University of Baltimore School of Law
Corporate Reorganizations
Spring, 2018

Class 1: Introduction to the Basics of Corporate Reorganizations

Richard Heinecke*
703-815-2488 home
RNHeinecke@verizon.net

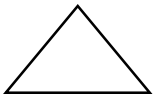
***These Schematics for Corporate Tax Reorganizations are by Richard Heinecke (any discussion and opinions are that of the author). Reference to any revenue ruling, revenue procedure, notice or announcement is from the text provided from published guidance in the IRB.**

Legend		
DE	=	an entity disregarded from its owner for FITP
FITP	=	U.S. Federal income tax purposes
LLC	=	limited liability company
PRS or PTSP	=	partnership
QRS	=	qualified REIT subsidiary
REIT	=	real estate investment trust
S corporation (vs. C corporation)	=	Subchapter S corporation
A, B, C, D, E, F, or G (Reorganization)	=	Letter corresponding to respective reorganization under IRC section 368(a)(1)
D	=	In the context of divisive transaction is meant to stand for the Distributing corporation
C		In the context of a divisive transaction is meant to stand for the Controlled corporation (the spun-off corporation)
Section	=	All references to section are to the Internal Revenue Code of 1986 (as well as 1954 Code, and prior acts, as the case may be)
ptar	=	party to a reorganization
cpcg	=	Common parent of a consolidated group
COI	=	Continuity of interest
COBE	=	Continuity of business enterprise
ATOB	=	Active Trade or Business
p/s	=	Preferred stock
c/s	=	Common stock
Nvps	=	Non-voting preferred stock

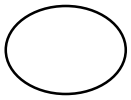
Unless specifically stated, the corporations discussed do not file as a consolidated group under section 1502.

Symbols=

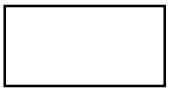
Symbol for partnership =



Symbol for DE or individual =



Symbol for corporation=



Section 1001(a)-(c)

(a) Computation of gain or loss. The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.
(b) Amount realized. The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. In determining the amount realized—

(1) there shall not be taken into account any amount received as reimbursement for real property taxes which are treated under section 164(d) as imposed on the purchaser, and
(2) there shall be taken into account amounts representing real property taxes which are treated under section 164(d) as imposed on the taxpayer if such taxes are to be paid by the purchaser.

(c) Recognition of gain or loss. Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.

Section 361(a) General rule . No gain or loss shall be recognized to a corporation if such corporation is a party to a reorganization and exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

Section 354(a)(1) In general. No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

Section 351(a) General rule. No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation.

Section 368(a) Reorganization (1) In general
For purposes of parts I and II and this part, the term “reorganization” means—

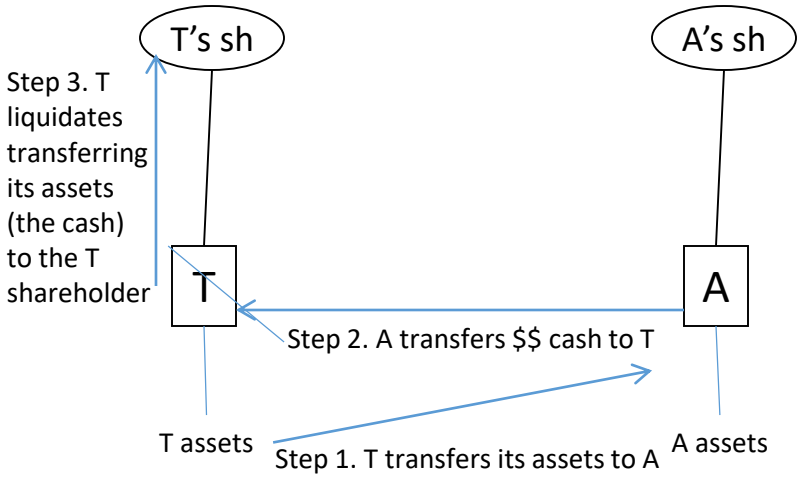
Section 368(a)(1) includes (A) through (G). These are the seven types of reorganizations specifically mentioned.

Part I of Subchapter C relates to Distributions by Corporations
Part II relates to Corporate liquidations
Part III relates to corporate organizations and reorganizations

If the parties engage in transactions such as an exchange under section 351 or a reorganization under section 368(a), it is specifically excepted from recognition under section 1001. See section 1001(c)

Example- Assume T is a stand-alone Subchapter C corporation and T's shareholder is an individual. Corporation A is a stand-alone corporation and both T and its sole individual shareholder are unrelated to T or its shareholder.

Transaction: T sells all of its assets to A in exchange for cash and T liquidates, distributing all of its cash to the T shareholder.

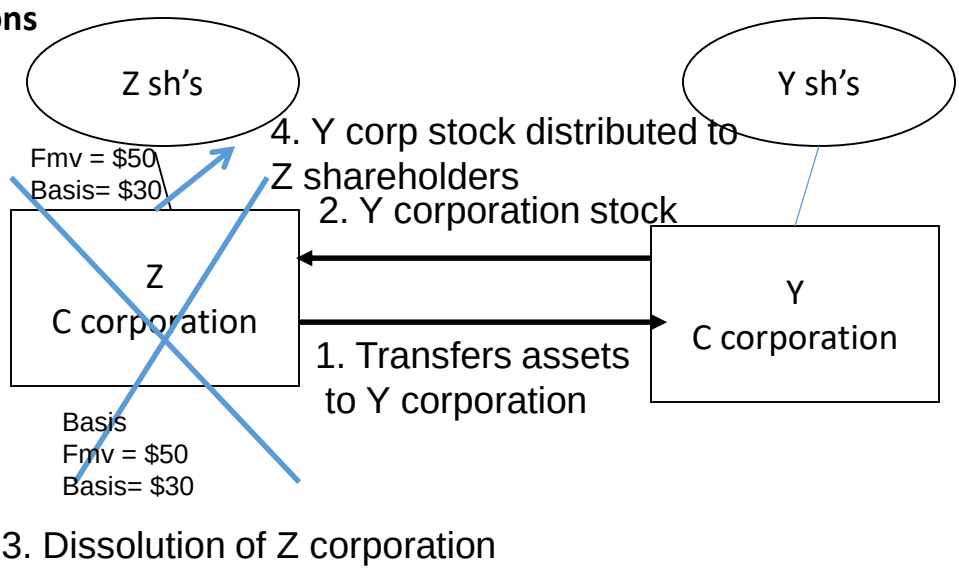


Result: For Federal income tax purposes (FITP) T Corporation recognizes gain on the sale of its assets to the A Corporation. (The corporate federal income tax rate can be as high as 35% [currently changed to 21%])

The individual T shareholder also recognizes gain (typically capital gains rate).

Corporation A obtains a cost basis in the assets formerly owned by T.

Reorganizations



Facts:

Z corporation has a $30 basis in its assets and those assets have a fair market value of $50. The Z shareholders have a $30 basis in the Z corporation stock and that Z stock has a fair market value of $50.

Pursuant to a state law merger statute, (1) Z corporation transfers its assets and liabilities to Y corporation (2) in exchange for Y corporation stock. (3) and (4) Z transfers the Y corporation stock to the Z corporation shareholders in cancellation of the Z corporation stock. Although Z corporation ceases to exist, Y corporation continues with the business formerly conducted by Z corporation and the Z shareholders continue as shareholders in Y corporation.

Even if the exchange was between the Y corporation and Z shareholders for the Y corporation's stock for the assets of Z corporation, the transaction is treated for fitp as if the Z corporation transfers its assets to Y corporation in exchange for Y corporation stock, followed by an exchange regarding the distribution of the Y corporation stock to the Z corporation shareholders upon the liquidation of Z corporation.

A. If the merger were taxable for FITP:

The Z corporation would realize and recognize gain upon the transfer of assets under section 1001. The gain would be $20 ($50 fmv of the presumed value of the Y corporation stock received for the Z assets less Z's $30 basis in its assets). The tax rate could be as high as 35%.

The Z shareholders would realize and recognize $20 gain upon the exchange of their Z stock for Y stock ($50 fmv of the presumed value of the Y stock received in exchange for the Z shareholder's Z corporation stock less the $30 basis in the Z shares held by the Z shareholders). See sections 331 and 1001(a) and (b).

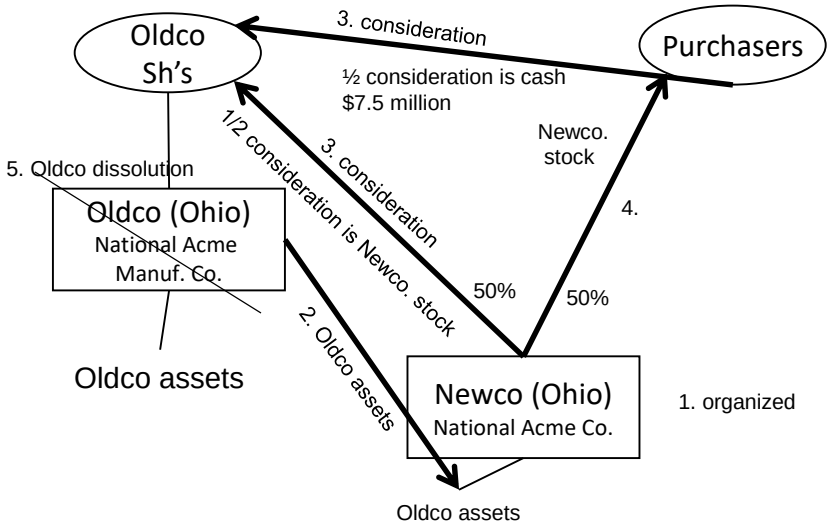
B. If the transaction was tax-free for FITP:

If there was non recognition treatment for these exchanges (such as one of the seven reorganization provisions)- the transaction is tax-free (deferred). See section 368(a)(1) and Treas. Reg. section 1.368-1.

