more than one person does not necessarily require simultaneous transfers by the persons involved, but there must be a transaction in which the rights of the parties were previously defined and the transaction occurs shortly thereafter. Transfers that involve a long lapse of time should be properly documented as part of a single plan. p. 17-6

7. If the real estate is appreciated (i.e., value exceeds basis), either approach can result in gain being recognized by Travis. Since the receipt of bonds (i.e., securities) is treated as the receipt of boot, a *sale* of the real estate results. That is, the realized gain is recognized. Under the mortgage scenario, § 357(b) would treat the release of debt as the receipt of boot. One possible alternative is to use preferred stock. This could give Travis more security than common stock, particularly if the preferred stock has a liquidation preference. To be nontaxable, however, the transfer should be tied to the original incorporation of the business. Otherwise, the 80% control requirement might not be satisfied. In addition, to avoid being considered boot, the preferred stock received must not meet the definition of nonqualified preferred stock. pp. 17-5, 17-6, 17-9, and 17-10

8. Whether the exchange qualifies under § 351 depends on whether there was a commitment to make the gift of Marvin's stock to the charity before the exchange. Control is not lost if stock received by a shareholder in a § 351 exchange is sold or given to others who are not parties to the exchange shortly after the transaction unless there was a plan for the ultimate sale or gift of the stock before the exchange. Assuming the subsequent transfer is *completely* donative, it will probably be disregarded for purposes of the control test. p. 17-7 and Example 7

9. The exchange is taxable to Paul, Mary, and Matt. It does not qualify under § 351 because Matt is not a member of the group transferring property and Mark and Mary together received only 66-2/3% of the stock. The post-transfer control requirement is not met. p. 17-7 and Example 8

10. A transferor who receives stock for both property and services can be included in the control group if the value of property transferred is not relatively small in comparison to the value of the services rendered in exchange for stock. The IRS generally requires that the value of the property transferred must be at least 10% of the value of the services provided. If the value of the property transferred is less than this amount, the IRS will not issue an advance ruling that the exchange meets the requirements of § 351. pp. 17-7 and 17-8

11. a. Ted is attempting to meet the control requirements of § 351. In order to qualify as a nontaxable exchange under § 351, the person or persons transferring property to a corporation for stock must own immediately after the transfer, stock possessing at least 80% of the total combined voting power of all classes of stock entitled to

vote and at least 80% of the total number of shares of all other classes of stock of the corporation. Unless Peggy joins Ted in the transaction, he will not meet the control requirement and must recognize gain of $80,000 on the transfer. p. 17-8

b. A transferor's interest cannot be counted if the stock received is of relatively small value in comparison to the value of that already owned and the primary purpose of the transfer is to qualify other transferors for § 351 treatment. For advance ruling purposes, the IRS treats the amount transferred as not being relatively small in value if it is equal to, or in excess of, 10% of the fair market value of the stock already owned by that person. Thus, if the one share of stock transferred to Peggy is less than 10% of the stock already owned by Peggy, Peggy's interest probably is not counted. Ted then is taxed on the transfer as he does not have an 80% interest in Robin Corporation. pp. 17-8 and 17-23

12. The shareholder's basis in the stock received is reduced by the amount of the liabilities assumed by the corporation. p. 17-9

13. Pursuant to § 357(a), the transfer of mortgaged property to a controlled corporation does not trigger gain. The transfer does not result in boot to the transferor shareholder. However, there are two exceptions to the rule of § 357(a). Section 357(b) provides that if the principal purpose of the assumption of the liabilities is to avoid tax *or* if there is not a bona fide business purpose behind the exchange, the liabilities are treated as boot. Further, § 357(c) provides that if the sum of the liabilities assumed exceeds the adjusted basis of the properties transferred, the excess is taxable gain. pp. 17-9 and 17-10

14. Beth would probably not be taxed as to the liabilities assumed by the corporation. Section 357(b) provides that if the principal purpose of the assumption of liabilities by the corporation is to avoid tax or if there is no bona fide business purpose behind the exchange, the liabilities in total are treated as money received and taxed as boot. The bona fide business purpose requirement causes difficulty if the liability is taken out shortly before the property is transferred and the proceeds are utilized for personal purposes. This is not the case here. Example 14

