CHAPTER 2-CORPORATE FORMATION

Problem, page 33

2-1. In this problem, taxpayers end up in economically identical situations – X Corp. gets the land, Alex ("A") gets half of the stock and $500 in cash and Bertha ("B") ends up with half the stock. Yet, if the tax consequences of their chosen form are respected, there are two different sets of tax consequences. The answer to the various parts of the problem focuses on the tax consequences, assuming the form is respected for tax purposes. You may want to discuss what factors will determine whether or not the form of the transaction will be respected. This problem is a useful illustration of how much form can matter in corporate taxation. Companion problems involving boot are found at pages 53 and 55 (problems 2.6-2.8).

2-1a. This variation raises the same issue as the *Intermountain* case – whether the transferor satisfies the control requirement under §§351 and 368(c). If the transaction is respected, A's transfer will qualify under §351. A will realize but not recognize a $700 gain on the exchange of land for X stock. A will take a $300 basis in the stock received under §358, preserving a potential $700 gain if and when A sells the stock. X Corp. will recognize no gain on the issuance of its own stock under §1032 and will take a $300 basis in the land under §362(a). A can tack on A's holding period for the land (if it is a capital asset or a §1231 asset) on to the X stock received under §1223(1), and X Corp. can include A's holding period in determining its holding period for the land under §1223(2). On the sale of half of the stock by A, A will realize and recognize a $350 gain under §1001 ($500 amount realized minus $150 basis in half of the stock). B will take a $500 basis in the purchased stock under §1012.

The sale of stock by A to B is much like the sale from Shook to Wilson in *Intermountain*. Because it occurs shortly after the incorporation, it is quite possible that A will not satisfy the control requirement. Recall that in *Intermountain*, there was a prearranged sale; here, the facts are incomplete. If the transaction does not qualify under §351 because A does not control X Corp. immediately after the incorporation (A only has a 50 percent interest and B is not a transferor of property), then A will realize and recognize a $700 gain on the incorporation. A will take a §1012 cost basis of $1,000 in the stock received. X Corp. will recognize no gain on the issuance of stock under §1032. A will recognize no further gain on the sale of half of the stock to B and B will take a $500 basis. None of the parties can tack holding periods.

2-1b. Under this variation, if respected, A will realize and recognize a $350 gain on the sale of a half interest in the land ($500 amount realized minus $150 basis). §1001. B will take a $500 basis in B's share of the property. On the incorporation, A and B are both transferors of property and will qualify under §351 (assuming that they are members of a transferor group (*i.e.,* their rights in the corporation are defined before the first transfer). A will realize but will not recognize a $350 gain ($500 of stock minus $150 basis in A's half interest). A will take a $150 basis in the stock received under §358, thereby preserving the unrecognized $350 gain. A can tack in accordance with §1223(1). B will realize and recognize no gain on the transfer since B's basis equals the amount realized. B will take a $500 basis in the stock received and can tack only B's holding period, not A's. X Corp. acquires the property with a total basis of $650 ($150 from A and $500 from B). If X Corp. sells the property immediately, can X Corp. tack on A's holding period under §1223(2)? Arguably, X Corp. can do so because the appreciation is due to A's half interest in the property. See *Citizens National Bank of Waco v. U.S.*, 417 F.2d 675 (5th Cir. 1969). In effect, X Corp. should take a split basis and holding period in the land.

It is possible that the Service may recharacterize the transaction in one of the ways discussed in problem 2-7.

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Problem 2-2. This problem illustrates the basic operation of §351. Among other things, it illustrates that the corporation and shareholder are different taxpayers and that a sale of stock by the shareholder or a sale of assets by the corporation generally has no immediate tax effect on the other.

2-2a. Section 351(a) applies to John, because he transfers property (*i.e.*, the land and building) solely in exchange for all of the C stock and John controls C immediately after the exchange (*i.e.*, he owns all of the C stock immediately after the transfer). Thus, John recognizes no gain or loss. §351(a). John's basis in the stock is $480,000 (the sum of his bases in the land of $80,000 and the building of $400,000 ($420,000 minus $20,000 of depreciation deductions)). §351(a). Because the assets transferred are neither capital assets (because John used them in his trade or business) nor §1231 assets (because they had not held for more than one year when transferred), John is treated as acquiring the stock on January 1 of Year 2 (*i.e.*, , he does not tack (i.e., add) his holding period for the contributed assets to his actual holding period for his stock). Cf. §1223(1) (for an exchanged-basis transaction, providing that the transferor's holding period for the property received includes his or her holding period for any surrendered property if that property is a capital asset or §1231 asset).

