

CHAPTER 2 - CORPORATE FORMATION AND CAPITAL STRUCTURE
TRUE/FALSE

TRUE/FALSE

1. During the year, R and S established T Corporation, which issued 100 shares of stock. R transferred land worth \$9,000 (basis \$8,000) to the corporation for 90 shares of stock while S contributed services worth \$1,000 for 10 shares of stock. Neither R nor S must recognize income due to their respective transfers.

ANS: F

Under § 351, R does not recognize gain because immediately after the exchange he owned 90 percent of the stock, which exceeds the control threshold of 80 percent. However, S must recognize income of \$1,000 because he is not a transferor of property.

PTS: 1 REF: Example 9 and pp. 2-7 through 2-9

2. An individual provides accounting services to a corporation in exchange for stock. The shareholder must recognize income and the corporation may deduct or capitalize the expenditure as would be appropriate.

ANS: T

Section 351(d)(1) provides that stock issued for services is not considered issued for property and thus does not qualify as a nontaxable exchange. The Service has ruled that the corporation may treat the transfer as if it had paid cash, and thus it may deduct or capitalize the expenditure as would be appropriate.

PTS: 1 REF: Example 5, p. 2-6, and Rev. Rul. 217, 1962-2 C.B. 59

3. B owns 85 percent of the stock of D Corporation, and C owns the remaining 15 percent. The corporation has been in operation for three years. During the year, B transferred land worth \$20,000 (basis \$11,000) to the corporation for additional shares, increasing his ownership to 88 percent. B is not required to recognize gain on the transfer.

ANS: T

Under § 351, B does not recognize gain because immediately after the exchange he owns 88 percent of the stock, which exceeds the control threshold of 80 percent. Note that § 351 applies to transfers to an existing corporation as well as a new corporation.

PTS: 1 REF: Example 7 and p. 2-7

4. G owns 85 percent of the stock of X Corporation, and H owns the remaining 15 percent. The corporation has been in operation for three years. During the year, G transferred land worth \$20,000 (basis \$11,000) to the corporation for a note bearing 10 percent interest and maturing in 15 years. G is not required to recognize gain on the transfer.

ANS: F

Receipt of a security under § 351 is treated as boot and causes recognition of gain.

PTS: 1 REF: p. 2-12

5. J owns all 150 shares of stock of Y Corporation, worth \$500,000. This year he convinced his son K to come into business with him. To this end, K contributes appreciated property worth \$100,000 (basis \$5,000) to the corporation for 50 shares of Y stock. K should recognize no gain on the transfer, assuming his father also transfers cash of \$25,000.

ANS: F

Due to the nominal nature of J's transfer, it is unlikely that J's ownership will be counted toward the 80 percent control test, causing K to recognize gain. Rev. Proc. 77-37, 1977-2 C.B. 568 requires that property constituting at least 10 percent of the value of the pre-existing ownership must be transferred before such ownership may be considered. In this case, J transfers \$25,000, which is only 5 percent of the \$500,000 value of his ownership. (

PTS: 1

REF: Example 14 and pp. 2-8 and 2-9

6. M incorporated her proprietorship this year. After receiving all of the stock of her new corporation, she immediately transferred 30 percent of the stock to her sister. M's exchange is not taxable even though she retained control only briefly after the exchange.

ANS: T

Momentary control is sufficient for nonrecognition as long as the transferor has the freedom to determine whether he or she will make a transfer after the exchange. A transferor does not have control if a prearranged plan exists that requires the transferor to make the transfer leading to loss of control.

PTS: 1

REF: Example 16 and pp. 2-10 and 2-11

7. J formed X Corporation during the year by transferring land worth \$50,000 to the corporation in exchange for all of its stock. The property had a basis of \$20,000 and was subject to a mortgage of \$15,000, which the corporation assumed. As a general rule, J must recognize gain of \$15,000.

ANS: F

Liabilities transferred generally are not treated as boot under § 357(a); thus, J is not required to recognize gain.

PTS: 1

REF: Example 18 and pp. 2-12 to 2-14

8. P formed Y Corporation by transferring property worth \$70,000 to the corporation for all of its stock. The property had a basis of \$30,000 and was subject to a mortgage of \$10,000. P's basis in her stock is \$20,000.

ANS: T

The shareholder's basis under § 358 is the basis of the property transferred increased by any gain recognized and decreased by any boot received. Although the liabilities are not treated as boot for purposes of determining gain or loss, they normally are considered in the basis calculation. Thus, the basis of the stock is \$20,000 (\$30,000 - \$10,000).

PTS: 1

REF: Exhibit 2-1, Example 27, and pp. 2-16 and 2-17

9. During the year, Proprietor incorporated his hobby shop in a transaction that generally qualifies for nonrecognition under § 351. As part of the formation, he transferred various liabilities to the new corporation, including a bill for a recent shipment of Prestochangos, the hottest toy on the market. When the corporation later paid the bill, it properly charged the items to its inventory account. In determining the tax consequences of exchange, the liability is ignored for determining Proprietor's gain recognized.

ANS: F

Under § 357(c)(3), liabilities that are properly capitalized by the corporation when paid are treated as liabilities for purposes of determining whether liabilities exceed basis of the assets transferred. In this case, after the corporation paid the expense it was capitalized as part of inventory. Thus, it must be considered a liability for purposes of determining whether liabilities transferred exceed basis.

PTS: 1

REF: Example 24 and pp. 2-16 and 2-17

10. N established L Corporation by transferring property worth \$100,000 (basis \$25,000) to the corporation for all of its stock. N's basis in the stock received is the same as the corporation's basis for the property, \$25,000.

ANS: T

Under § 358, the shareholder's basis in the stock received is the same as the basis of the property transferred, adjusted for boot received and gain recognized, neither of which were present in this situation. Thus, the basis in the stock is \$25,000. Under § 362, the corporation's basis is the same as the shareholder's basis increased by any gain recognized.