Weiss, Collector of Internal Revenue, v. Stearn

USSC 265 U.S. 242, May 26, 1924 (based on the 9-8-1916 Act)

This case was decided on facts under the Revenue Act of 1916 in 1925 after the reorganization exception to gain recognition was Codified in the Revenue Act of 1918



Facts: Oldco is an Ohio corporation. Purchaser Eastman, Dillon & Co., deposited $7,500,000 with a trustee and Oldco shareholders deposited their Oldco stock certificates with the trustee. The depositors organized Newco, a new Ohio corporation that took over the property and liabilities of the corporation and Oldco was then dissolved. The trustee delivered half of the Newco stock and the whole $7.5m to the old stock holders pro rata, and the other half of the stock to the Purchasers, so that each of the old shareholders received half cash and half stock of the New company, representing an interest in the corporate property and business half as large as he had before.

The $7.5m cash from the purchasers to the old shareholders was taxable and not at issue.

Issue: whether the stock in the new company received was the same capital investment as their old shares without any resulting taxable gain under the Revenue Act of 1916.

In the present case the old shareholders received different certificates of stock which represented exactly the same proportion in a corporation having the same stockholders, the same assets, powers, purposes and management as the old company.

There was no segregation of any of the assets of either the old company or the new company and all of the assets in the old company are in the new company which is property of the shareholders of the new company which is represented by all of the new company's stock. The transaction was treated as a financial reorganization. The Court held that the stock in the new company received was the same capital investment as their old shares without any resulting taxable gain under the Revenue Act of 1916.

Marr v. U.S., 268 U.S. 536, June 1, 1925

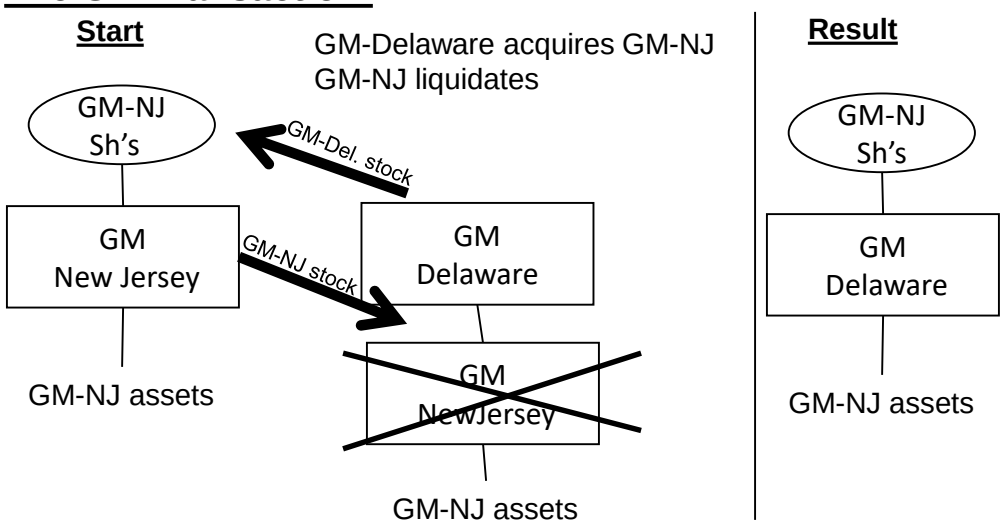
Dividend based on the 9-8-1916 Act

Facts: Marr and his wife purchased 339 p/s shares and 425 c/s shares
For $76,400 of New Jersey GM prior to 3-1-1913.

<u>The Taxpayer's</u> - In 1916 the Marrs received $400,866.57 in the form of Delaware GM shares
451 p/s shares; 2125 c/s shares; and a small amount of cash.

The difference in the cost and what Taxpayers received = $324,466.57 (gain)
Tax = $24,944.12; in the Court of Claims the government won.

<u>The GM Transaction-</u>



<u>GM-NJ (Oldco)</u>		**<u>GM Delaware (Newco)</u>**
$15m 7% voting p/s	-	$20m 6% n/v p/s
$15m c/s par $100	-	$82.6m c/s par $100
A&P large surplus $842.50 per share		
Shareholders 1 share p/s	-	1 &1/3 p/s and fractional $$
Shareholders 1 share c/s	-	5 shares c/s
Shareholders		$75m c/s needed for exchange $7.6m c/s sold or held Treas.

According to the Supreme Court in Marr- the exchange was taxable and distinguishable from Eisner v. Macomber and Weiss v. Stearn (where additional value in the new securities was not taxable, the identity of the former companies were preserved). The Court stated that in Eisner v. Macomber, there was no new corporate entity; There was an exchange of certificates but not of interests. And in Weiss v. Stearn, although a new corporation had in fact been organized to take over the business of the old, the corporate identity was substantially maintained because the new corporation was: (1) organized under the laws of the same state, with presumably the same powers of the old; and (2) there was no change in the character of the of the securities issued.
In Eisner v. Macomber, as well as Weiss v. Stearn, the transaction was considered in essence an exchange of certificates representing the same interests, not an exchange of interests.

According to the Court in Marr, the new corporation was considered different from the old. The old corporation was a New Jersey corporation and the new corporation was a Delaware corporation. The inherent differences in rights and powers, both preferred and common stock of the old is different from the new. Also, 6% n/v preferred stock is different from a 7% voting preferred stock. A common stock with a $20m preferred and $1.2m annual dividend is different from a $15m preferred and $1.05M annual dividend charge.

The Dissent
The four dissenting justices in Marr indicated that the case was similar to Weiss v. Stearn and believed the distinction should not be whether there was an incorporation in another state. The going concern continued in the new corporation. The shareholders did not receive anything from the new business concern or assets except new statements of their undivided interests which should not result in taxable income.

Note that the Decision in Marr, in 1925 was based on the 1916 statute before the Revenue Act of 1918.

The Revenue Act of 1918 introduced reorganizations. These are currently found in section 368(a)(1) (these have expanded to seven).

- 368(a)(1)(A)- statutory merger
- 368(a)(1)(B)- acquiring acquires target stock for acquiring voting stock
- 368(a)(1)(C)-acquiring acquires substantially all of target's assets for acquiring voting stock
- 368(a)(1)(D) acquiring acquires substantially all of target's assets and target, or its shareholder, control target after the acquisition
- 368(a)(1)(E)- a recapitalization of one corporation
- 368(a)(1)(F)- a change in form or state of one corporation
- 368(a)(1)(G)- acquiring acquires substantially all of target's assets (and target is a debtor in a Title 11 or similar case).

Judicial doctrines, now incorporated into regulations, also apply to corporate reorganization exchanges:

- Business Purpose
- Continuity of interest (COI)
- Continuity of Business Enterprise (COBE)
- Step Transaction Doctrine

Other considerations: <u>Plan of reorganization</u>, <u>party to a reorganization</u> (both requirements in the regulations); and the <u>economic substance doctrine</u>.

Reorganizations can be divided into many categories:

- Asset versus stock reorganizations (and hybrids)
    - A, C, D, F, and G reorganizations are asset reorganizations
    - B reorganizations are stock reorganizations
    - an (a)(2)(E) reorganization is a hybrid reorganization similar to a B reorganization with some elements of an A reorganization.
    - An (a)(2)(D) is another type of reorganization more closely resembling an asset reorganization
- Acquisitive vs. divisive
- Single-party reorganizations (a recapitalization) versus two-party reorganizations versus three-party reorganizations (triangular reorganizations and two-party reorganizations followed by other transactions).

- Subchapter C corporations and their shareholders are each potentially subject to a level of recognition.

- A corporate reorganization may be taxable or tax-free. Basically, reference to a “reorganization” in these materials is with respect to a nonrecognition transaction. The greater part of this outline is devoted to tax-free reorganizations. Although one might loosely refer to a corporate reorganization as “tax-free”, a “tax-free” corporate reorganization technically results in a non-recognition transaction with deferral of any gains and losses.

- Many factors are considered by the parties including:

    - The business needs, legal and technical constraints

    - The tax rates of the buyer, seller, and the target corporation

    - Whether the reorganization can be structured as an equity transfer or an asset transfer

    - Depending the facts, the transaction might only result in recognition (tax) on one level

    - Whether shareholder approval is necessary

    - Whether there are minority and/or dissenting shareholders

    - Whether there are tax-exempt, foreign corporations or unique entities and unique shareholders (S Corporations, QSubs, REITs, QRS’s, LLC’s)

    - Step Transaction Doctrine (applies to reorganizations unless specifically excepted). See regulations section 1.368-1(INSERT CITE)

Types of Control (non-exclusive list)

- **Section 368(c) control-**

  80% of the aggregate vote **and** 80% of the shares of each non-voting class

  There is no attribution under section 318

  Applies to: Section 351, most of section 368 (other than an acquisitive D reorganization)

- **Section 304(c) control-**

  50% of vote or 50% of value (an "or" test)

  Section 318 attribution applies

  Applies to: Acquisitive D reorganizations under section 368(a)(1)(D)

- **Section 1504(a) ownership-**

  80% of vote **and** 80% of value

  Applies to: Section 332 (liquidations); sections 336(e) and 338;

  Consolidated and affiliated groups under section 1501, etc.