15. If gain were not recognized in § 357(c) situations, a shareholder would have a *negative* basis in the stock received. Under § 357(b), the result is to treat the liability transferred as boot. Thus, recognized gain results under § 357(b) only if there is realized gain. pp. 17-9, 17-10, and Example 16

16. a. If a shareholder receives "other property" (boot) in addition to stock in a § 351 transfer, gain is recognized to the shareholder to the extent of the lesser of the gain realized or the boot received. The gain recognized affects the shareholder's basis in the stock received. Section 358(a) provides that the basis of stock received is the same as the basis the shareholder had in the property transferred, increased by any gain recognized on the exchange, and decreased by boot received.

b. If a shareholder transfers a liability to the corporation along with property, the basis in the stock received is reduced by the amount of the liability transferred to the corporation. However, the transfer of the liability to the corporation will not produce gain to the transferor-shareholder (unless the liability exceeds the basis of the assets transferred or there was a tax avoidance scheme or no bona fide business purpose underlying the transfer).

c. The shareholder's basis in the property transferred becomes the basis of the stock received, increased by the amount of gain recognized to the shareholder, and decreased by the amount of boot received and the amount of liabilities transferred to the corporation.

Figure 17-1

17. If the services performed constitute an ordinary and necessary business expense (e.g., the shareholder serves as the office manager), the corporation may deduct the value of the stock issued. Otherwise, the cost must be capitalized. For example, accounting or legal services provided by a shareholder in organizing the corporation must be capitalized. Compare Examples 21 and 22

18. The basis rules are not the same for property acquired from a shareholder and for property acquired from a nonshareholder. The basis of property received by a corporation from a shareholder as a capital contribution is the basis in the hands of the shareholder increased by any gain recognized by the shareholder. The basis of property transferred to a corporation by a nonshareholder as a contribution to capital is zero. pp. 17-15 and 17-16

19. The advantages of utilizing debt are numerous. Interest on debt is deductible by the corporation, while dividend payments are not. Further, the shareholders are not taxed on the receipt of loan repayments unless they exceed basis. With respect to equity, as long as a corporation has earnings and profits it is difficult to withdraw the investment without triggering dividend income. p. 17-16

20. If a shareholder lends money to a corporation in his or her capacity as an investor, any resulting bad debt generally is classified as nonbusiness. However, if the loan is made in some capacity that qualifies as a trade or business, the shareholder-creditor can incur a business bad debt. Employee status is a trade or business, and a loss on a loan made to protect the shareholder's position as an employee qualifies for business bad debt treatment.

    Shareholders also may receive business bad debt treatment if they are in the trade or business of lending money or of buying, promoting, and selling corporations. The "dominant" or "primary" motive for making the loan controls the classification of the loss.

    pp. 17-19 and 17-20

21. a. No deduction is allowed for a mere decline in value of property. A deduction may be taken as a loss from the sale or exchange of a capital asset on the last day of the taxable year in which stock becomes completely worthless. [§ 165(g)(1)] Here the stock is not completely worthless.

    b. No deduction is permitted for a loss on a sale of property to a related party. § 267(a)(1)

    c. Mark may deduct a loss on a sale to a third party. Loss is established through a sale or exchange.

    d. Mark may deduct an ordinary loss only if the stock is not a capital asset or if it is § 1244 stock. If Mark was a broker and the stock was held for resale to his customers, he would have an ordinary loss. Normally, however, stock is held as investment property and is a capital asset. In that case, the loss would be a capital loss unless § 1244 applies.

pp. 17-19 and 17-20

22. Keith is attempting to enjoy the benefits of gain deferral and, at the same time, avoid the loss deferral aspects of § 351. In selling the loss assets for cash, instead of exchanging them for stock, a taxable event results, and losses can be recognized. However, the plan probably will not be succeed. Because the sale is so close in time to the formation of the corporation, the IRS would collapse the sale and take the approach that the transfer of the loss assets also falls under § 351.