PTS: 1

REF: Exhibits 2-1 and 2-2, Examples 25 and 29, and pp. 2-16, 2-19 and 2-20

11. The holding period of stock received in an exchange qualifying for nontaxable treatment under § 351 begins on the date the transferred asset was acquired, assuming the asset was a building used in the transferor's sole proprietorship.

ANS: T

Since the basis for the stock is determined by using the basis of the property transferred, the transferor's holding period for any stock received in exchange for a capital asset or § 1231 property is the same as that of the asset.

PTS: 1

REF: p. 2-19 and § 1223(1)

12. If a corporation receives a nonshareholder contribution representing an inducement rather than payment for corporate goods or services, the corporation must include the transfer in gross income.

ANS: F

Such nonshareholder contributions may be excluded from gross income. If the contribution is property, the basis of the property is considered zero so that normal tax benefits associated with basis (e.g., depreciation) cannot be obtained.

PTS: 1

REF: Example 36, p. 2-24 and § 118

13. If a corporation receives a nonshareholder contribution representing an inducement rather than payment for corporate goods or services, the corporation must include the transfer in gross income.

ANS: F

Such nonshareholder contributions may be excluded from gross income. If the contribution is property, the basis of the property is considered zero so that normal tax benefits associated with basis (e.g., depreciation) cannot be obtained.

PTS: 1

REF: Example 36, p. 2-24 and § 118

14. A court decision that recharacterizes a corporation's debt obligations as stock normally would result in unfavorable tax consequences for an individual holding the purported debt.

ANS: T

For an individual taxpayer, recharacterization of debt as equity would cause interest payments to be treated as dividends, resulting in double taxation. In addition, repayments of principal would no longer be tax-free but under the redemption rules would probably be treated as dividends as well.

PTS: 1

REF: Example 37 and 38 and pp. 2-25 and 2-26

15. Assuming both investments become worthless after three years, a married individual investing in a corporation would be indifferent to whether he receives a \$20,000 note or \$20,000 of § 1244 stock in exchange for a \$20,000 transfer.

ANS: F

The loss on the § 1244 stock would be an ordinary loss while the loss on the security would be a capital loss. The ordinary loss would be deductible in full on the individual return (\$100,000 limit on joint return), whereas the capital loss deduction would be limited to \$3,000.

PTS: 1

REF: Examples 40 and 41 and pp. 2-30 through 2-32

16. Holder contributed \$50,000 to a newly formed corporation in exchange for § 1244 stock. During the year, he sold the stock to Buyer. The stock qualifies as § 1244 stock in Buyer's hands.

ANS: F

Only the original holders of the stock are entitled to § 1244 treatment. Since Buyer purchased the stock from an original holder, she is denied § 1244 treatment.

PTS: 1

REF: p. 2-31

17. Contributor transferred \$50,000 to his newly formed corporation in exchange for § 1244 stock. During the year, he gave some of the stock to his son who will someday own the entire business. The stock qualifies as § 1244 stock in the son's hands.

ANS: F

Only the original holders of the stock are entitled to § 1244 treatment. Because the son received the stock from an original holder, he is denied § 1244 treatment.

PTS: 1

REF: p. 2-31

18. T Corporation transferred \$75,000 to a newly formed corporation in exchange for stock. At the time of the contribution, the new corporation's total capital was \$500,000. T Corporation's stock qualifies as § 1244 stock.

ANS: F

Only stock issued to individuals and partnerships qualifies for § 1244 stock treatment. Because T is a corporation, it does not receive § 1244 treatment.

PTS: 1

REF: p. 2-31

19. Transferor contributed \$180,000 of cash to his newly formed corporation in exchange for stock. As part of the same plan, Manager received \$20,000 of stock for services to be performed during the first year of business. Manager's stock qualifies as § 1244 stock.

ANS: F

Stock received for services does not qualify as § 1244 stock.

PTS: 1

REF: p. 2-32

20. Transferor contributed \$120,000 to a newly formed corporation in exchange for stock. At the time of the contribution, the corporation's total contributed capital was \$5 million. Transferor's stock qualifies as § 1244 stock.

ANS: F

The corporation must qualify as a "small business corporation" when the stock was issued. To meet this requirement, the total amount contributed for stock may not exceed \$1 million. Consequently, the corporation is not considered a small business corporation and the stock is not § 1244 stock.

PTS: 1

REF: p. 2-32

MULTIPLE CHOICE

21. 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.
- 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.
 - D realizes a \$4,000 gain which is not recognized. The gain escapes tax only temporarily.
 - 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 realizes a gain of \$4,000. In this case, the gain must be recognized under the continuity of interest doctrine.

ANS: B

Under § 351, a transfer is nontaxable only if those that transfer property, as a group, own 80 percent of the stock immediately after the exchange. In this case, D's exchange qualifies for § 351 because immediately after the exchange he owns 100 percent of the stock. As a result, the realized gain of \$4,000 (\$10,000 — \$6,000) is not recognized. This gain does not escape tax permanently, however, but is deferred through the basis that D must assign to his stock. D's basis in the stock is generally a substituted basis, in this case, \$6,000. Thus, if D sells his stock for its \$10,000 value, the deferred gain would be recognized.

PTS: 1

REF: Examples 4 and 25 and pp. 2-5 and 2-16

22. Several years ago, Theodore Theory started his own company for manufacturing peripheral equipment such as memory chips and boards. This year he transferred all of the assets and liabilities of his high-tech business, worth \$10 million, to a newly formed corporation in exchange for 10 percent of its stock. The other transferor was a large conglomerate that contributed the assets of its technology division, worth \$90 million, to the corporation in exchange for 90 percent of the stock. Theo retired to Florida and followed his investment in The Wall Street Journal while the conglomerate took over total control of the new enterprise. Which of the following statements is true?
- Theo should qualify for nonrecognition under § 351 in this situation, since the transaction meets its literal requirements and is consistent with the policy underlying the provision.
 - Theo will qualify for nonrecognition under a literal interpretation of the Code even though the application of § 351 in this situation is inconsistent with the policy underlying the provision.
 - Theo will not qualify for nonrecognition in this situation under § 351, since he has neither met the literal requirements of the provision nor satisfied the policy underlying the law.
 - Although application of § 351 is consistent with the policy underlying the provision in this situation, Theo will not qualify for nonrecognition because he has not met the provision's

literal requirements.

