

Organization of a Corporation: Section 351 and Related Problems

3A Requirements of § 351 Nonrecognition

GENERAL COMMENTS: This is an introductory lesson intended to teach the basic principles before diving into the mechanics of § 351 transactions. Therefore, many of the same issues are covered in Lesson 3B. Note that while the fiscal year, the accounting method, and other tax decisions that must be made upon incorporation are not discussed here, you may cover these topics in the lesson.

(1) The transfer is a sale or disposition under § 1001. *A* will realize \$100 in amount and \$50 in gain and will recognize the gain "except as otherwise provided in this subtitle," because the general rule of the Code is that transfers for value are subject to tax. *X* will take a § 1012 cost basis so that the \$50 gain inherent in the land in *A*'s hands cannot again be taxed. If *X* exchanges its stock, that stock is property the fair market value of which normally is realized by the recipient under § 1001(b), and *X* still gets a cost basis of \$100 in the land. Section 351 "otherwise provides" if various conditions to be studied herein are met, with the result that *A* does not recognize the realized gain and *X* takes a carryover basis in the land. Conceptually, this rule seems to have been adopted in part to facilitate the incorporation of assets without recognition of gain (thus, normally benefiting the transferor) or loss (thus, normally benefiting the government), and in recognition of the feeling that somehow *A* has not "cashed in" because *A*'s interest in the land continues in the form of *A*'s stock. Compare § 721. B&E ¶ 3.01.

(2) No, because *B* is not in the control club (one element of the control requirement), since he did not contribute property for his stock, and *A* does not have control alone. B&E ¶ 3.08. The corporation, however, is protected from recognition of gain on the exchange of its stock for services by § 1032. B&E ¶ 3.12.

INSTRUCTOR'S MANUAL

- (3) *A* and *B* are in control immediately after the exchanges and gave property for stock. The fact that *B* got stock worth more than the value of his property does not oust him from the control club, as long as the property *B* transferred was of more than nominal value. B&E ¶ 3.08[1]. Therefore, *A* and *B* comprise the control club and their exchanges of property are shielded from recognition by § 351(a). B&E ¶ 3.08[2]. As Regs. § 1.351-1(b)(1) suggests, however, something else is going on here. Discuss the following: (1) § 83(a) \$60 compensation to *B*; (2) § 83(h) \$60 deduction to *A*; (3) § 1001 disposition of \$60 (\$45 basis) in stock of *X* that was deemed received initially by *A* and then paid by *A* to *B* for services, resulting in a \$15 gain.
- (4) This problem is designed simply to help the student work through the fact that the 80 percent requirement applies to each class of nonvoting stock (a second element of the control requirement); control is lacking here. Rev. Rul. 59-259; B&E ¶ 3.07. An S election is possible if the common classes differ only as to vote. Regs. § 1.1361-1(d)(i). If the Class D stock becomes voting stock, then *A* has control because *A* has more than 80 percent of the total vote.
- (5) Although § 351 applies outside of initial organization of the corporation, that section could not apply here, because of § 351(d)(2); the nonsecurity debt is not property. B&E ¶ 3.02[3]. *A* does not need § 351 to provide gain nonrecognition, because he has a \$10 basis in the receivable ("tax cost basis" and § 1012) for which he gets \$6 worth of stock, and a \$4 loss is realized. Section 1001(c) requires the loss to be recognized except when § 267(a)(1) applies, which section will disallow the loss if this is a sale or exchange. Section 1271(a)(1) supplies the sale or exchange treatment upon the debt retirement, overruling *Fairbanks*, if this is a debt instrument under § 1275(a)(1)(A) (which it is; see Regs. § 1.1275-1(d); B&E ¶ 4.21). Section 1032 shields *X* from income upon exchange of stock. B&E ¶ 3.12. Under § 108(e)(8), *X* has discharged a \$10 debt with stock worth \$6 and so has \$4 COD income. If *X* were not on the accrual method and had not yet deducted the \$10 when paid on the cash method, *X* would have no COD income, under § 108(e)(2). If *X* were insolvent, it would not recognize the \$4 COD income. B&E ¶ 4.25.
- (6) The issue is whether the license is "property" for purposes of § 351. Currently, the Service apparently will not rule on whether a nonexclusive license of intellectual property is "property." Rev. Rul. 64-56 treats an exclusive license as property.