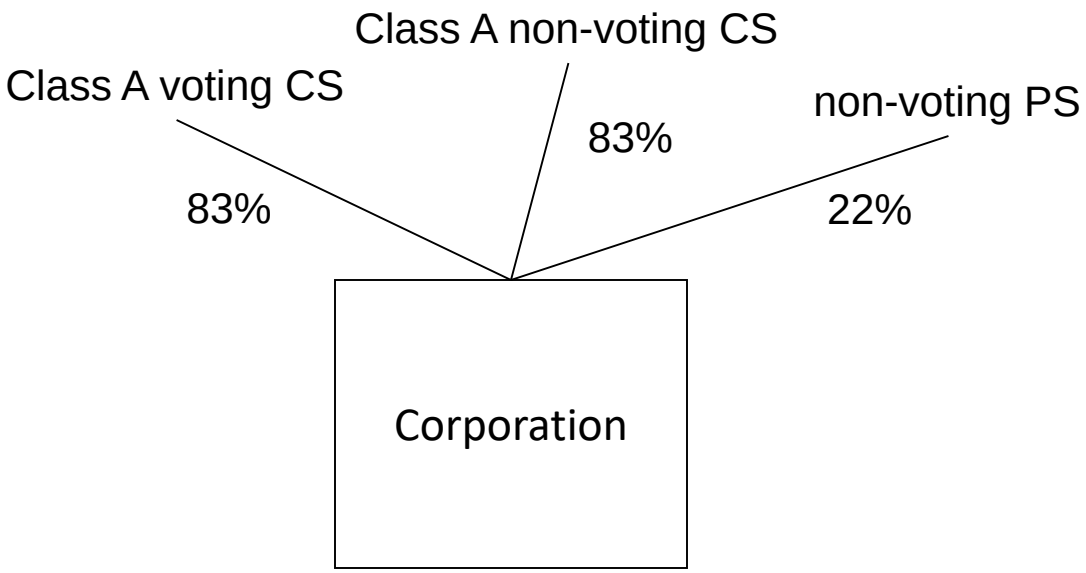
- **Section 1563-**

  Controlled group of corporations
  - -Parent-subsidiary controlled group and
  - -Brother-sister controlled group
  - -Combined group
  - -Section 1561

- **Section 269**

- **Section 482**

Rev. Rul. 59-259, 1959-2 C.B. 115 (section 368(c)) Control



Certain persons transferred property to a corporation in exchange for voting and non-voting stock, i.e., 83 percent of the Class A voting common stock, 83 percent of the Class A non-voting common stock, and 22 percent of the non-voting preferred stock. However, due to the relative number of non-voting common and preferred shares outstanding, these persons owned more than 80 percent of the total number of shares of the outstanding non-voting stock.

“Control" as defined by section 368(c) requires ownership of stock possessing at least 80 percent of the total combined voting power of all classes of voting stock and the ownership of at least 80 percent of the total number of shares of each class of outstanding non-voting stock. A transfer of property under the above circumstances does not constitute a transfer to a controlled corporation within the purview of section 351.

Step Transaction Doctrine

Case law

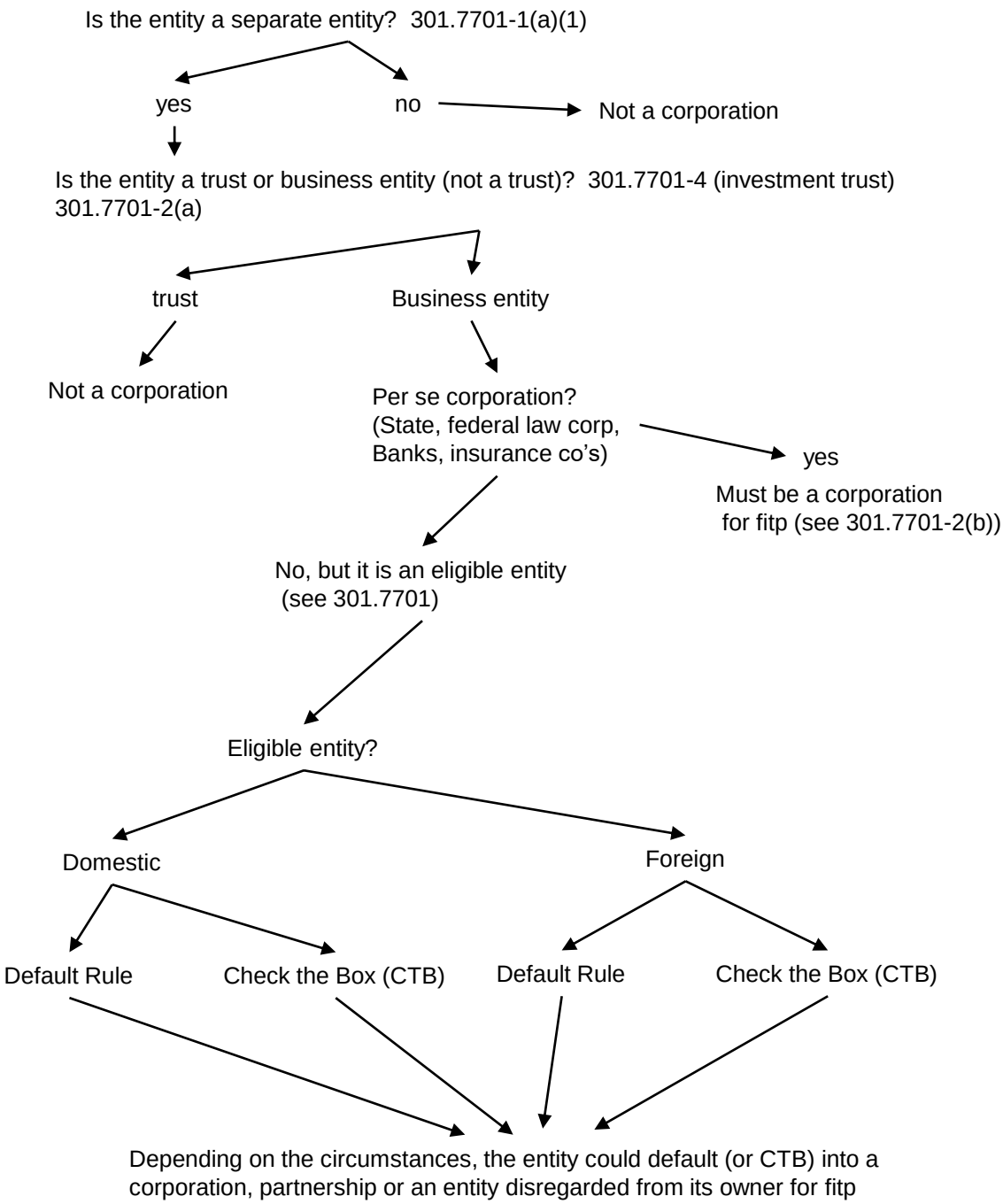
Regulations

§1.368-1 Purpose and scope of exception of reorganization exchanges.

(a) Reorganizations. As used in the regulations under parts I, II, and III (section 301 and following), subchapter C, chapter 1 of the Code, the terms reorganization and party to a reorganization mean only a reorganization or a party to a reorganization as defined in subsections (a) and (b) of section 368. In determining whether a transaction qualifies as a reorganization under section 368(a), the transaction must be evaluated under relevant provisions of law, including the step transaction doctrine. But see §§1.368-2(f) and (k) and 1.338-3(d). The preceding two sentences apply to transactions occurring after January 28, 1998, except that they do not apply to any transaction occurring pursuant to a written agreement which is binding on January 28, 1998, and at all times thereafter. With respect to insolvency reorganizations, see part IV, subchapter C, chapter 1 of the Code.

Is the entity a Corporation for FITP?

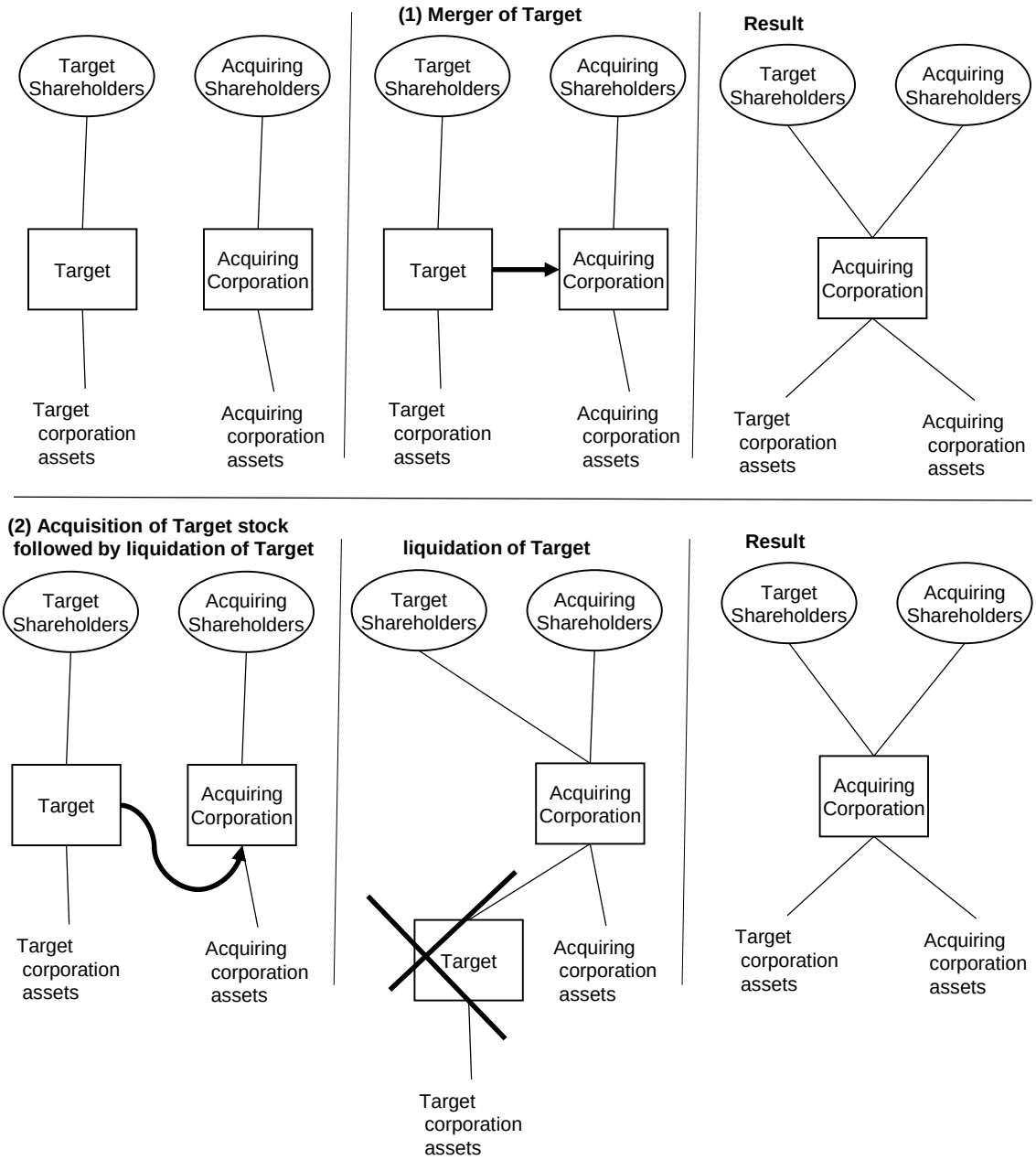
Incorporation



Other than a sale, (at least) four ways to directly acquire Target* assets for FITP