C has no gain or loss under §1032 (and possibly under §351(a)). C's basis in the land is $80,000 and in the building is $400,000. §362(a)(1). Because C takes a transferred basis in the land and building, C is treated as acquiring the land and building on January 15 of Year 1 (*i.e.*, when John acquired the property). §1223(2).

2-2b. On his sale of stock, John has a realized and recognized gain of $70,000 ($550,000 amount realized less $480,000 basis). §1001(a) and (c). That gain is a capital gain because the stock is a capital asset (§1221), but it is also a short-term capital gain, because John's holding period for the stock begins on January 1 of Year 2. C has no realized or recognized gain or loss because none of its assets have been sold. *See Moline Properties v. Commissioner*, 319 U.S. 436 (1943).

2-2c. On the sale by C, John has no realized or recognized gain or loss. Under *Williams v. McGowan*, 152 F.2d 570 (2d Cir. 1945), C must account for its sale of the land and building separately, allocating the sales price between the assets in proportion to their values.. Because the value of the assets has not changed and the amount paid equals the aggregate fair market value of the assets sold, the amount considered paid for each asset (*i.e.*, the amount realized) should be its fair market value, $80,000 for the land and $420,000 for the building). Because the basis of the land is $80,000, C has no gain or loss on the land sale. The adjusted basis of the building is $400,000, and C therefore has a $20,000 gain on the sale of the building (*i.e.*, $420,000 amount realized less $400,000 adjusted basis). Because C is considered to have held the asset for not more than one year, the gain would be ordinary income. The assets are not capital assets (since they are excluded under §1221(a)(2) as assets used in a trade or business) and not described in §1231(b) (since they have not been held for more than one year).

Would the result differ if C sold the land and building on January 16 of year 2? Then, the gain on the building, at least in part, would have been taken into account under §1231, because the building would have been considered held for more than one year at the time of the transfer and would have been depreciable property used in a trade or business. The treatment of the gain depends on the interplay of §§291(a), 1231, and 1250. Assume that the property was depreciated on a straight-line basis. Under §291(a), 20 percent of the gain would be ordinary. Under §1231(a), the remainder of the gain would be §1231 gain perhaps taken into account as long-term capital gain.
The results follow from the holding period requirement in §1231.

2-2d. For the same reasons as described in the answer to question 2-2a, John recognizes no gain or loss on the exchange. Under §358(a), he takes a $120,000 basis in his stock (§358). Because the inventory is not a capital or §1231 asset, John is considered to acquire the stock on its acquisition date.

Under §1001(a) and (c), John recognizes a $430,000 gain on his sale of the stock ($550,000 amount realized less $120,000 basis). Because his holding period for the stock begins on January 1 of Year 2, his gain on the sale of the stock is short-term capital gain.

Thus, John is able to convert ordinary income to capital gain by contributing the inventory to the corporation and selling stock of the corporation, but the gain is short-term capital gain, generally taxed at ordinary income rates. If John retained the stock for more than one year, any gain on the sale would be long-term capital gain. When the corporation sells the inventory, it will have ordinary income, assuming that the corporation continues to hold the asset as inventory. §1221(a)(1) (inventory not a capital asset).

2-2e. The results in (a)-(d) are unaffected. Section 351 can apply to transfers to an existing corporation as well as a newly formed corporation (*i.e.*, it may apply to a "midstream" transfer).

How about if John owned all C stock before the exchange and C issued no stock to John in exchange for the property? The issuance of stock would be a meaningless gesture if John already owned all of the stock of C, because, whether or not C issued stock to John, he would own all equity interests in C and, more importantly, have the same rights in C. Thus, John is deemed to receive C stock and satisfy the exchange requirement under §351.

How about if John Inc., rather than John, made the transfers to C Inc.? The results would be the same, because John, Inc. is a person. This question is included to remind students that not only may a person be an individual, but it may also be a trust, estate, partnership, association, company, or corporation. §7701(a)(1).

Problem 2-3. This problem illustrates how § 351 may apply when more than one person transfers property to a corporation. It explores when those persons may be members of a transferor group.

2-3a. Under Treas. Regs. §1.351-1(a)(1), "[t]he phrase `immediately after the exchange' does not necessarily require simultaneous exchanges by two or more persons [if] the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure". Thus, for persons to be members of a transferor group, a plan must exist before the first transfer that defines the consideration that each member of the group will transfer and the consideration that each will receive and that plan must be executed expeditiously.