ANS: B

Theo qualifies for nonrecognition, since the literal requirements of § 351 are satisfied (i.e., Theo is one of the transferrers that own at least 80 percent of the stock immediately after the exchange). However, it is doubtful whether the policy of § 351 is well served, since there has been more than a mere change in the form of Theo's investment. He has discarded the role of entrepreneur for that of investor in a huge conglomerate.

PTS: 1

REF: p. 2-4

23. This year C and D formed a new corporation. C and D both contributed appreciated property, receiving 90 and 10 shares of the corporation's stock respectively.
- C must recognize gain.
 - D must recognize gain.
 - C and D must recognize gain.
 - Neither C nor D must recognize gain.

ANS: D

Neither must recognize gain. Under § 351, a transfer is nontaxable if those that transfer property, as a group, own 80 percent of the stock immediately after the exchange. In this case, C and D own 100 percent of the stock.

PTS: 1

REF: Example 6 and p. 2-7

24. T Corporation was formed 10 years ago by J, K, and L. These three shareholders currently own all of the corporation's stock as follows: J owns 500 shares, K owns 100 shares, and L owns 100 shares. This year J contributed property worth \$90,000 (basis \$20,000) to the corporation in exchange for an additional 300 shares. J will
- recognize gain on the exchange because on the exchange he received only 30 percent of the stock outstanding after the exchange.
 - recognize gain because the transfer is not to a newly formed corporation.
 - recognize no gain because transfers to a corporation by a shareholder in exchange for a stock interest are nontaxable regardless of the transferor's stock ownership.
 - recognize no gain because he has sufficient stock ownership after the exchange.

ANS: D

Under § 351, a transfer is nontaxable only if those that transfer property, as a group, own 80 percent of the stock immediately after the exchange. In this case, J owns 80 percent of the stock after the exchange (500 + his preexisting equity interest of 300 shares or 800 of the total 1,000 shares outstanding). Therefore the transaction is nontaxable.

PTS: 1

REF: Example 7 and p. 2-7

25. During the year, M, N, and O formed a new corporation. Solely in exchange for stock, M and N contributed appreciated property, while O contributed services. The exchanges of M and N will be nontaxable if
- O receives 30 percent of the stock.
 - O receives 80 percent of the stock.
 - O receives 10 percent of the stock.
 - M and N receive 50 percent of the stock.
 - None of the above.

ANS: C

Under § 351, a transfer is nontaxable if those that transfer property, as a group, own 80 percent of the stock immediately after the exchange. Therefore, if the transfers of the property transferors are to be nontaxable, a person that contributes only services can receive at most 20 percent of the stock.

PTS: 1 REF: Example 9 and p. 2-8

26. During the year, R, S, T, and U formed a new corporation. R contributed appreciated property, S and T contributed cash, and U contributed services. R, S, T, and U each received XU of the stock. Based on these facts
- R must report taxable income.
 - R and U must report taxable income.
 - U must report taxable income.
 - transfers to a corporation in exchange for stock are nontaxable and thus none of the parties report taxable income.

ANS: B

Under § 351, a transfer is nontaxable if those that transfer property, as a group, own 80 percent of the stock immediately after the exchange. In this case, those who transfer property, R, S, and T, receive only 75 percent of the stock. Thus, R's transfer is taxable. In addition, § 351 does not apply to a contribution of services. Stock received for services is treated as compensation, and thus, U must include the value of the stock received for services rendered as income.

PTS: 1 REF: Example 10 and pp. 2-8 and 2-9

27. This year X, Y, and Z formed a new corporation. X and Y contributed appreciated property for 50 percent of the stock. Z contributed property and services for the remaining 50 percent of the stock. Of the amounts given below, what is the minimum amount of stock that Z must receive for his property contribution if the exchanges of X and Y are to be nontaxable.
- 8 percent
 - 10 percent
 - 20 percent
 - 30 percent
 - 50 percent

ANS: A

Under § 351, a transfer is nontaxable only if those that transfer property, as a group, own 80 percent of the stock immediately after the exchange. For purposes of the 80 percent test, the Regulations provide that all of the stock received by a transferor of both property and services is counted toward control, not just the amount received for property. The Regulations provide, however, that property contributions which are nominal in amount are disregarded for this purpose. The Service has indicated that for ruling purposes, the value of the stock received for property must be at least 10 percent of the value of services. Therefore, the minimum amount of stock that X can receive for services is 4.55 percent determined as follows:

x	=	Value of stock received for services
.10 x	=	Value of stock received for property
x + .10 x	=	50%
x	=	45.45%
.10 x	=	4.55%

Of the percentages given, 8 percent is the closest to 4.55 percent.

PTS: 1 REF: Example 13 and pp. 2-7 and 2-8

28. 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 amount of gross income must F recognize due to the incorporation transaction?
- a. \$0
 - b. \$10,000
 - c. \$25,000
 - d. \$35,000
 - e. None of the above.

ANS: B

The transfer generally qualifies for nonrecognition under § 351, since the transferors of property, F and G, control the corporation immediately after the exchange. However, § 351 does not apply to contributions of services. Consequently, F must recognize income equal to the value of the services.

PTS: 1

REF: Example 5 and pp. 2-6 through 2-9

29. 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 F's total basis in the stock that he received?
- a. \$15,000
 - b. \$40,000
 - c. \$25,000
 - d. \$50,000
 - e. None of the above.