    But even if the sale could be disassociated from § 351, the loss disallowance rules of § 267 would apply to disallow the loss. Section 267 disallows a loss deduction for exchanges between a shareholder and a corporation in which the shareholder owns more than 50% in value of the stock. pp. 17-22 and 17-23

23. Leasing some property to a controlled corporation may be a more attractive alternative than transferring ownership. Leasing provides the taxpayer with the opportunity of withdrawing money from the corporation without the payment being characterized as a dividend. If the property is donated to a family member in a lower tax bracket, the lease income can be shifted as well. If the depreciation and other deductions available in connection with the property are in excess of the lease income, the taxpayer would retain the property until the income exceeds the deductions. p. 17-24

PROBLEMS

24. a. $6,000 ordinary gain.

    b. $30,000 [$30,000 (basis of inventory) + $6,000 (gain recognized) – $6,000 (boot received)].

    c. $36,000 [$30,000 (basis of inventory) + $6,000 (gain recognized)].

    d. Seth recognizes gain of $9,000 (the amount of cash received). The gain is ordinary income because of the § 1245 depreciation recapture provisions.

    e. Seth has a basis of $45,000 in the Lark Corporation stock computed as follows: $45,000 (basis in the equipment) + $9,000 (gain recognized) – $9,000 (boot received).

    f. Lark Corporation has a basis of $54,000 in the equipment, computed as follows: $45,000 (basis of the equipment to Seth) + $9,000 (gain recognized by Seth).

    g. Pam has no recognized gain or loss. A secret process is property for purposes of § 351.

    h. Pam has a basis of $15,000 in the Lark Corporation stock.

    i. Lark Corporation has a basis of $15,000 in the secret process.

    j. Kelly has no taxable income on the transfer.

k. Kelly has a basis of $30,000 in the Lark Corporation stock.

pp. 17-3, 17-4, 17-12, and Figures 17-1 and 17-2

25. a. $0.

b. $180,000.

c. $140,000.

d. $0.

e. $264,000.

f. $120,000 (basis in the equipment) and $4,000 (basis in the patent).

g. The answers would not change. There is no requirement that the transferors receive the same type of stock. Further, both common stock and most preferred stock qualify as "stock." However, if Gail received "nonqualified preferred stock," her realized gain would be recognized because this type of preferred stock is treated as boot.

h. The answers would not change. There is no requirement that the transferors be individuals.

pp. 17-4, 17-5, 17-12, and Figures 17-1 and 17-2

26. a. None of the three individuals will recognize gain. The nonrecognition provisions of § 351 apply to all the exchanges. Example 5

b. Clyde will recognize gain of $410,000 ($500,000 – $90,000) on the exchange. Example 4

c. Clyde would be well advised to avoid having his transfer considered a part of an integrated plan that also includes Jane's and Jon's transfers. If his transfer is considered independent of the others, not only would Jane and Jon be able to benefit from the § 351 provisions (i.e., their gains realized would not be recognized), but Clyde's loss of $90,000 ($500,000 – $590,000) could be recognized. p. 17-6

27. Willis, Hoffman Maloney, and Raabe, CPAs
5191 Natorp Boulevard
Mason, OH 45040

March 28, 2003

Mr. Andrew Boninti
1635 Maple Street
Syracuse, NY 13201

Dear Mr. Boninti:

This letter is in response to your question as to whether you must report gain on the transfer of property to Gray Corporation for 60% of the stock in Gray. Our conclusion is based on the facts as outlined in your March 12 letter. Any change in facts may cause our conclusion to be inaccurate.

The property you transferred had a tax basis of $30,000 and a fair market value of $600,000. You received stock representing a 60% interest in Gray Corporation in consideration for your transfer of the property. The other 40% interest is owned by Kendall Smith, who acquired her shares several years ago.

Because the interest you acquired in Gray Corporation represents less than an 80% interest in Gray Corporation, you must report gain on the transfer. Your gain will be $570,000 [$600,000 (value of the stock received) – $30,000 (your tax basis in the property transferred)].

Should you need more information or need to clarify our conclusion, do not hesitate to contact me.

Sincerely,

Martha R. Harris, CPA
Partner

TAX FILE MEMORANDUM

March 18, 2003

FROM: Martha R. Harris

SUBJECT: Andrew Boninti

Today I talked to Andrew Boninti with respect to his transfer of appreciated property to Gray Corporation in which he obtained only a 60% stock interest. The remaining 40% interest was held by Kendall Smith, who acquired her interest several years ago.

<u>At issue</u>: Must a shareholder recognize gain on the transfer of appreciated property to an existing corporation if the shareholder has less than an 80% control of the transferee corporation after the transfer?