(using only two parties- triangular [3 party] transactions will be discussed subsequently)

Acquisition of Assets

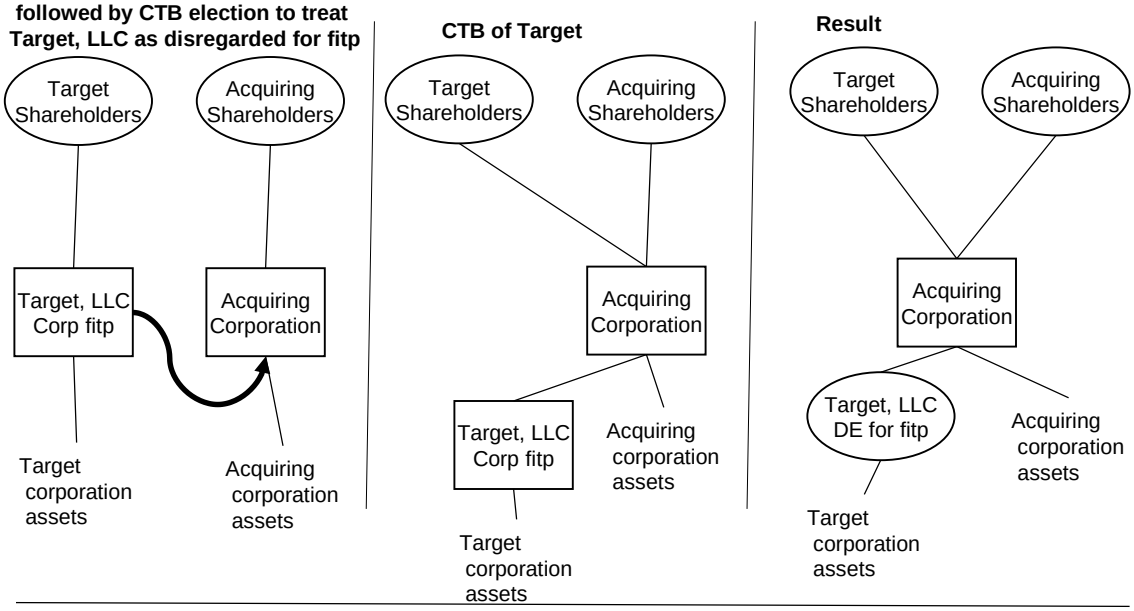


*** A per se corporation is a corporation for fitp. An LLC, may, or may not, be treated as a corporation for fitp (an LLC may also be treated as a partnership or as disregarded for fitp).**

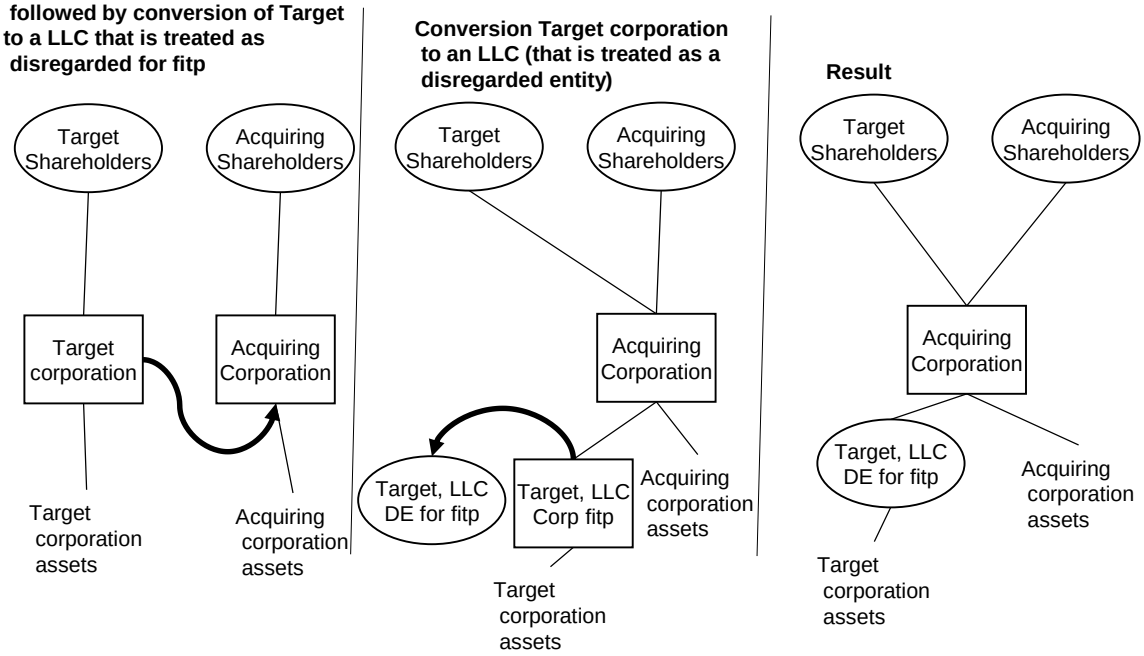
Other than a sale, (at least) four ways to directly acquire Target* assets for FITP

Acquisition of Assets

(3) Acquisition of Target, LLC (treated as a corporation for fitp), followed by CTB election to treat Target, LLC as disregarded for fitp



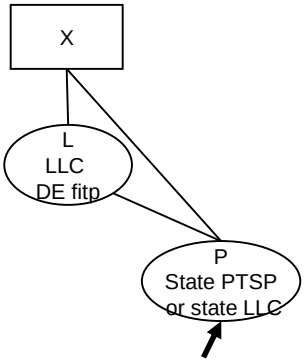
(4) Acquisition of Target corp. followed by conversion of Target to a LLC that is treated as disregarded for fitp



Rev. Rul. 2004-77, 2004-31 IRB

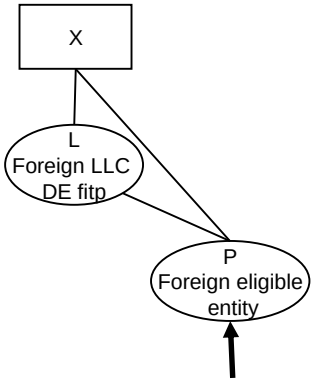
Entity Classification §7701

Situation 1



DE
Can't be a partnership for fitp

Situation 2



DE for fitp, or corporation for fitp
Can't be a partnership for fitp

ISSUE: How is an eligible entity (as defined in § 301.7701-3(a) of the Procedure and Administration Regulations) classified for federal tax purposes if the entity has two members under local law, but one of the members of the eligible entity is disregarded as an entity separate from the other member of the eligible entity for federal tax purposes?

FACTS:
Facts Situation 1. X, a domestic corporation, is the sole owner of L, a domestic limited liability company (LLC). Under § 301.7701-3(b)(1), L is disregarded as an entity separate from its owner, X. L and X are the only members under local law of P, a state law limited partnership or LLC. There are no other constructive or beneficial owners of P other than L and X. L and P are eligible entities that do not elect under § 301.7701-3(c) to be treated as associations for federal tax purposes.

Facts Situation 2. X is an entity that is classified as a corporation under § 301.7701-2(b). X is the sole owner of L, a foreign eligible entity. Under § 301.7701-3(c), L has elected to be disregarded as an entity separate from its owner. L and X are the only members under local law of P, a foreign eligible entity. There are no other constructive or beneficial owners of P other than L and X.

Law and Analysis
Situation 1. Under § 301.7701-2(c)(2), L is disregarded as an entity separate from its owner, X, and its activities are treated in the same manner as a branch or division of X. Because L is disregarded as an entity separate from X, X is treated as owning all of the interests in P. P is a domestic entity, with only one owner for federal tax purposes, that has not made an election to be classified as an association taxable as a corporation. Because P has only one owner for federal tax purposes, P cannot be classified as a partnership under § 7701(a)(2).For federal tax purposes, P is disregarded as an entity separate from its owner.

Situation 2. Under § 301.7701-3(c), L is disregarded as an entity separate from its owner, X, and its activities are treated in the same manner as a branch or division of X. Because L is disregarded as an entity separate from X, X is treated as owning all of the interests in P. Because P has only one owner for federal tax purposes, P cannot be classified as a partnership under § 7701(a)(2). For federal tax purposes, P is either disregarded as an entity separate from its owner or an association taxable as a corporation.

HOLDING
If an eligible entity has two members under local law, but one of the members of the eligible entity is, for federal tax purposes, disregarded as an entity separate from the other member of the eligible entity, then the eligible entity cannot be classified as a partnership and is either disregarded as an entity separate from its owner or an association taxable as a corporation.

Disregarded and Not Disregarded

Incorporation
1 of 3 slides

Although an entity might be disregarded from its owner for FITP, the same entity might not be disregarded for the tax liability for which the entity was not disregarded, FITW, employment taxes, and FUTA tax purposes.

301.7701-2(c)(2) (in part) (partial cites)

(i) In general. Except as otherwise provided in this paragraph (c), a business entity that has a single owner and is not a corporation under paragraph (b) of this section is disregarded as an entity separate from its owner.

….
(iii) Tax liabilities of certain disregarded entities

(A) In general. An entity that is disregarded as separate from its owner for any purpose under this section is treated as an entity separate from its owner for purposes of—

(1) Federal tax liabilities of the entity with respect to any taxable period for which the entity was not disregarded;

(2) Federal tax liabilities of any other entity for which the entity is liable; and

(3) Refunds or credits of Federal tax.