ANS: C

The transfer generally qualifies for nonrecognition under § 351, since the transferors of property, F and G, control the corporation immediately after the exchange. However, § 351 does not apply to contributions of services. Consequently, F must recognize income equal to the value of the services. Under § 358, F's basis is \$15,000, the same as the property transferred, increased by gain recognized (\$0) and decreased by boot received (\$0). The basis for the stock received for services is equal to the income recognized, or \$10,000. Thus, the total basis is \$25,000 (\$15,000 + \$10,000).

PTS: 1

REF: Example 17 and pp. 2-7, 2-8, 2-10, 2-11, 2-16 and 2-17

30. 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 amount of gross income must G recognize due to the incorporation transaction?
- a. \$0
 - b. \$20,000
 - c. \$11,000
 - d. \$61,000
 - e. None of the above.

ANS: C

Since the transaction qualifies for nontaxable treatment under § 351, no gain is recognized unless boot is received. For this purpose, the liabilities are not considered boot under § 357. However, § 357(c) provides that gain must be recognized to the extent liabilities exceed the aggregate of the basis of property transferred, which in this case is \$11,000 (\$20,000 — \$9,000).

PTS: 1

REF: Examples 21 and 22 and p. 2-14

31. 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?
- \$0
 - \$9,000
 - \$20,000
 - \$11,000
 - None of the above.

ANS: A

Under § 358, G's basis is \$0, the same as the property transferred (\$9,000), increased by gain recognized (\$11,000), and decreased by boot received (\$20,000 liability).

PTS: 1

REF: Example 27 and p. 2-17

32. 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
- neither income nor deduction.
 - some amount of income but no amount of deduction.
 - no income but some amount of deduction.
 - some amount of income and some amount of deduction.

ANS: C

The corporation recognizes no income on the exchange, but is entitled to deduct the amount paid for the services, or alternatively to capitalize and amortize a portion of the amount attributable to the services.

PTS: 1

REF: p. 2-18 and § 1032

33. 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. Assuming G recognized \$27,500 of gain on the exchange, the corporation's basis for the land received is
- \$9,000
 - \$70,000
 - \$36,500
 - \$50,000

ANS: C

The corporation's basis under § 362 is the same as the transferor's, increased by any gain recognized, or \$36,500 (\$27,500 + \$9,000).

PTS: 1

REF: Exhibit 2-2, Example 29 and pp. 2-18 and 2-19

34. 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. If G should sell his stock, the holding period will
- include the holding period of the land.
 - begin on the date of the transfer.
 - always be considered long-term regardless of the holding period of the land or the date of the transfer.
 - always be considered short-term regardless of the holding period of the land or the date of the transfer.

ANS: A

Under § 1223, the holding period of the asset transferred (the land) tacks to the stock, since the asset is § 1231 property or a capital asset and the basis of the stock is determined by reference to the basis of the land.

PTS: 1

REF: p. 2-18

35. 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. The following statements concern the computation of depreciation of the equipment contributed by F. In which statement is the computation of depreciation correctly described?
- Assuming F and G were incorporating their partnership, the partnership will report no depreciation and the corporation will report all the depreciation allowable.
 - Assuming F and G had never before been in business, the corporation will compute its depreciation deduction for the entire year by applying the depreciation percentage to the adjusted basis of the property.
 - Assuming F contributed the equipment that she had used in her sole proprietorship business for two years (which is continued by the corporation), the corporation may treat the asset as newly acquired property, use the first year depreciation percentage, and claim 10/12 of the amount so determined in computing depreciation.
 - Assuming F transferred equipment that she had used in her own business, the corporation will merely step into the shoes of F and claim the deduction she would otherwise be able to claim, and F will not claim any depreciation for the year of the transfer.
 - None of the above.

ANS: E

The corporation must use the same method for computing the depreciation as the transferor and claim 10/12 of that amount.

PTS: 1

REF: Examples 33 through 35 and pp. 2-21 and 2-22

36. This year D, E, and F formed a new corporation. D exchanged equipment worth \$40,000 for 40 percent of the stock and services worth \$15,000 for 15 percent of the stock. E exchanged machinery worth \$30,000 for 30 percent of the stock and services worth \$10,000 for 10 percent of the stock. F exchanged land worth \$5,000 for 5 percent of the stock. Which of the following statements is true?
- F's transfer does not qualify for nonrecognition treatment under § 351 because he did not receive a sufficient equity interest.
 - For § 351 purposes, D, E, and F are treated as owning only 75 percent of the stock and therefore their exchanges of property do not qualify for § 351 treatment.
 - All of the property exchanges qualify for nonrecognition treatment under § 351.

- d. More than one of the above is true.
- e. None of the above is true.

ANS: C

Under § 351, a transfer is nontaxable only if those that transfer property, as a group, own 80 percent of the stock immediately after the exchange. For purposes of the 80 percent test, the Regulations generally provide that all of the stock received by a transferor of both property and services is counted toward control not just the amount received for property. Therefore, D, E, and F are deemed to own 100 percent of the stock after their exchanges. As a result, each of their property exchanges are nontaxable.

PTS: 1

REF: Examples 11 and 12 and p. 2-8

37. J, L, and R formed a new corporation. J exchanged equipment worth \$35,000 (basis \$8,000) for 35 percent of the stock, and services worth \$25,000 for 25 percent of the stock; L exchanged land worth \$25,000 (basis \$5,000) for 25 percent of the stock; and R received 15 percent of the stock in exchange for securities worth \$15,000 (basis \$10,000). Which of the following statements is true?
- a. The transaction would not be eligible for nonrecognition because more than 20 percent of the stock received was in exchange for services.
 - b. The transaction will be eligible for nonrecognition, but J will have to recognize gain on the compensation for services.
 - c. Only the basis of the property transferred is considered in determining whether nonrecognition is granted; the three shareholders owned 80 percent of the property transferred.
 - d. None of the above.