LESSON 3

(7) The analysis here is (1) does *A* have control "immediately after" by *A*'s own stock ownership, and (2) why does not the principle that applied in (3) apply here? Contrast with (3) in which *B* was also a property transferor and thus was in the "control club." This is similar to (3), except for the fact that in this problem, there is a real, rather than deemed, retransfer of *A*'s stock and the "immediately after" issue must be addressed (the third element of the control requirement). Section 351(a) does not apply to *A*'s property exchange if *A* lost control "immediately after." Whether § 351 applies depends on which of the three step transaction tests applies and the facts. B&E ¶ 3.09.

Consider discussing *American Bantam Car* and Rev. Rul. 78-294 and generally introducing the step transaction doctrine. Consider also discussing *West Coast Marketing* to sensitize students early to the possibility that an apparent § 351 exchange may be disregarded (the "disregardable corporation") where business purpose is lacking (although the government's theory there was that the second step attempted reorganization failed). If § 351 applies, then *A* recognizes \$5 of gain on the transfer of 20 shares to *B* and *A* has a \$45 basis in the remaining 60 shares; but if *A* has only 75 percent of stock "immediately after," then § 351 does not apply and *A* recognizes \$20 of gain on the exchange with *X* and no further gain upon paying *B* because *A* has an \$80 basis in the 80 shares. In either event, *B* recognizes \$20 of compensation income and takes a \$20 basis in the stock. Consider discussing the investment company exception. B&E ¶ 3.15[1].

(8) Yes, because Regs. § 1.351-1(a)(1)(ii) prevents *A* from being treated as transferring property for stock; thus, *A* is not in the control club and *B*, the property transferor, does not have control immediately thereafter.

(9) *A* does not want to recognize the appreciation in the stock and expects § 1014 to eliminate that gain for his heirs. *A* and *X* can incorporate *Y*, with *A* giving his 20 percent *T* stock interest in exchange for *Y* stock (possibly preferred, but *not* nonqualified preferred) and *X* giving cash worth 80 percent of outstanding *T* stock in exchange for the balance of *Y*'s stock. *Y* will then form a subsidiary that will merge into *T* in a "cash merger," with the 80 percent shareholders receiving cash for their *T* shares and *Y* retaining its 20 percent of *T*'s shares and becoming the sole shareholder of *T*. B&E ¶ 3.19; Rev. Rul. 84-71 (National Starch ruling). If *T* and *X* had simply engaged in a merger or other reorganization with 80 percent of the *T* shareholders receiving cash for their stock and *A* receiving *X* stock for his *T* stock, *A* would have recognized the gain

INSTRUCTOR'S MANUAL

in his *T* stock because of the failure of the reorganization to satisfy the continuity of interest requirement. B&E ¶ 12.21[2][b].

Consider discussing generally the use of § 351 in creating holding companies. The letter rulings reveal many fact patterns; for examples, see Ltr. Ruls. 8913032, 8929005, 8917005; Rev Proc. 2003-3, § 3(29).

3B Boot; Basis; Debt; "Midstream" Issues

(1)(a) Section 351(a) applies. Upon exchange with *X*, (1) *A*'s amount realized is \$100; (2) *A*'s gain realized is \$60; (3) nothing is recognized, because of § 351(a); (4) *A*'s basis in stock received is \$40 under § 358(a)(1); (5) *A*'s holding period in the stock tacks under § 1223(1); (6) *X*'s basis in property is \$40 under § 362(a)(1); (7) *X*'s holding period for property received tacks under § 1223(2); and (8) *X* would recognize \$60 long-term capital gain on a sale of the property. On the separate sale of half the stock, *A* realizes and recognizes a capital gain of \$30 and has a basis of \$20 in the remaining 50 shares, while *B* takes a cost basis of \$50 in the purchased shares. B&E ¶ 3.10, 3.11. If the property's basis were \$200, loss would not be recognized under § 351(a) (whether or not boot is received) and the losses will be built into the stock basis as well as the property basis inside the corporation. Then when *A* sells half of the stock to *B*, *A* will recoup \$50 loss, retaining a \$100 basis in the other half of the stock. Thus, there is a full doubling of the \$100 loss in the property (although the Service hates this result, since it forms the foundation for many tax shelter transactions).