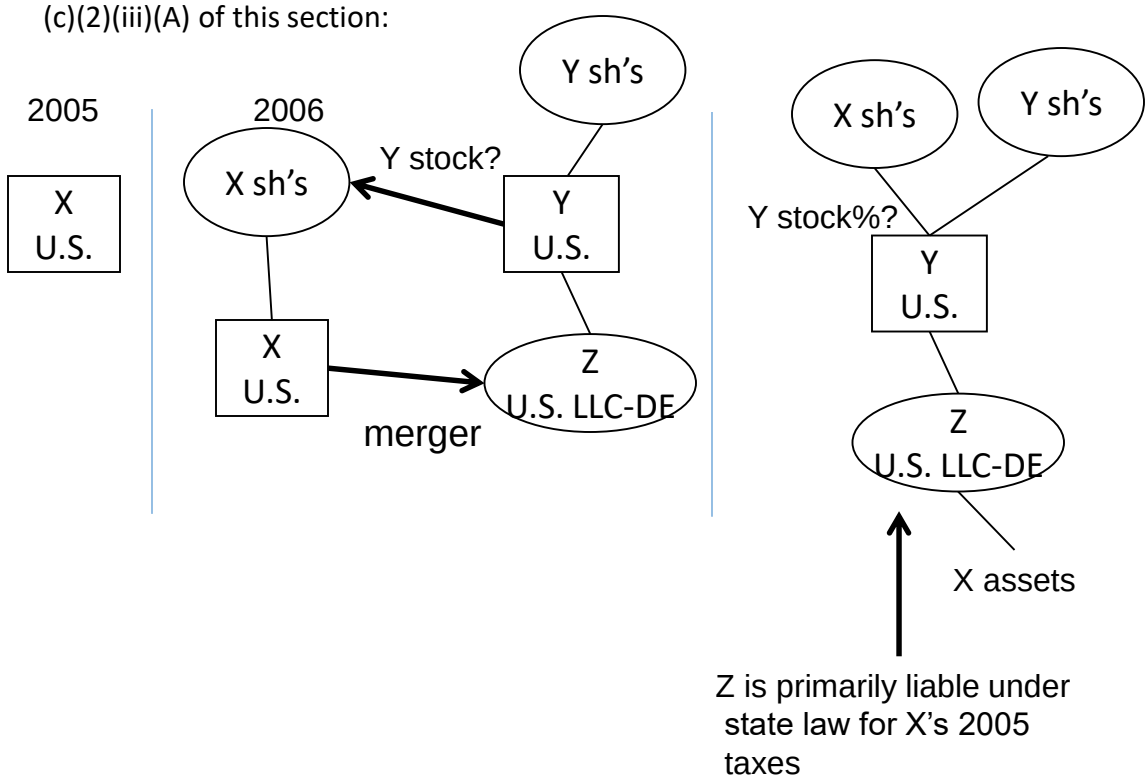
(B) Examples. The following examples illustrate the application of paragraph (c)(2)(iii)(A) of this section:

Disregarded and Not Disregarded

Incorporation
2 of 3 slides

301.7701-2(c)(2)(iii)(B) examples- (iii) Tax liabilities of certain disregarded entities

(B) Examples. The following examples illustrate the application of paragraph (c)(2)(iii)(A) of this section:



<u>Example 1</u> In 2006, X, a domestic corporation that reports its taxes on a calendar year basis, merges into Z, a domestic LLC wholly owned by Y that is disregarded as an entity separate from Y, in a state law merger. X was not a member of a consolidated group at any time during its taxable year ending in December 2005. Under the applicable state law, Z is the successor to X and is liable for all of X's debts. In 2009, the Internal Revenue Service (IRS) seeks to extend the period of limitations on assessment for X's 2005 taxable year. Because Z is the successor to X and is liable for X's 2005 taxes that remain unpaid, Z is the proper party to sign the consent to extend the period of limitations.

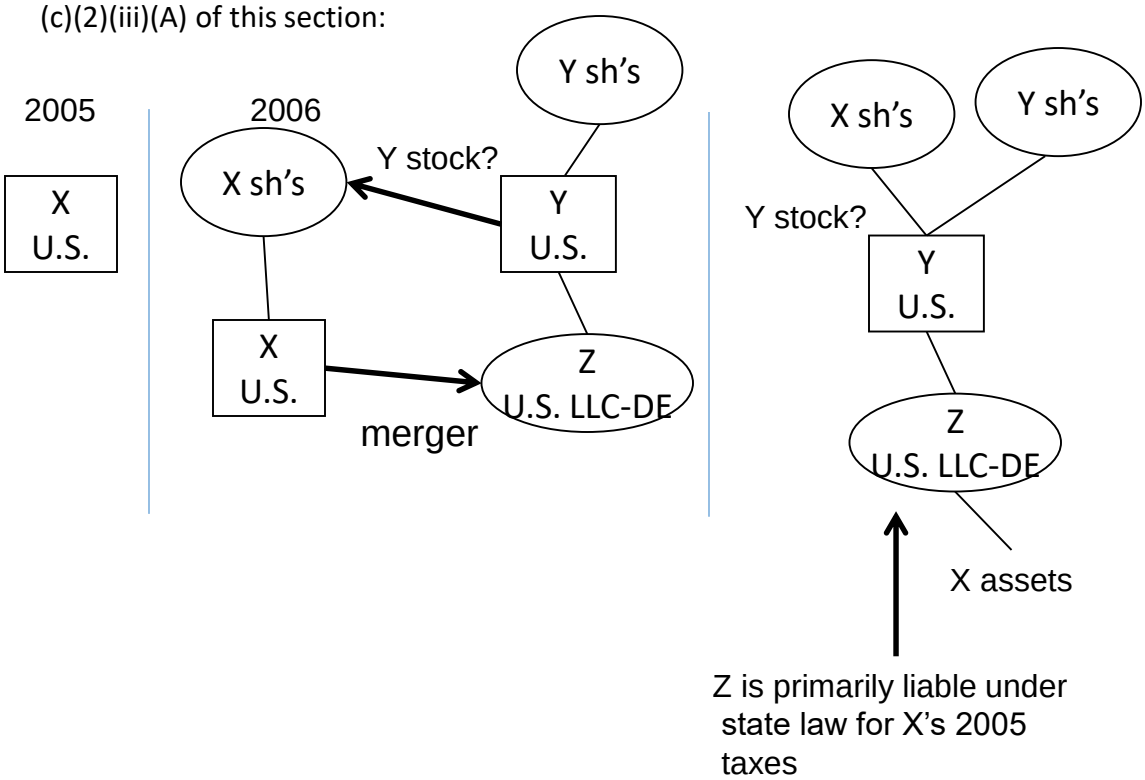
Notes: For FITP, the merger would be an exchange perhaps qualifying under section 368(a)(1) and Y corporation would be the successor to X corporation for section 381(a) purposes; for collection purposes, Z is the successor for the X corporation. (not disregarded for collection purposes).

Disregarded and Not Disregarded

Incorporation
3 of 3 slides

301.7701-2(c)(2)(iii)(B) examples- (iii) Tax liabilities of certain disregarded entities

(B) Examples. The following examples illustrate the application of paragraph (c)(2)(iii)(A) of this section:



<u>Example 2.</u>

The facts are the same as in Example 1, except that in 2007, the IRS determines that X miscalculated and underreported its income tax liability for 2005. Because Z is the successor to X and is liable for X's 2005 taxes that remain unpaid, the deficiency may be assessed against Z and, in the event that Z fails to pay the liability after notice and demand, a general tax lien will arise against all of Z's property and rights to property.

Notes: For FITP, the merger would be an exchange perhaps qualifying under section 368(a)(1) and Y corporation would be the successor to X corporation for section 381(a) purposes; for collection purposes, Z is the successor for the X corporation. (not disregarded for collection purposes).

Section 351

§351

The precursor to section 351 was enacted in 1921 (a section 351 transaction by itself is not a reorganization- but there can be overlaps [for example, B and section 351]).

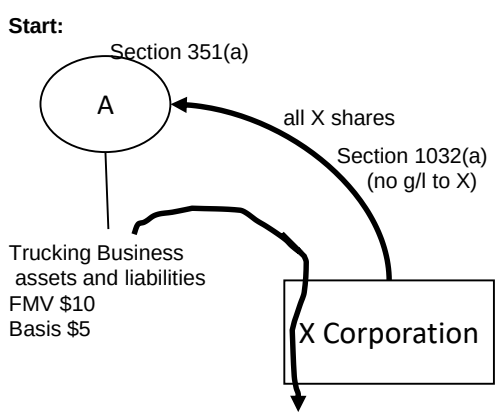
Section 351(a) General rule. No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation.

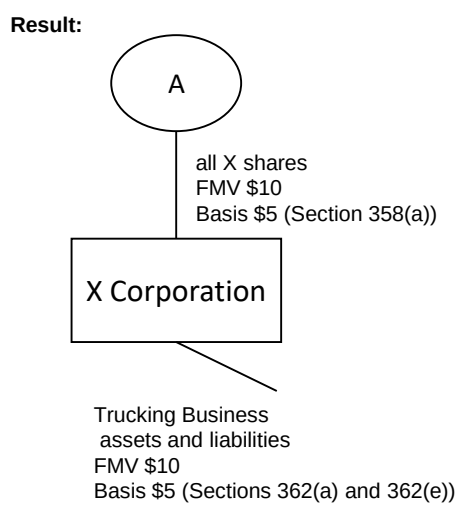
Compare Section 351 (not a reorganization provision) with section 361

Section 351 transaction Code Section Examples: A's Business, a Trucking business, is incorporated as X corporation, whereby A contributes the Trucking Business in exchange for all of the X corporation's stock. Assuming this qualifies as an exchange under section 351(a), the operating Code provisions are:

Transferor (A Get's Transferred Basis [donor's basis] in X Corporation)::
§351(a) No gain or loss to the transferor
§368(c) control for purposes of section 351(a)
§358(a) Transferred basis for A in X corporation stock $5 (outside basis)
§1223(1) Holding period for Transferor in X corporation stock