ANS: B

Section 351 provides that all the stock received where a shareholder exchanges both services and property can be considered toward the 80 percent required for control. However, income must be recognized by the shareholder on the compensation for services. There is no requirement that for nonrecognition, the amount of property involved in transfers to a corporation be limited to a set percentage.

PTS: 1

REF: pp. 2-7 and 2-8

38. This year T transferred property worth \$10,000 (basis \$3,000) to C Corporation in exchange for a 15 year bond worth \$5,000 and all of C's stock worth \$5,000.
- a. The transfer is nontaxable because the transferor received stock and debt on the exchange.
 - b. T must recognize gain of \$7,000 since § 351 does not apply to the transaction.
 - c. T must recognize gain of \$5,000.
 - d. None of the above.

ANS: C

If the transferor exchanges property for debt of the corporation, such debt is considered boot. Therefore, T's gain realized of \$7,000 (\$10,000 — \$3,000) must be recognized to the extent of the debt received, \$5,000.

PTS: 1

REF: p. 2-11

39. S has decided to incorporate her proprietorship. She anticipates transferring all of the assets to the corporation for 100 percent of its stock. The corporation will issue only voting common stock. Immediately after the exchange, S plans to give 15 percent of the stock to her daughter and sell another 20 percent to an interested investor. S is under no obligation to give stock to her daughter or to sell stock to the investor. If the provisions of § 351 are applied to the transfer,
- a. control is measured before the gift and sale and, therefore, no gain or loss is recognized by

S on the transfer.

- b. control is measured immediately after the gift and sale and, inasmuch as S no longer controls 80 percent of the stock, she must recognize gain or loss on the transfer of the proprietorship assets into the corporation.
- c. because S has made a plan to circumvent the § 351 requirement concerning control, gain or loss must be recognized.
- d. b and c above are true.
- e. none of the above are true.

ANS: A

Section 351 requires control to exist “immediately after the exchange.” However, “momentary control” has been ruled sufficient if the transferor has—on receipt of the stock—freedom to retain or dispose of the stock. Intent in no way invalidates this transfer, as long as loss of control is not inevitable.

PTS: 1

REF: pp. 2-9 and 2-10

40. S transfers land to a new corporation for stock. The corporation plans to issue 1,000 shares of voting common stock and 500 shares of nonvoting preferred stock. Common stock notwithstanding, the minimum number of preferred shares that S must receive to be in control is
- a. 0
 - b. 251
 - c. 375
 - d. 400

ANS: D

500 shares 80 percent = 400 shares. The transferor must receive at least 80 percent of each class of stock.

PTS: 1

REF: p. 2-7

41. In a § 351 transfer, stock includes all of the following except
- a. preferred.
 - b. preferred and nonvoting.
 - c. nonparticipating.
 - d. stock rights and warrants.

ANS: D

Stock rights and warrants do not qualify as stock, since they only give a right to obtain an equity interest.

PTS: 1

REF: p. 2-7

42. This year, T transferred appreciated property to a newly formed corporation. Which of the following items may not be received if the exchange is to be tax-free?
- a. Bonds with a maturity of 15 years.
 - b. Nonvoting cumulative participating preferred stock.
 - c. Neither of the above may be received.
 - d. Both of the above may be received.

ANS: A

Any type of security is treated as cash, which requires gain recognition. A taxpayer can receive any type of stock in a tax-free incorporation.

PTS: 1

REF: pp. 2-7 and 2-11

43. Which of the following is a true statement about § 351 transfers?
- a. A transferor who contributes appreciated property to a corporation can receive items other than stock and the entire exchange may still qualify for tax-free treatment.
 - b. The amount of boot received as a result of the assumption of liabilities by the corporation is limited to the excess of liabilities over basis of assets transferred.
 - c. Partnerships may not be incorporated under this provision.
 - d. None of the above are true.

ANS: D

Choice a is false because a transferor can receive only stock and qualify for tax-free treatment under § 351. Choice b is false because the excess of liabilities over basis does not represent boot but represents gain that the transferor must recognize. Choice c is false because partnerships may be incorporated under § 351.

PTS: 1

REF: p. 2-10

44. This year, A transferred land worth \$150,000 (basis \$90,000) to his wholly owned corporation in exchange for voting, preferred stock. The land was subject to a mortgage of \$40,000. Due to the transfer, A must recognize gain of
- a. \$0
 - b. \$40,000
 - c. \$60,000
 - d. \$100,000

ANS: A

When a taxpayer is relieved of a liability, it is normally treated as if the taxpayer received cash and then paid off the liability (U.S. v. Hendler). This decision made many incorporation transactions taxable. Section 357(a) was enacted so that relief of a liability is not treated as boot, and thus no gain is recognized.

PTS: 1

REF: Example 18 and p. 2-13

45. This year P and Q formed ABC Corporation. P transferred a building worth \$90,000 (basis \$25,000) to the corporation in an exchange generally qualifying under § 351. The building was subject to a mortgage of \$10,000, and P received stock worth \$80,000 on the exchange. P will recognize
- a. no gain or loss and have a basis in his stock of \$25,000.
 - b. no gain or loss and have a basis in his stock of \$15,000.
 - c. a gain of \$10,000 and have a basis in his stock of \$25,000.
 - d. a gain of \$15,000.
 - e. a gain of \$65,000.

ANS: A

P realizes a gain of \$65,000 (\$80,000 + \$10,000 - \$25,000). Although P has effectively received cash to the extent he was relieved of the \$10,000 liability, such relief is not considered boot under § 357(a). Therefore no gain is recognized. However, relief of the liability must be considered in the basis calculation. Therefore, P's basis is \$15,000 (the same as the basis of the property transferred, \$25,000, increased by gain, \$0, and reduced by the liability, \$10,000).