<u>Conclusion</u>: Yes. To qualify as a nontaxable transaction under § 351, the transferor must be in control of the transferee corporation immediately after the exchange. Control means that the person or persons transferring the property must have an 80% stock ownership in the transferee corporation. The transferor shareholder must own stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock. Control can apply to a single person or to several individuals if they are parties to an integrated transaction. In this case Kendall acquired her interest in the corporation several years ago; thus, she would not be part of the transaction involving Andrew. Because Andrew obtained only a 60% interest in Gray Corporation, the transfer is a taxable exchange. Andrew must recognize gain measured by the excess of the fair

market value of the stock received over the tax basis of the property he transferred. Therefore, the gain he recognizes is $570,000 ($600,000 – $30,000).

p. 17-6

28.
- Is the secret process property for purposes of § 351?
- Is the letter of credit property?
- Do the transfers qualify under § 351?
- If the transfers qualify under § 351, will Kevin be taxed on the stock received in exchange for the services he renders to Crow Corporation?
- What is Crow's basis in the secret process and the letter of credit, if they qualify as property?
- Will Crow Corporation have a tax deduction for the value of the stock it transfers to Kevin in consideration of the services he renders to Crow prior to Crow's incorporation?
- How will Crow treat the transfer of stock for services rendered by Kevin?

p. 17-7

29. Jaime will have a taxable gain of $510,000 on the exchange. The exchange will not qualify under § 351 because Jaime does not have 80% control in Hummingbird Corporation immediately following the property transfer. The general rule under § 351 applies to transfers to an existing corporation, as well as to a newly formed corporation. Jaime will have a basis of $600,000 in the stock received, and Hummingbird Corporation will have a basis of $600,000 in the property received. Example 12

30. a. Ann does not recognize a gain. Bob recognizes a gain of $15,000, the value of the services Bob rendered to the corporation. Bob does not recognize gain on the transfer of property to the corporation. Examples 3 and 11

b. Ann has a basis of $150,000 in the stock in Robin Corporation. Bob has a basis of $45,000 in his stock in Robin Corporation [$30,000 (basis in property transferred) + $15,000 (gain recognized)]. Figure 17-1

c. Robin Corporation has a basis of $150,000 in the property Ann transferred and a basis of $30,000 in property Bob transferred. Robin Corporation capitalizes $15,000 as organization costs. Figure 17-2 and Example 22

31. To be a member of the control group and aid in qualifying all transferors under the 80% test, a person contributing services must transfer property having more than a relatively small value in relation to the services performed. Stock issued for property of relatively small value compared with the value of the stock to be received for services rendered by the person transferring such property will not be treated as issued in return for property. The value of property transferred by Bob is less than 10% of the value of the services he provided. Bob will probably not qualify as a member of the control group. If Bob does not qualify as a member of the control group, Ann's transfer will also not qualify under

§ 351. Ann transferred property for only 70% of the stock. Therefore, both Ann and Bob would recognize gain on the exchanges. Robin's basis in the property transferred by Ann and Bob will be $420,000 and $15,000, respectively. Examples 9 and 10

32. Paul recognizes a gain of $20,000 on the transaction under § 357(c) [$105,000 (liability) – $85,000 (basis in the transferred property)]. Paul has a zero basis in the stock in Swift Corporation, computed as follows: $85,000 (basis in the property transferred to Swift Corporation) – $105,000 (liability) + $20,000 (gain recognized). Swift Corporation has a basis of $105,000 in the property computed as follows: $85,000 (basis to Paul) + $20,000 (gain recognized by Paul). Examples 16 and 19

33.
- Did the exchange three years ago qualify as a nontaxable exchange under § 1031?
- What basis did Chris acquire in the land?
- What basis will Chris have in the Amber Corporation stock?
- Does Chris have control in Amber?
- How are the mortgages on the land treated for tax purposes?
- Will the second mortgage be treated as "boot" under § 357(b)?
- What basis will Amber Corporation have in the land?

34. a. Sara does not recognize gain on the transfer. Jane has income of $15,000, the value of the services she renders to Wren Corporation.

b. Wren Corporation has a basis of $25,000 in the property it acquires from Sara and a basis of $10,000 in the property it acquires from Jane. It has a $15,000 business deduction under § 162 for the value of the services Jane renders.

Example 21

35. a. Jane has income of $15,000 for the value of the services rendered.

b. Wren Corporation has a basis of $10,000 in the property it acquires from Jane. It must capitalize the $15,000 as an organizational expense.