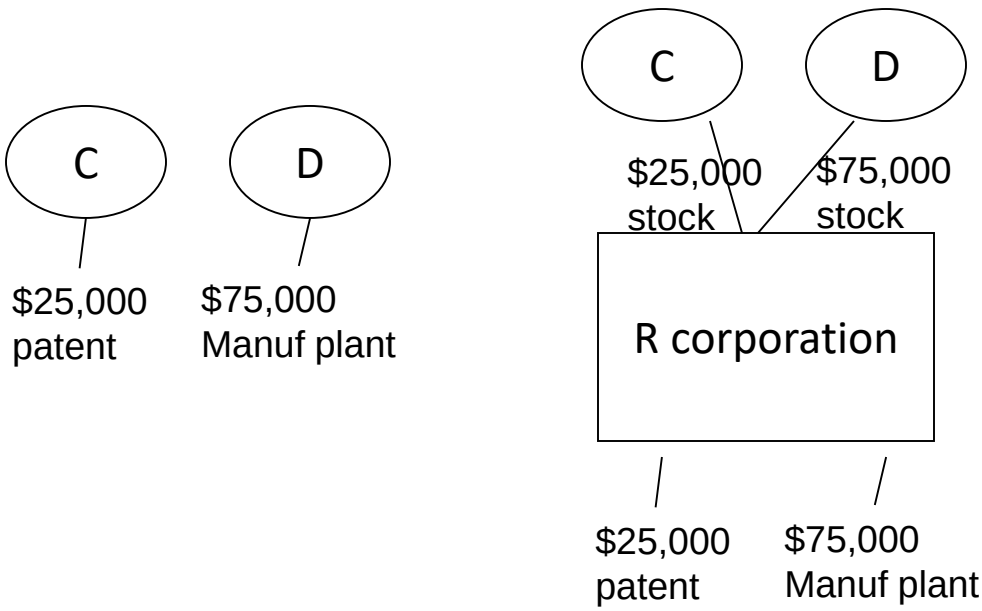
Transferee (X corporation get's Exchanged Basis [from owner's basis] in assets received)::
§1032(a) No gain or loss to X Corporation on issuance of its stock to A
§362(a) X Corporation receives owner's asset basis (exchange basis- preserves basis amount)
§362(e) No built-in-loss from property transferred to X corporation
§1223(2) Holding period preserved in assets now held by X corporation





Treas. Reg. 1.351-1(a)(2)

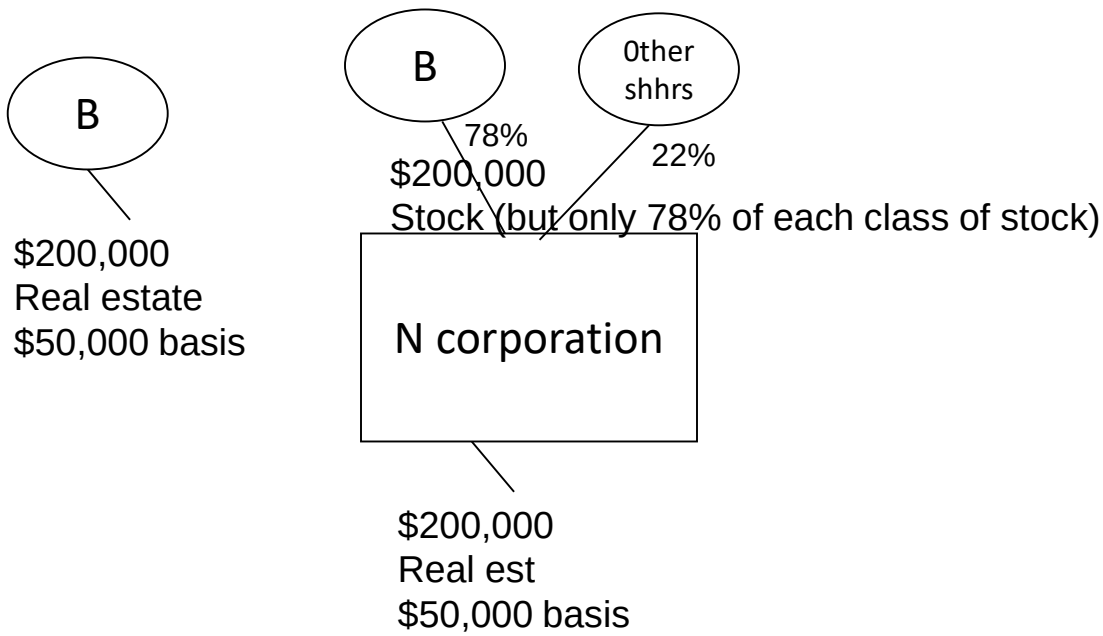
§351



1.351-1(a)(2)

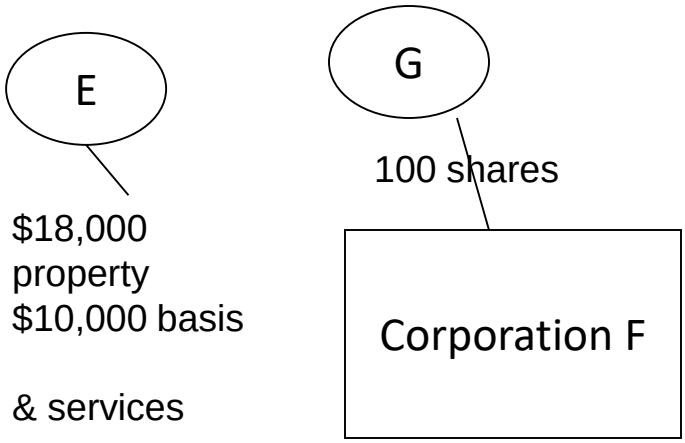
Example (1). C owns a patent right worth $ 25,000 and D owns a manufacturing plant worth $ 75,000. C and D organize the R Corporation with an authorized capital stock of $ 100,000. C transfers his patent right to the R Corporation for $ 25,000 of its stock and D transfers his plant to the new corporation for $ 75,000 of its stock. No gain or loss to C or D is recognized.

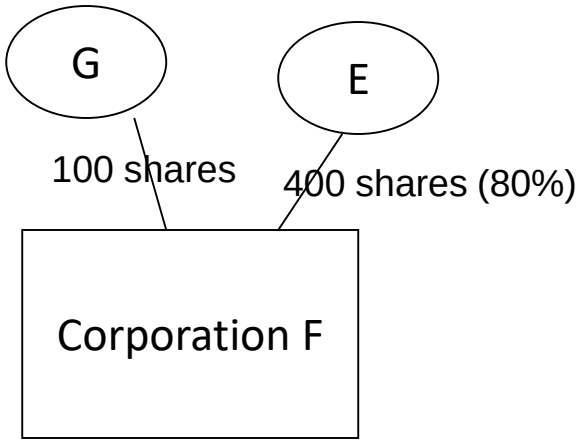
Treas. Reg. 1.351-1(a)(2) **§351**



1.351-1(a)(2)

Example (2). B owns certain real estate which cost him $ 50,000 in 1930, but which has a fair market value of $ 200,000 in 1955. He transfers the property to the N Corporation in 1955 for 78 percent of each class of stock of the corporation having a fair market value of $ 200,000, the remaining 22 percent of the stock of the corporation having been issued by the corporation in 1940 to other persons for cash. B realized a taxable gain of $ 150,000 on this transaction.



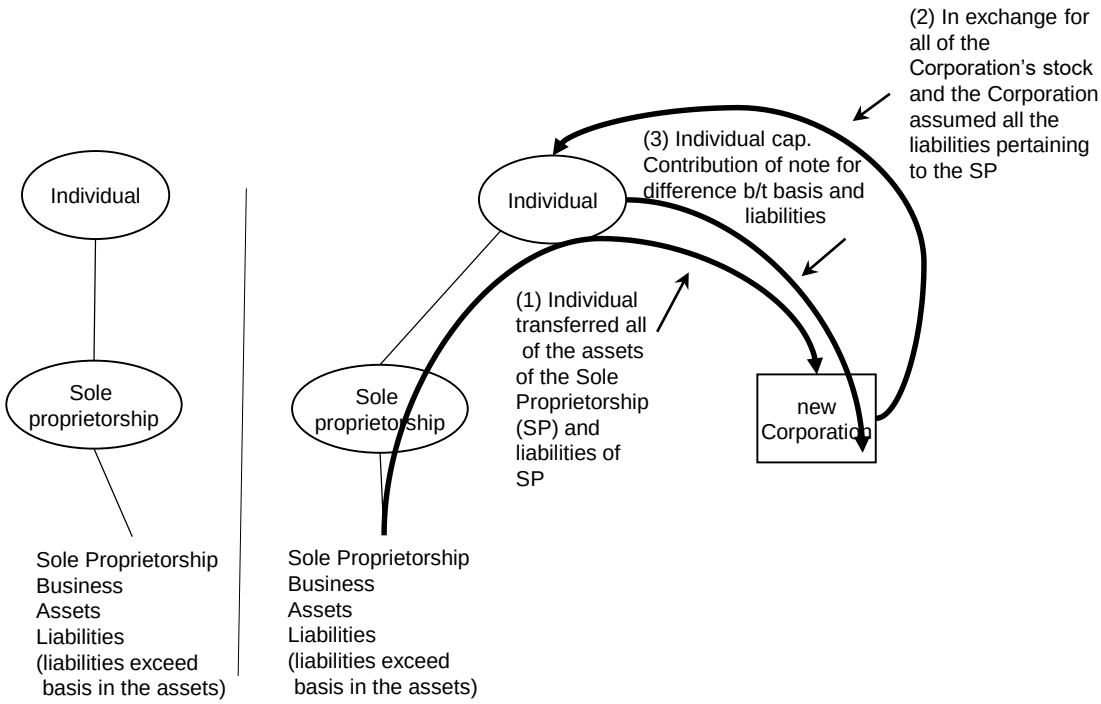


1.351-1(a)(2)