PTS: 1

REF: Example 27 and p. 2-17

46. This year J and K formed New Corporation. J transferred the assets below to New in exchange for stock.

Adjusted Fair Market

	<i>Basis</i>	<i>Value</i>
Building	<u>\$ 45,000</u>	<u>\$ 90,000</u>
Equipment	<u>100,000</u>	<u>110,000</u>
Total	<u><u>\$145, 000</u></u>	<u><u>\$200, 000</u></u>

In addition the building was subject to a mortgage of \$50,000. J received stock worth \$150,000 on the exchange. Assume that the transfer meets the requirements of § 351. J will recognize

- no gain or loss.
- \$5,000 gain.
- \$50,000 gain.
- \$60,000 gain.

ANS: A

J realizes a gain of \$55,000 (\$150,000 + \$50,000 - \$145,000). Although J has effectively received cash to the extent he was relieved of the \$50,000 liability, such relief is not considered boot under § 357(a). In addition, § 357(c) (requiring gain to be recognized when the taxpayer is relieved of liabilities that exceed basis) does not apply here because the total liabilities from which J was relieved, \$50,000, does not exceed the total basis of the property transferred, \$145,000. When applying the test of § 357(c), aggregate liabilities must be compared to aggregate basis. Thus, no gain is recognized.

PTS: 1

REF: Example 22 and p. 2-14

47. This year J and K formed New Corporation. J transferred the assets below to New in exchange for stock.

	<i>Adjusted Basis</i>	<i>Fair Market Value</i>
Building	\$ 45,000	\$ 90,000
Equipment	<u>100,000</u>	<u>110,000</u>
Total	<u><u>\$145, 000</u></u>	<u><u>\$200, 000</u></u>

In addition the building was subject to a mortgage of \$50,000. J received stock worth \$150,000 on the exchange. Assume that the transfer meets the requirements of § 351. J's basis in his stock is

- \$145,000.
- \$95,000.
- \$100,000.
- \$150,000.
- some other amount.

ANS: B

J realizes a gain of \$55,000 (\$150,000 + \$50,000 - \$145,000). Although J has effectively received cash to the extent he was relieved of the \$50,000 liability, such relief is not considered boot under § 357(a). In addition, § 357(c) (requiring gain to be recognized when the taxpayer is relieved of liabilities that exceed basis) does not apply here because the total liabilities from which J was relieved, \$50,000, does not exceed the total basis of the property transferred, \$145,000. When applying the test of § 357(c), aggregate liabilities must be compared to aggregate basis. Thus, no gain is recognized. However, the liability is considered for basis purposes. Consequently, J's basis is \$95,000 (basis of the property transferred, \$145,000, + gain, \$0, - liability \$50,000).

PTS: 1

REF: Examples 18 and 27 and pp. 2-13 and 2-17

48. Promoter incorporated his real estate business, transferring the following liabilities
1. \$100,000 mortgage on real estate acquired four years ago (the \$100,000 represented the unpaid balance of the original mortgage).
 2. \$25,000 second mortgage on real estate (Promoter had borrowed the \$25,000 to use for personal purposes one week before the transfer).
 3. \$40,000 of accounts payable for expenses incurred for architectural fees related to construction of a new 2,000-unit complex.

Upon review, the IRS would probably treat which of the following amounts as boot?

- a. \$165,000
- b. \$25,000
- c. \$65,000
- d. \$140,000
- e. \$125,000

ANS: A

Because there is no valid business purpose for the second mortgage, § 357(b) and Reg. § 1.357-1(c) require that all liabilities from which the taxpayer was relieved—not just the tainted ones—are to be treated as boot (\$100,000 + \$40,000 + \$25,000).

PTS: 1

REF: footnote 29 and pp. 2-14 and 2-15

49. Entrepreneur, a cash basis taxpayer, incorporated his solely owned software business during the year. Among the items transferred to the newly formed corporation were various liabilities, including a bill from a supplier for 1,000 floppy disks on which Entrepreneur's world famous program TX 4-5-6 is copied for later sale. Assuming the cost of the disks is properly deducted when the corporation pays the bill, which of the following statements is true regarding the treatment of the liability on the exchange?
- a. The liability must be considered for purposes of determining Entrepreneur's gain but is ignored for determining his basis in his stock.
 - b. The liability must be considered for purposes of determining both Entrepreneur's gain and his basis in his stock.
 - c. The liability need not be considered for purposes of determining Entrepreneur's gain but must be considered for determining his basis in his stock.
 - d. The liability need not be considered for purposes of determining Entrepreneur's gain or basis in his stock.

ANS: D

Code § 357(a) provides that liabilities generally are not treated as boot for purposes of determining the transferor's gain or loss recognized on an exchange. However, § 357(c) generally requires the taxpayer to recognize gain to the extent the liabilities transferred exceed the total basis of the property transferred. In making this calculation, § 357(c)(3) provides that those liabilities relating to routine deductible expenditures are not considered liabilities. In addition, such liabilities are ignored in computing the shareholder's basis. Because the liability is not considered for purposes of determining Entrepreneur's gain choices a and b are incorrect. Choice b is also wrong because such liabilities are similarly ignored in determining shareholder's basis. Choice c is wrong because it states that the liability must be considered for the determination of Entrepreneur's basis in his stock.

PTS: 1

REF: Example 28 and pp. 2-17 and 2-18

50. Which of the following is not directly considered in calculating the basis of stock received in a § 351 transfer?
- a. Basis of the property transferred.

- b. Fair market value of the stock received.
- c. Fair market value of the property received.
- d. Liabilities assumed by the corporation.

ANS: B

The fair market value of the stock received is not used to determine the shareholder's basis but is used to determine the gain realized.

PTS: 1

REF: Exhibit 2-1 and pp. 2-17 and 2-18

51. B transferred depreciable equipment worth \$12,000 (basis \$9,000) to his wholly owned corporation this year in exchange for stock worth \$7,000 and cash of \$5,000. B's gain or loss on the transaction and his basis for the stock received is
- a. \$3,000 gain, \$7,000 basis.
 - b. \$0 gain, \$9,000 basis.
 - c. \$3,000 gain, \$12,000 basis.
 - d. \$5,000 gain, \$9,000 basis.
 - e. none of the above.