Example 22

36. a. Rose Corporation will not recognize any income from the transfer of land and cash. It is a capital contribution by a nonshareholder, not taxed pursuant to § 118.

b. Rose will have a zero basis in the land. § 362(c)(1)(B)

c. The purchased property will have a zero basis. The cost of the property, $50,000, would be reduced by the $50,000 of cash donated by the city.

d. In the situation where Rose uses $25,000 of its own funds in excess of the $50,000 contribution, the basis of the property acquired will be $25,000. § 362(c)(2) pp. 17-15, 17-16, and Example 25

37. Willis, Hoffman, Maloney, and Raabe, CPAs
5191 Natorp Boulevard
Mason, OH 45040

June 5, 2003

Ms. Emily Patrick
36 Paradise Road
Northampton, MA 01060

Dear Ms. Patrick:

This letter deals with the tax treatment that applies following the bankruptcy of Teal Corporation this year. Under the facts given, Teal Corporation was formed a number of years ago with an investment of $200,000 cash in return for which you received $20,000 in stock and $180,000 in 8 percent interest-bearing bonds maturing in nine years. Later, you lent the corporation an additional $50,000 on open account. During the corporation's existence, you were paid an annual salary of $60,000. Because our conclusion is based on these facts, please inform us if our understanding is inaccurate.

If the stock was issued pursuant to § 1244 of the Internal Revenue Code, you have a $20,000 ordinary loss on the worthless stock. Otherwise, the $20,000 investment in the stock results in capital loss treatment. A danger exists that the IRS could argue thin capitalization and reclassify the long-term debt as equity. This produces a capital loss on that portion of your investment. Also, it could contend that both the long-term debt (regardless of whether it can be deemed hybrid stock) and the $50,000 open account are nonbusiness bad debts and, therefore, short-term capital losses. If the IRS makes this assertion, we would recommend that you counter with the argument that the $50,000 open account is a business bad debt. To do this you need to show that the primary motive in lending the money to Teal Corporation was to protect your employment with the corporation. Further, if you are in the business of lending money or of buying, promoting, and selling corporations, you might be able to deduct both the $180,000 and the $50,000 as business bad debts which are treated as ordinary losses.

As this is a complicated situation, please call us if we may provide further assistance.

Sincerely,

Sarah Mitchell, CPA

pp. 17-16 to 17-21 and Example 27

38. Willis, Hoffman, Maloney, and Raabe, CPAs
5191 Natorp Boulevard
Mason, OH 45040

November 14, 2003

Mr. Steve Ferguson, President
Jaybird Corporation
555 Industry Lane

Pueblo, CO 81001

Dear Mr. Ferguson:

This letter is in response to your question with respect to the tax treatment of loans in the amount of $300,000 each from your shareholders, Vera, Wade, and Wes. Our conclusion is based on the facts as outlined in your November 10 letter. Any changes in facts may cause our conclusion to be inaccurate.

The corporation seeks additional capital in the amount of $900,000 to construct a building. Your equal shareholders, Vera, Wade, and Wes propose to loan the corporation $300,000 each. The corporation will issue to each a four-year note in the amount of $300,000 with interest payable annually at two points below the prime rate. Jaybird's current taxable income is $2 million.

Payments on the notes would probably be treated as dividends for tax purposes. The debt instruments have too many features of stock. The debt will not bear a legitimate rate of interest and it is proportionate to the stock holdings of Vera, Wade, and Wes. Because Jaybird has substantial current taxable income, the payment on the loans could indicate an attempt to withdraw earnings in the form of principal and interest payments on debt obligations rather than as dividend payments.

Should you need more information or need to clarify our conclusion, do not hesitate to contact me.

Sincerely,

Susan K. Papenfuse, CPA
Partner

TAX FILE MEMORANDUM

November 13, 2003

FROM: Susan K. Papenfuse

SUBJECT: Jaybird Corporation

Today, I conferred with the Steve Ferguson, President of Jaybird Corporation with respect to his November 10 letter. The corporation needs additional capital to construct a building in the amount of $900,000. The three equal shareholders of Jaybird Corporation, Vera, Wade, and Wes, each propose to loan Jaybird Corporation $300,000, taking from Jaybird a $300,000 four-year note with interest payable annually at two points below the prime rate. Mr. Ferguson informed me that Jaybird Corporation has current taxable income of $2 million.

<u>At issue</u>: Would the loans of $300,000 each by Jaybird's shareholders, represent debt or could the IRS successfully reclassify the debt as equity?