(1)(b) Section 351(a) does not apply. On exchange with *X*, (1) *A*'s amount realized is \$100; (2) *A*'s capital gain realized is \$60; (3) *A*'s capital gain recognized is \$60; (4) *A*'s basis in stock of *X* received is \$100 under § 1012; (5) a new holding period in the stock begins; (6) *X* takes cost basis in the property equal to the assumed \$100 value of its stock (Rev. Rul. 56-100; B&E ¶ 3.12[4]); (7) a new holding period begins; and (8) *X* would realize no gain on sale of the property. Upon sale to *B*, *A* realizes no gain or loss and holds the remaining 50 shares with a \$50 basis. Also B&E ¶ 3.09[2] (decontrol). Under the alternative of a \$200 basis in the property, § 351(b)(2) does not apply and *A* would recognize a \$100 loss because § 267(b)(2) requires more than 50 percent value (assuming the step transaction doctrine also applies to prevent *A* from ever having control of *X*); however, consider attribution and the possibility that a control block exists. B&E ¶ 5.04[2]. *A* has no gain or loss on the sale of half the stock to *B* and has

LESSON 3

\$50 basis in the remaining shares. *X* would take \$100 stepped-down basis in the property.

S election: The results in (a) and (b) would be the same, except that *X* will not be taxed on the later sale of the property in problem (1)(a). *S* election will avoid the subchapter C lobster pot: doubling of gain potential. B&E ¶ 1.03. Note that the carryover of low basis in appreciated property, to both the stock received and the corporation as its basis in the property, results in less basis to support loss pass-through and more potential gain of *X* that will pass-through. Note the shareholder limitations and two classes of stock limitation. B&E ¶¶ 6.02, 6.06. Consider incorporation of a partnership and *S* election and transitory ownership of stock by a partnership. B&E ¶ 3.18; Rev. Rul. 84-111.

(2) This probably produces the same results as (1)(a) to *A* and *B* but not to *X*. *A* recognizes \$30 capital gain on the property sale before a good § 351(a) exchange with *X*. *A* has \$30 gain realized but not recognized and a basis of \$20 in the 50 shares of *X* stock received, with the holding period tacked. *X* holds the half of the property received from *A* with a \$20 basis and tacks *A*'s holding period, and the half received from *B* with a \$50 basis and tacks *B*'s short holding period. *X* recognizes \$30 gain on its sale of the property, probably all long-term capital gain. Although the property has a split holding period, all the gain is attributable to the capital gain portion. See Rev. Rul. 67-309. *B*'s 50 shares have a \$50 basis under § 358(a)(1); technically, the holding period tacks, but there is nothing to tack. B&E ¶¶ 3.10, 3.11.

Consider the possibility that a transitory sale of property to *B* will be a disregarded step.

(3) Same as first step of (1)(a), except *A* gets boot of \$50; *A* realizes gain of \$60, which is recognized as capital gain to the extent of boot (\$50). IRC § 351(b)(1); B&E ¶ 3.05. *A*'s stock basis is \$40 (\$40 - \$50 + \$50). IRC § 358(a)(1); B&E ¶ 3.10. The holding period should still tack. B&E ¶ 3.10. *X*'s property basis is \$90, and *X* will tack *A*'s holding period and would recognize \$10 long-term capital gain on the sale of the property. IRC §§ 362(a)(1), 1223(2); B&E ¶ 3.11. *B* has a § 358(a)(1) \$50 basis in his stock with a new holding period.

Note: As a summary observation on problems (1) through (3) above, form generally controls in subchapter C, particularly where the tax interests of the parties are competing. See, for example, Rev. Rul. 84-111; B&E ¶ 3.18[1]. But compare Rev. Rul.

INSTRUCTOR'S MANUAL

2003-51 (where the Service did not hold the taxpayer to its chosen form (which could have violated § 351 control) because another clearly tax-free format existed; B&E ¶ 3.09[5]).

(4) Discuss the concept of “security” debt and its prior importance (B&E ¶¶ 3.03, 3.04), the remaining areas of relevance, such as § 351(d)(2), and the fact that since 1989, we need not determine whether this is security debt because all of *X*’s debt is boot. The result is the same as in (3) because *A* has a \$50 boot gain, but here *A* can report it on the installment method. See Prop. Regs. § 1.453-1(f)(3) (1984) (which backloaded basis of \$40 into 50 shares of stock and also would delay—probably improperly—*X*’s basis increase to \$90 until *A*’s gain recognition); B&E ¶ 3.11[4]. Consider discussing the many limitations in § 453 on installment sale treatment.