ANS: A

Because the cash received exceeds the gain realized, all of the gain of \$3,000 must be recognized. The basis in the stock is the same as the basis of the property, \$9,000, increased by the \$3,000 gain and decreased by the \$5,000 boot, or \$7,000.

PTS: 1

REF: Example 26 and p. 2-17

52. B, C, and D each own 30 shares of the 90 shares of stock outstanding of We-Cater-To-You Corporation. This year B contributed a van previously used in his proprietorship worth \$10,000 (basis \$12,000) in exchange for 10 shares of stock. B will
- a. recognize no gain or loss on the exchange and have a basis in the stock received of \$10,000.
 - b. recognize a \$2,000 loss on the exchange and have a basis in the stock received of \$10,000.
 - c. recognize no gain or loss on the exchange and have a basis in the stock received of \$12,000.
 - d. recognize a \$2,000 loss on the exchange and have a basis in the stock received of \$12,000.

ANS: B

Under § 351, a transfer is nontaxable only if those that transfer property, as a group, own 80 percent of the stock immediately after the exchange. In this case, B is the only transferor of property, and immediately after the exchange he owns only 40 percent $[30 + (10/100)]$. Therefore, his transfer is a taxable transaction, allowing him to recognize a loss of \$2,000 (\$10,000 - \$12,000). Note that § 267 (relating to losses on sales between related parties) does not apply because B does not own more than 50 percent of the corporation's stock. Because the transaction is taxable B's basis in his stock is \$10,000. In effect, he has acquired the stock by giving property worth \$10,000.

PTS: 1

REF: Example 8 and pp. 2-7 and 2-16

53. C incorporated her sole proprietorship two years ago by transferring equipment that was worth \$100,000 and had a basis of \$40,000 (cost \$70,000, depreciation claimed and deducted \$30,000). The corporation sold the equipment for \$65,000. During the period that the corporation held the asset, it had claimed and deducted \$10,000 in depreciation. The corporation must recognize
- a. § 1231 gain of \$25,000 and § 1245 gain of \$10,000.
 - b. § 1231 gain of \$35,000 only.
 - c. § 1245 gain of \$35,000 only.
 - d. § 1245 gain of \$5,000 only.

e. none of the above.

ANS: C

The basis of the property to the corporation under § 362 is the same as the transferor's, or \$40,000. This amount must be reduced by the \$10,000 depreciation to give the corporation a basis of \$30,000. Thus, the corporation recognizes a \$35,000 (\$65,000 - \$30,000) gain on the sale. All of the \$30,000 depreciation recapture potential carries over to the corporation and is added to the \$10,000 claimed by the corporation, resulting in total depreciation recapture potential of \$40,000. Thus, all \$35,000 of the gain is ordinary income under § 1245.

PTS: 1

REF: p. 2-21

54. G incorporated his sole proprietorship three years ago by transferring all of the business assets to the corporation for all of its stock. Included among the assets transferred was equipment on which there was unearned investment credit. Which of the following statements is true?
- a. A sale of the equipment by the corporation will trigger unearned investment credit recapture, all of which must be recaptured by the corporation.
 - b. A sale by G of his entire interest in the corporation will trigger unearned investment credit recapture, all of which must be recaptured by G.
 - c. Unearned investment credit must be recaptured by G subsequent to the transfer because it is triggered upon transfer.
 - d. None of the above are true.

ANS: B

Answer a is false because investment credit is recaptured by the shareholder. Answer c is false because investment credit need not be recaptured if all substantial assets are transferred and the transferor retains a substantial interest in the corporation.

PTS: 1

REF: p. 2-20

55. Although the investment credit was generally repealed beginning in 1986, the possibility for the recapture of unearned credits continues to exist. The recapture rules relating to the investment credit generally provide that the credit must be recaptured upon a disposition prior to the time when the credit has been fully earned. In a transfer of property to a corporation, investment credit recapture
- a. is the obligation of the corporation.
 - b. is required if the transferor retains a substantial interest in the business.
 - c. is not required if a mere change in form occurs.
 - d. may be required regardless of whether the transfer qualifies for nonrecognition treatment under § 351.
 - e. c and d above.

ANS: E

Recapture is not required if a substantial interest is retained in the business—if a "mere change in the form of conducting the business" is deemed to occur. Recapture is the obligation of the transferor-shareholder, not the corporation.

PTS: 1

REF: p. 2-21

56. X incorporated her calendar year proprietorship on October 1 of this year. In exchange for all of its stock, she transferred her business's assets, including a computer that she had purchased for \$20,000 in June of the prior year and used only in her business. Assume the applicable depreciation percentages are 10 percent for last year and 20 percent for the current year. What is the total amount of depreciation that can be properly deducted by X for her proprietorship for the current and the prior year?
- a. \$6,000
 - b. \$5,000

- c. \$2,000
- d. Choice of a or b.

ANS: B

X may properly deduct depreciation of \$5,000: \$2,000 for the prior year ($10\% \times \$20,000$) and \$3,000 for the current year ($20\% \times \$20,000 = \$4,000$) $\times 9/12$, for her portion of the year before transferring the asset to the corporation.

PTS: 1 REF: Example 33 and pp. 2-21 and 2-22

57. During the year, the city of Houston contributed land worth \$100,000 to XYZ,

Inc. in order to lure the company to establish a factory in the city. XYZ will report

- a. \$100,000 income and will have a basis in the property of \$100,000.
- b. no income and will have a basis in the property of \$100,000.
- c. no income and will have a zero basis in the property.
- d. \$100,000 income and will have a zero basis in the property.

ANS: A

The clearest indication that "debt" is actually a disguised equity interest is a ratio of debt to stock ownership exceeding 4:1. (Here, 85%: 15% = 5.67:1.) Proportionate holdings are not conclusive evidence that the debt is equity, especially in the case of a solely owned corporation with properly structured debt.