Jaybird Corporation would want to deduct interest payments on the notes payable to its shareholders. Thus, it would not want the debt reclassified as equity as all payments, including payments on the principal, would be treated as dividends.

The IRS has authority under § 385 to characterize corporate debt wholly as equity or as part debt and part equity. Section 385 lists several factors that *may* be used to determine whether a debtor-creditor relationship or a shareholder-corporation relationship exists. If the debt instrument does not bear a reasonable rate of interest, the debt is susceptible to reclassification as equity. Further, if holdings of debt and stock are proportionate, the debt may be reclassified as equity. When debt and equity obligations are held in the same proportion, shareholders are, apart from tax considerations, indifferent as to whether corporate distributions are in the form of interest or dividends. When funds are loaned to finance capital asset acquisitions, the funds may also be reclassified as equity. Funds used to acquire capital assets a corporation needs to operate are generally obtained through equity investments.

Conclusion: Should the shareholders of Jaybird Corporation loan it money in the form proposed, the IRS could probably successfully contend the debt was really an equity interest. The loans present a problem because the debt is proportionate to the stock holdings of Vera, Wade, and Wes. In addition, the interest rate is below the prime rate. Jaybird Corporation will use the funds to construct a building. This also indicates the debt is in reality an equity investment.

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39. Sam has an ordinary loss of $50,000 and a long-term capital loss of $40,000. Example 28

40. Willis, Hoffman, Maloney, and Raabe, CPAs
5191 Natorp Boulevard
Mason, OH 45040

July 30, 2003

Mr. Mike Sanders
2600 Riverview Drive
Plank, MO 63701

Dear Mr. Sanders:

This letter is in response to your question with respect to stock you held in a corporation that qualified as a small business corporation under § 1244. Our conclusion is based upon the facts you provided us. Any change in facts may cause our conclusion to be inaccurate.

Your brother, Paul, gave you the stock a few months after he acquired the stock. Paul paid $30,000 for the stock three years ago. You sold the stock this tax year for $10,000.

You may deduct the difference between the selling price of the stock, $10,000, and the cost of the stock to your brother Paul, $30,000. When property is given to another, there is a carryover of the basis the donor had in the property. Thus, your tax basis in the stock will be the $30,000 tax basis your brother, Paul, had in the stock. You will have a long-term capital loss of $20,000 on the sale of the stock. Because you were not the original holder of the stock, you may not take an ordinary loss deduction on the sale.

Should you need more information or need to clarify our conclusion, do not hesitate to contact me.

Sincerely yours,

David C. Via, CPA
Partner

TAX FILE MEMORANDUM

July 18, 2003

FROM: David C. Via

SUBJECT: Mike Sanders

Today I talked to Mike Sanders with respect to his sale of stock which was issued to his brother, Paul, pursuant to § 1244. Paul paid $30,000 for the stock three years ago and gave the stock to his brother, Mike, a few months after he acquired it. Mike sold the stock in the current tax year for $10,000.

<u>At issue</u>: May a donee of stock in a corporation that qualified as a small business corporation under § 1244 take an ordinary loss deduction pursuant to § 1244?

<u>Conclusion</u>: No. Only the original holder of § 1244 stock qualifies for ordinary loss treatment.

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41. a. The basis of the stock to Susan is $50,000.

    b. The basis of the stock for purposes of § 1244 is only $25,000.

    c. Susan would have a $30,000 loss ($20,000 – $50,000), only $5,000 of which would be ordinary under § 1244. The remaining $25,000 loss would be a capital loss.

Example 29

42. The shareholders of Blue Corporation have avoided pro rata holding of debt by having Mitch lease property to the corporation and receiving an annual rent that approximates the yield on the loans from Frank and Cora. Because the loans are not pro rata, the IRS may have difficulty in reclassifying the debt as equity. In addition, Blue Corporation can defend its debt-equity ratio by stressing the fair market value of its assets. If the tax basis of Blue Corporation's assets is used in determining its debt-equity ratio, it is 6 to 1 [$300,000 (liabilities) to $50,000 (tax basis of assets)]. However, if fair market value of its assets is used, the ratio is only .5 to 1 [$300,000 (liabilities) to $600,000 (value of assets)]. Thus, Blue appears to have an acceptable debt-equity ratio. Examples 32 to 34