Persons can be considered part of a transferor group even if they do not transfer the property to the corporation at the same time. The multiple transfers, however, have to be planned and rights defined before the first of the transfers. Thus, a transferor group may be demonstrated by a written plan establishing the rights of the parties before the transfer, as long as the plan is consummated as written. An oral plan may also establish that persons are members of a transferor group (i.e., if the transfers are sufficiently connected or part of a plan). Proof of an oral plan may take into account --

(i) The time that separates the transfers;

(ii) Evidence of meetings or discussions (or, perhaps, prior dealings) among the transferors before the first transfer;

(iii) The business connection between the assets transferred (or, perhaps, between the assets transferred and businesses of the corporation); and

(iv) Evidence that reason for later transfer arose only after first transfer.

It is likely that when the transfers occur on the same day, they are part of a plan under which the rights of the parties have been previously defined. Thus, Mary and John are likely members of a transferor group, although we may need more facts.

2-3b. Because of the greater time separating John and Mary's contributions, it is somewhat less likely that they are connected. We would need to look at the facts to determine if Mary's rights were fixed at the time of John's transfer (i.e., the first transfer).

If they were fixed, John and Mary's transfers would qualify under §351(a), neither would recognize gain or loss, and C would take carryover bases in the transferred assets. *But see* §362(e)(2).

If the rights were not fixed (so that Mary's and John's contribution could not be combined), would John care? He would transfer property in exchange for all of the C stock and would control C immediately after the transfer. Thus, under §351(a), he would not recognize gain or loss on the transfer. Consequently, John's qualification under §351 is not affected by whether Mary's contribution is treated as part of an overall plan with John's contribution. Mary's transfer, however, would not be described in §351 because Mary would not control C by herself immediately after her transfer. She would recognize gain or loss and C would take a fair market value (or cost) basis in the assets it acquires from Mary. §1012. John may care how Mary is treated, because C's basis in the asset contributed by Mary (and John's indirect share of that basis and any built-in gain or loss on the asset) will depend on whether Mary's transfer qualifies under §351.

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Problem 2-4. This problem illustrates how a shareholder takes boot into account in a §351 exchange.

2-4a. Section 351 applies to the exchange, because Sally ("S") and George ("G") transfer property to W in exchange for W stock, and immediately after the exchange control W, owning all of its stock. Because G receives non-stock consideration (i.e., boot) from W, §351(a) does not apply to G's transfer, but §351(b) does. That section applies if §351(a) does not apply only because a transferor received property other than qualifying stock as consideration in the exchange. Under §351(b), G recognizes no realized loss and recognizes any realized gain, but not in excess of the money plus fair market value of property other than W stock received (*i.e.*, the lesser of the realized gain or boot). G realizes a $120,000 gain ($140,000 ($100,000 value of stock received plus $40,000 cash received) less $20,000 basis), but he receives non-stock consideration of only $40,000. Therefore, he recognizes only $40,000 of his $120,000 realized gain. G's basis in the W stock is $20,000, computed under §358(a) as follows -- $20,000 (the basis of the property exchanged) less $40,000 (§358(a)(1)(A)(i) for the money received) plus $40,000 (§358(a)(1)(B)(ii) for the gain recognized). His holding period for the stock includes his holding period for the property transferred to the extent the transferred property was a capital asset or §1231 asset at the time of the transfer. §1223(1).

S recognizes no gain or loss on the transfer because she receives solely W stock in exchange for the land. §351(a). She takes a $60,000 basis in his stock under §358(a)(1) if §351 applies. She also tacks the holding period of the land on to the holding period of the stock if she held the land as a capital asset or §1231 asset. §1223(1).

W recognizes no gain or loss on the exchange under §1032 (for the stock exchange) and general principles (for its use of cash). W's basis in the property received from G is $60,000, $20,000 (basis in the hands of the transferor, G) plus $40,000 (gain recognized by the transferor, G). §362(a). Its basis in the property received from S is $60,000 (*i.e.*, S's basis). W's holding period for each asset includes the transferor's holding period for the asset. §1223(2).

2-4b. The consequences to S (and the analysis) are the same as are described above.

For the same reasons as are described above, §351(b) applies to G's transfer. Under §1001(a), he has only $10,000 of realized gain ($140,000 amount realized minus $130,000 basis). That gain is recognized, but not in excess of the boot (i.e., the lesser of realized gain ($10,000) or the fair market value of the boot ($40,000) is recognized). Thus, G recognizes a $10,000 gain. §351(b). His basis in the W stock is $100,000 ($130,000 basis in the transferred property less $40,000 (cash received) plus $10,000 (gain recognized)). §358(a)(1). If the transferred equipment was a capital or §1231 asset, his holding period for the stock includes his holding period for the asset. §1223(1) (providing that property received in an exchanged-basis transaction tacks the holding period of the surrendered property if that property was a capital or §1231 asset).