PTS: 1 REF: pp. 2-25 through 2-27

58. From an individual's perspective, which of the following is not an advantage of utilizing debt when determining whether debt (i.e., long-term securities) or stock should be used as part of the capital structure of the business?
- a. It is less costly to pay a return to the investor.
 - b. It can be transferred without concern for control.
 - c. It provides a defense against possible imposition of the accumulated earnings tax.
 - d. It receives more favorable treatment should it become worthless.

ANS: D

Loss on a worthless security that is a capital asset, whether stock or debt, is treated as a loss from the sale or exchange of a capital asset on the last day of the taxable year. Thus, worthless debt and worthless stock are treated the same. Moreover, if the stock were § 1244 stock, the treatment of stock would be more favorable, since ordinary loss treatment is allowed, subject to limitations.

PTS: 1 REF: pp. 2-30 and 2-31

59. L and R each received \$500,000 from their mother to start their own businesses. L transferred her \$500,000 to her corporation for shares of stock worth \$200,000 and a \$300,000 note bearing 10 percent interest. The interest is payable in annual installments of \$30,000 for 15 years. In contrast, R contributed his \$500,000 to his corporation in exchange solely for stock. Assume both corporations are equally successful and have current EP (earnings and profits) exceeding \$30,000 at the end of their first year. During the year, L receives an annual principal payment of \$25,000. To acquire \$25,000, R redeems stock of his corporation worth \$25,000. Which of the following statements is true?
- a. L's principal payment is tax-free.
 - b. L's debt could be reclassified as stock if the corporation were too thinly capitalized.
 - c. R's \$25,000 will be taxed as a dividend.
 - d. All of the above.

ANS: D

This example points out the advantages of owning debt over stock. But if the capital structure consists primarily of debt and little stock, it is said to be too thinly capitalized, and the debt may be reclassified as stock.

PTS: 1 REF: pp. 2-25 through 2-27

60. Several years ago, R incorporated his sole proprietorship, receiving stock and debt as part of the transaction. In which of the following situations is the debt likely to be recharacterized as stock?
- 85 percent debt, 15 percent stock
 - 50 percent debt, 50 percent stock
 - 15 percent debt, 85 percent stock
 - 40 percent debt, 60 percent stock

ANS: A

The clearest indication that "debt" is actually a disguised equity interest is a ratio of debt to stock ownership exceeding 4:1. (Here, 85%: 15% = 5.67:1.) Proportionate holdings are not conclusive evidence that the debt is equity, especially in the case of a solely owned corporation with properly structured debt.

PTS: 1 REF: pp. 2-25 through 2-27

61. Hybrid securities are quite susceptible to being reclassified as stock. Which of the following is characteristic of hybrid securities?
- A maturity date that is reasonably close in time.
 - Interest payable regardless of the corporation's income.
 - Not subordinated to debt of general creditors.
 - None of the above.

ANS: D

All of these are characteristics of straight debt, which contains an unqualified promise to pay a certain sum at a maturity date along with a fixed percentage in interest.

PTS: 1 REF: pp. 2-27 through 2-29

62. N Corporation was formed by L in 2001, issuing \$2 million in stock. Several years ago, M was admitted as a new shareholder, receiving 100 shares of stock and a note in exchange for property. The stock and note have a basis of \$30,000 and \$40,000, respectively. On October 5 of the current year, the corporation declared bankruptcy, and the stock and note became worthless. How much may M deduct on her individual return for this year?
- \$70,000, if married status.
 - \$50,000, if single status.
 - \$73,000, if married status.
 - \$51,500, if single status.
 - \$3,000, if married or single status.

ANS: E

Since the note and stock are worthless and have been held for longer than one year, M has a long-term capital loss of \$70,000. M may deduct a maximum of \$3,000 due to the limitations on deductions of capital losses. Note that the stock involved could not be § 1244 stock because the initial capitalization exceeded \$1 million.

PTS: 1 REF: pp. 2-30 through 2-31

63. In January last year, D, single, established a corporation and acquired § 1244 stock. This year the stock, which had a basis of \$120,000, became worthless. D had no other property transactions during the year. D's adjusted gross income will decrease because of these transactions by
- a. \$50,000.
 - b. \$120,000.
 - c. \$3,000.
 - d. \$53,000.
 - e. \$103,000.

ANS: D

The loss on § 1244 stock is treated as an ordinary loss up to a maximum of \$50,000 annually for a single taxpayer. The remainder of the loss is treated as a capital loss, for which the maximum deduction is \$3,000. Thus, D's A.G.I. decreases by \$53,000.

PTS: 1

REF: Example 41 and pp. 2-31 and 2-32

64. Taxable transfers of property to a corporation may be desirable under certain conditions. Taxpayers may avert nonrecognition by
- a. selling the property to the corporation for debt.
 - b. exchanging the property in a § 351 transaction in which boot is received.
 - c. exchanging the property with the corporation where § 351 does not apply.
 - d. all of the above.

ANS: D

All three methods are used by taxpayers to make use of the advantages of taxable transfers. These plans do not always avert nonrecognition, however.

PTS: 1

REF: pp. 2-35 through 2-38

65. Ten years ago J purchased land for \$40,000. The land has appreciated in value and now could be subdivided and sold for \$450,000. The land currently constitutes a capital asset for J under § 1221. What form of development of the property would have the most favorable tax consequences for J?
- a. Subdivide the property and sell the lots.
 - b. Form a corporation and transfer the property for stock under the nonrecognition provisions of § 351.
 - c. Form a corporation to develop the land and sell the land to it, taking an installment note payable for the sales price.

ANS: C

Although J sold the land to the corporation and must recognize gain, all the gain is capital gain. By selling the land for debt, J has obtained cash out of his corporation via deductible interest payments and tax-free payments of principal, instead of dividends (b). Income from the sale of lots (a) would probably be taxable as ordinary income.

PTS: 1

REF: Example 45 and pp. 2-36 and 2-37