(5) *A* receives nonqualified preferred stock of *X*. Section 351(a) does not apply at all because *A* received no other stock. Therefore, *A* recognizes a \$60 gain and recognizes no more gain on selling the nonqualified preferred stock for its value. Discuss how this treatment could allow *A* to recognize a loss on property contributed for the nonqualified preferred (subject to various loss recognition limitations), and how NQP received along with other stock is simply boot under § 351(b). Discuss the definition of NQP and the many unanswered questions. B&E ¶ 3.05[4].

(6) *A* realizes \$100 in amount and \$60 of gain. Section 357(b) could be asserted to cause debt assumption (including taking subject to) to be treated as payment of \$50 boot by *X*. B&E ¶ 3.06[3]. In such case, *A* will recognize \$50 gain and take a basis in the stock of \$40 ($\$40 - \$50 + \50). *X*’s basis in the property would be \$90 ($\$40 + \50). If not, § 357(c) will apply to treat the debt in excess of basis, \$10, as gain from the sale or exchange of, in this case, a capital asset. IRC § 357(d)(1)(B); B&E ¶¶ 3.06[4]–3.06[7]. *A*’s stock basis would be zero, because § 358(d)(1) treats the entire \$50 debt assumption as payment of money for purposes of § 358(a)(1)(A)(ii) ($\$40 - \$50 + \$10 = 0$). This leaves the remaining \$50 of gain built into the stock. *A*’s stock holding period tacks. *X*’s basis in the property is \$50, and the holding period tacks so that a later sale produces \$50 capital gain. B&E ¶¶ 3.10, 3.11. Consider discussing the negative basis route seemingly approved in *Easson*. B&E ¶ 3.06[4].

(7) Under § 357(d)(1)(A), absent other “facts and circumstances,” it appears that *X* has not assumed the liability. That the debt is secured by the property transferred does not

LESSON 3

by itself create an assumption. Therefore, § 357(c) does not apply. *A* takes a \$40 basis in the 100 shares and does not recognize any gain. However, *X*'s payment of *A*'s \$50 liability should be treated as a distribution to *A* at the time of payment. B&E ¶ 8.05[7]. See IRC §§ 357(d), 362(d); B&E ¶¶ 3.06[4][f], 3.11[7].

(8) *A* realizes \$100 in amount and \$100 of gain (since he has no basis in the receivables), but does not recognize any gain because of § 351, since the incorporation is not treated as an assignment of income and the debt assumption is not treated as debt in excess of basis. Rev. Rul. 80-198; IRC § 357(c)(3)(A)(i); B&E ¶¶ 3.06, 3.17. *A*'s stock basis is zero and will not tack the receivables holding period. IRC §§ 358(d)(2), 1223(1). *X*'s property basis is zero so *X* will have \$100 in ordinary income upon collecting the receivables (although the holding period tacks under § 1223(2), these are not capital assets) and may deduct \$50 upon paying the payables. Rev. Rul. 80-198; B&E ¶ 3.17.

Variation: If the receivables become subject to 34 or 35 percent tax while the payables are deducted against a higher individual tax rate, *A* may have achieved too good a result that will not qualify under Rev. Rul. 80-198. B&E ¶ 3.17[2]. But 2003 legislation (reducing the top § 1 rate to 35 percent) presumably resolves this problem. Conversely, if payables go in without receivables, § 482 can be asserted to cure the mismatch. B&E ¶ 3.17[3].

(9) The second issue in *Lessinger* is raised here: the possibility of avoiding § 357(c) by *A* giving his own note to the corporation. The Second Circuit held that it worked but in a questionable decision; *Peracchi* is questionable also. B&E ¶ 3.06[4][b]. Subsequent enactment of § 357(d)(1)(B) offers little additional hope because it states that the nonrecourse amount must be treated as assumed. In question (7), the formal assumption causes § 357(c) to apply unless the contribution of the \$10 note is a "fact or circumstance" that limits the assumption to \$40, in which case there would be no § 357(c) gain recognition.

Contribution to capital. While no specific problem is assigned, consider discussing in lecture format contributions to capital, including specifically *Fink* and *Lessinger* (first issue: necessity of issuing stock); IRC §§ 108(e)(6), 118, 1244 (importance of issuing stock to avoid § 1211(b)).