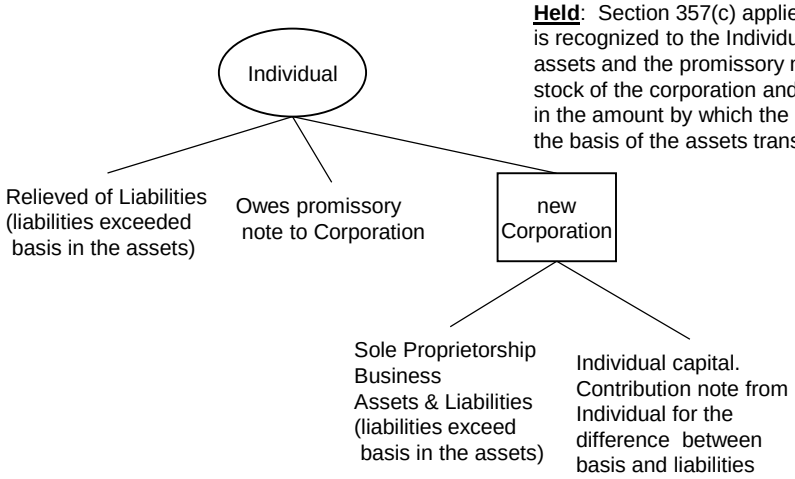
Example (3). E, an individual, owns property with a basis of $ 10,000 but which has a fair market value of $ 18,000. E also had rendered services valued at $ 2,000 to Corporation F. Corporation F has outstanding 100 shares of common stock all of which are held by G. Corporation F issues 400 shares of its common stock (having a fair market value of $ 20,000) to E in exchange for his property worth $ 18,000 and in compensation for the services he has rendered worth $ 2,000. Since immediately after the transaction, E owns 80 percent of the outstanding stock of Corporation F, no gain is recognized upon the exchange of the property for the stock. However, E realized $ 2,000 of ordinary income as compensation for services rendered to Corporation F.

Note: A small amount of services for property in a section 351 exchange will not disqualify the exchange.

Rev. Rul. 68-629, 1968-2 C.B. 154 (Zero Basis) 351/357(c)



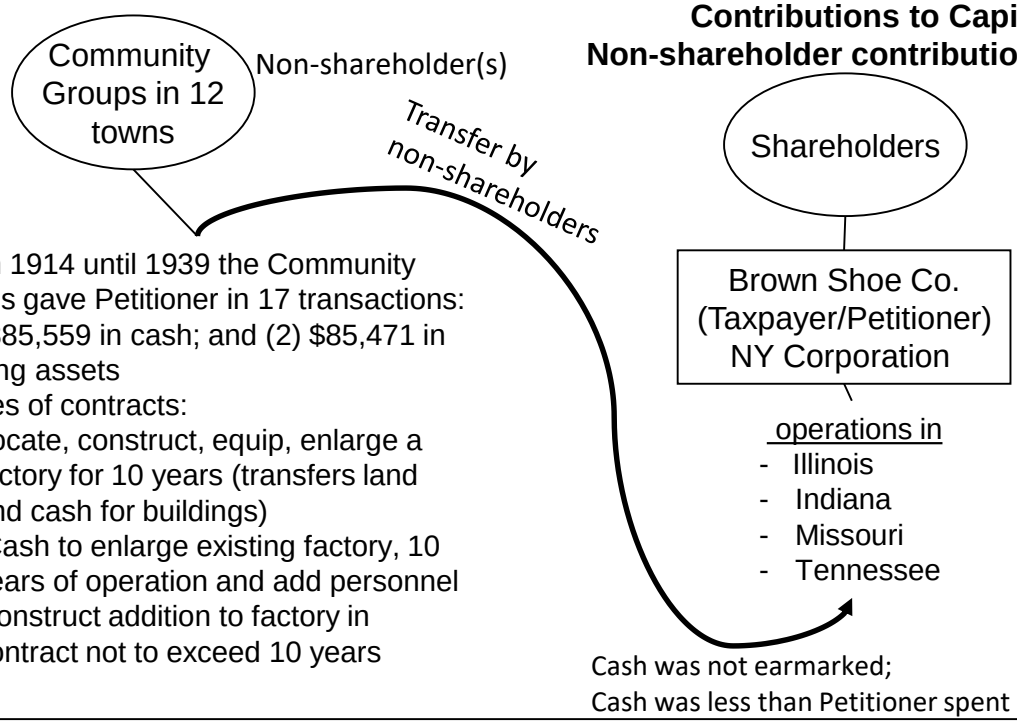
Held: Section 357(c) applies to the transaction and gain is recognized to the Individual on the transfer of the assets and the promissory note in exchange for the stock of the corporation and the assumption of liabilities in the amount by which the liabilities assumed exceeds the basis of the assets transferred



Note that there are amendments to Section 118

<u>Brown Shoe Co., Inc. v. Comm.</u>, 339 U.S. 583 (1950)

Section 118
Contributions to Capital
Non-shareholder contributions



From 1914 until 1939 the Community groups gave Petitioner in 17 transactions: (1) $885,559 in cash; and (2) $85,471 in building assets

3 types of contracts:

(1) Locate, construct, equip, enlarge a factory for 10 years (transfers land and cash for buildings)
(2) Cash to enlarge existing factory, 10 years of operation and add personnel
(3) construct addition to factory in contract not to exceed 10 years

Taxpayer had taken depreciation deductions (War profits tax under then statute section 113(a)(8)(B)) on the value of the contributions of property donated by the Community Groups and Commissioner disallowed the deductions. Argued they were depreciable gifts or contributions to capital.

<u>Procedural-</u> Tax Court held against the Commissioner that the cash contributions and corresponding deductions should be allowed to the taxpayer because there was a cost to build and Taxpayer paid with own money and money contributed was not earmarked. Tax Court agreed, however, with the Commissioner that the building contribution and depreciation associated with that should be disallowed. Tax Court stated that only stockholders can make capital contributions.

Court of Appeals (8th Cir.) reversed the Tax Court and held that the cash contributions and the depreciation associated with that should be disallowed.

US Sup. Court reversed the Court of Appeals

<u>HOLDING</u>: US Supreme Court held contributions to capital can be made by persons without a proprietary interest in a corporation. Even property contributed must be replaced at some point and depreciation deductions look towards the continuity of a corporation. that Taxpayer is entitled to the deductions.

-The contribution(s) to petitioner were provided by citizens of the respective communities who neither sought nor could have anticipated any direct service or recompense what[so[?]]ever, their only expectation being that such contributions might prove advantageous to the community at large.

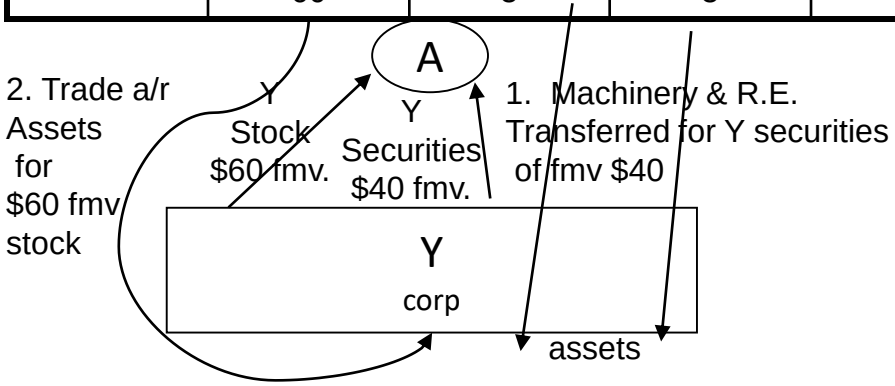
-Note, in response to this case, §362 was amended. Section 362 is different for 351 versus 118. For non-shareholder contribution under section 118, §362(c)(1)(B) provides the transferee will get a zero basis in the property (property other than money). See also §362(c)(2).

Rev. Rul. 85-164 (358 Basis in a §351 transaction)

§§351/358

A's Sole Proprietorship's assets:

	Trade A/R	Machinery	Real Estate	Total
FMV $	60	10	30	100
Basis $	0	5	25	30
LTC?	ST	LT	LT	40% LT 60% ST
Potential for G/L $	60	5	5	70



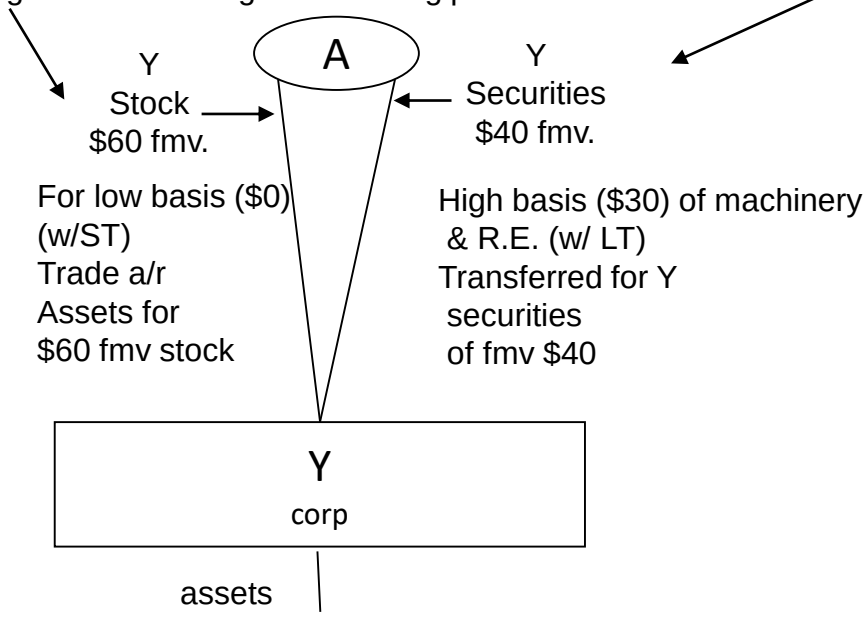
Facts: A, an individual, was engaged in a business as a sole proprietor. The assets of the sole proprietorship consisted of trade accounts receivable with an adjusted basis of zero and a fair market value of 60x dollars, machinery with an adjusted basis of 5x dollars and a fair market value of 10x dollars, and real estate (land and building) with an adjusted basis of 25x dollars and a fair market value of 30x dollars. A had held the real estate and machinery for over one year. Both the real estate and machinery were property described in section 1231 .

In order to limit personal liability, A transferred all of the assets associated with the sole proprietorship to a new corporation, Y, in exchange for all of Y's stock and securities. A transferred the accounts receivable to Y in exchange for 100 shares of common stock, the fair market value of which was 60x dollars. A transferred the machinery and real estate to Y in exchange for the securities, which had a principal amount and a fair market value of 40x dollars. The selection of specific items for exchange was made to allocate assets with a high basis and long-term holding period to the securities.

Rev. Rul. 85-164 (358 Basis in a §351 transaction) §§351/358

Taxpayer preferred:

that the selection of specific items for exchange was made to allocate assets with a high basis and long-term holding period to the securities.



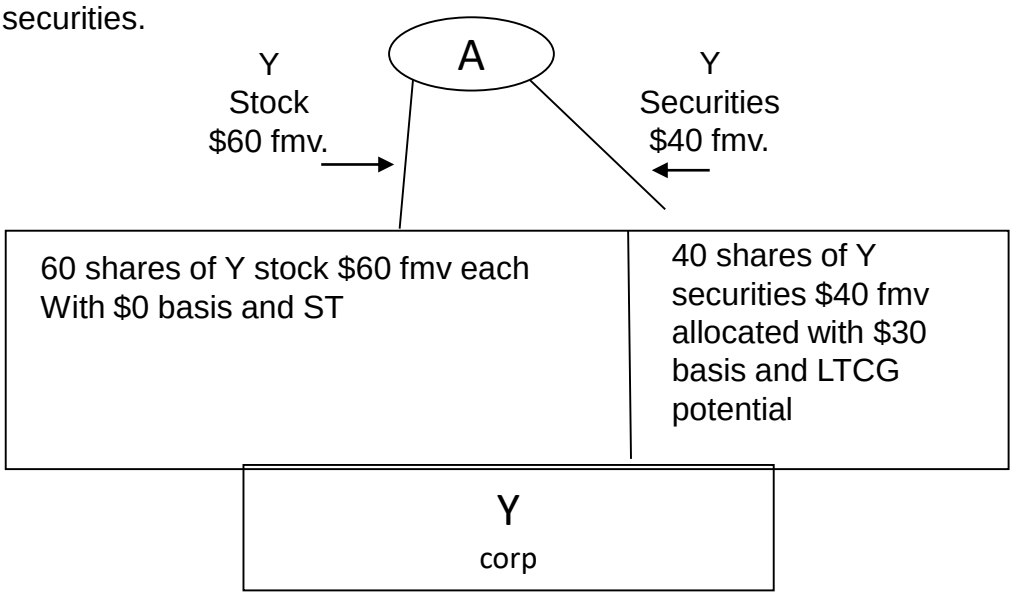
	Trade A/R	Machinery	Real Estate	Total
FMV $	60	10	30	100
Basis $	0	5	25	30
LTC?	ST	LT	LT	40% LT 60% ST
Potential for G/L $	60	5	5	70

ISSUE: May a transferor determine the bases and holding periods of stock and securities received in a transfer under section §351 by designating the specific property to be exchanged for particular stock or securities?

Rev. Rul. 85-164 (358 Basis in a §351 transaction) §§351/358

ISSUE: May a transferor determine the bases and holding periods of stock and securities received in a transfer under section 351 by designating the specific property to be exchanged for particular stock or securities?

Taxpayer preferred: that the selection of specific items for exchange was made to allocate assets with a high basis and long-term holding period to the securities.



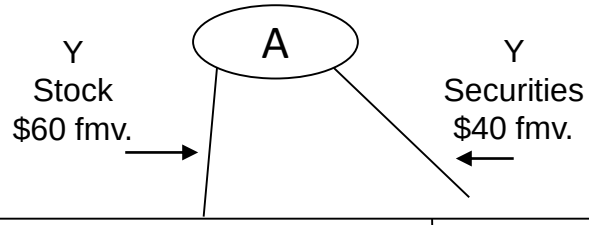
LAW AND ANALYSIS

Section 351(a) provides that no gain or loss will be recognized if property is transferred to a corporation by a person solely in exchange for stock or securities in such corporation and immediately after the exchange such person is in control (as defined in section 368(c)) of the corporation.

Section 358(a)(1) and Treas. Reg. section 1.358-1 provide that in the case of an exchange to which section 351 applies in which only non-recognition property is received, the basis of all of the stock and securities received in the exchange shall be the same as the basis of all property exchanged therefor. Section 358(b)(1) directs that, under regulations prescribed by the Secretary, the basis determined under subsection (a)(1) shall be allocated among the properties permitted to be received without the recognition of gain or loss.

Rev. Rul. 85-164 (358 Basis in a §351 transaction) §§351/358

Holding:



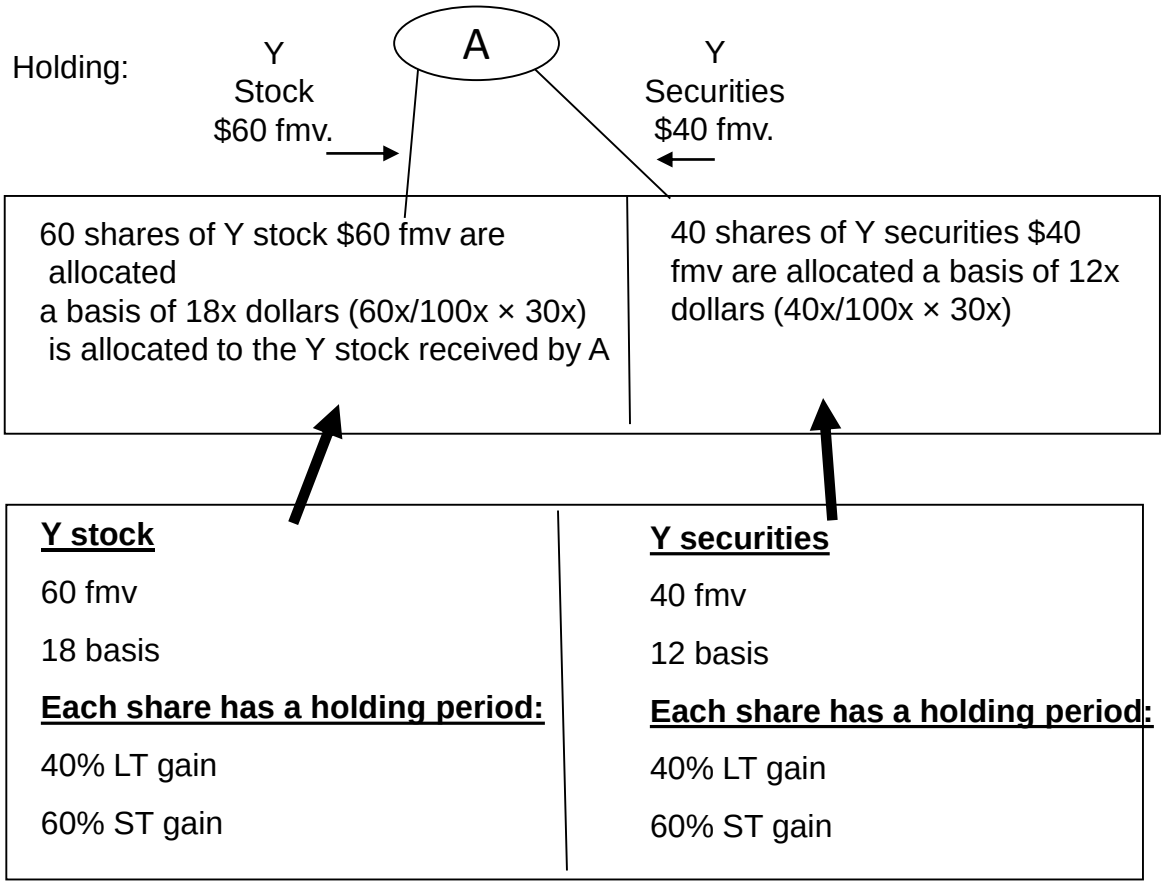
60 shares of Y stock $60 fmv are allocated a basis of 18x dollars = (60x/100x × 30x) is allocated to the Y stock received by A	40 shares of Y securities $40 fmv are allocated a basis of Basis is 12x dollars Derived by = (40x/100x × 30x)

determine this for (1) the stock, and (2) the securities

$$\frac{\text{Specific Stock/securities Received fmv}}{\text{Total Stock/securities Received fmv}} \times \text{Basis Total of assets transferred} = \text{Basis allocated to the shares received in that block}$$

<u>Holding for basis:</u> A may not determine the bases and holding periods of the Y stock and securities received by designating specific property to be exchanged for particular stock or securities. Under sections 1.358-1 and 1.358-2(b)(2) of the regulations, the aggregate basis of the property transferred is allocated among the stock and the securities received in proportion to the fair market values of each class. The holding period of the Y stock and securities received by A is determined by referring to the assets deemed exchanged for each portion of the stock and securities. The aggregate basis of the property transferred was 30x dollars. Since the stock and securities A received had fair market values of 60x dollars and 40x dollars, respectively, a basis of 18x dollars (60x/100x × 30x) is allocated to the Y stock received by A, and a basis of 12x dollars (40x/100x × 30x) is allocated to the Y securities received.

Rev. Rul. 85-164 (358 Basis in a §351 transaction) §§351/358



Holding for the holding period:

In addition, each share of Y stock and each security received by A has a split holding period and a split basis for purposes of determining long-term or short-term capital gain or loss. That fraction of each share of Y stock or security attributable to the real estate and machinery (40x/100x) is traded as including the period (over one year) for which A held the real estate and machinery and has a basis solely attributable to the real estate and machinery (e.g., the 40x/100x of each share of stock attributable to the real estate and machinery will have a basis of 18x dollars (18x/100 shares)). The fraction of each share of Y stock or security attributable to the accounts receivable (60x/100x) has a holding period beginning on the day after the exchange and has a zero basis. If part or all of the stock or securities received in the exchange is disposed of at a time when the split holding period is relevant in determining tax liability, the same fractions will be applied to apportion the amount realized among the above components of the stock or security.