The results to W are the same, except that W's basis in the asset received from G is $140,000 ($130,000 basis to G plus $10,000 gain recognized by G). §362(a).

Problem 2-5. This problem illustrates the application of §351(f). Assume that §1031 does not apply to W's exchange.

2-5a. The consequences and analysis for S and G would basically be the same. In addition, G would take a fair market value basis in the property received. §358(a)(2). Further, his holding period for the asset would begin on the day he acquires it. Note that G's consequences do not depend on W's basis in the property.

If the distributed asset has a $35,000 basis, W would recognize a $5,000 gain. The consequences to W are the same as if W had distributed the asset in a non-liquidating distribution with respect to stock (loss not recognized on loss property but gain recognized on appreciated property as if W sold the property for its fair market value). §351(f). *See* §311(a) and (b). Other consequences to W are the same, including that W's basis in the property it receives from G equals G's basis plus any gain *G* recognizes on the exchange. For example, under §362(a)(1), W generally takes a basis in the transferred asset equal to G's adjusted basis in the asset immediately before the transfer plus any gain *G* recognizes on the transfer.

If, instead, the asset W distributes had a $55,000 basis, W would not recognize any loss on the distribution, because under §311(a), no loss is recognized. Because G would take a basis in that asset equal to its value (§358(a)(2), W's distribution simply eliminates the built-in loss in the loss asset. The results to W and G would otherwise be the same.

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2-6. In this problem, taxpayers end up in economically identical situations – X Corp. gets the land, Alex ("A") gets half of the stock and $500 in cash and Bertha ("B") ends up with half the stock. Yet, if the tax consequences of their chosen form are respected, there are two different sets of tax consequences. The answer to the various parts of the problem focuses on the tax consequences, assuming the form is respected for tax purposes. You may want to discuss what factors will determine whether or not the form of the transaction will be respected. This problem is a useful illustration of how much form can matter in corporate taxation. Companion problems not involving boot are found at page 33 (problem 2.1).

2-6a. If the transaction is respected, if A and B are members of a transferor group, their transfers will qualify under §351 since they are transferors of property who together meet the control test. A does not receive solely stock or securities and must recognize the realized $700 gain under §351(b) to the extent of the $500 boot received. The $500 gain will be a capital gain if the land is a capital asset in A's hands (long-term or short-term depending on holding period). A's basis in the stock received equals $300 (basis of property transferred) minus $500 (cash received) plus $500 (gain recognized). §358(a)(1). This makes sense since the $200 of realized but unrecognized gain is preserved, awaiting A's sale of the X Corp. stock. X Corp. will take a basis of $800 in the land under §362 ($300 transferor's basis plus $500 gain recognized). Both A and X Corp. can tack holding periods under §1223 since basis is determined in whole or part from transferor's basis. B realizes and recognizes no gain on the purchase and takes a $500 basis in the stock under §358 while X Corp. has no gain or loss on the exchange of its stock for property under §1032.

2-6b. This variation takes students down one of two roads. Generally, the assumption of a liability is not treated as the payment of boot for purposes of §351. §357(a) (the anti-*Hendler* rule). Sections §357(b) and (c) are exceptions to §357(a). If the transaction falls under §357(b), then X. Corp.'s assumption of the liability will be treated as $500 of boot to A and the tax consequences are the same as those described in problem 2-6a. Note that if §357(b) applies to any liability, all of a transferor's liabilities assumed are governed by that provision. See §357(b) (first parenthetical). Whether a transaction would fall under §357(b) would depend on factors such as whether the liability was incurred just prior to the §351 transfer or whether the liability was incurred for personal purposes.

If the liability was incurred in the ordinary course of business, then §357(c) should apply. A will recognize a $200 long- or short-term capital gain (if the asset is a capital asset) since the liability exceeds A's basis in the transferred asset by $200. §357(c)(1). A's basis in the stock received will be $0 under §358 ($300 basis of transferred asset minus $500 cash received under §358(d)(1) plus $200 gain recognized), reflecting the fact that of the $700 realized gain, A only recognizes $200 on the §351 transfer. If and when

A sells the stock for $500, A will recognize the realized but unrecognized $500. X Corp. takes a basis in the transferred property under §362 of $500 (A's carryover basis of $300 plus A's $200 recognized gain). Both A and X Corp. can tack holding periods under §1223. B's tax consequences are the same as in problem 2-6a.

Note that where both §§357(b) and (c) apply, §357(b) takes precedence. §357(c)(2)(A).

You may want to point out that we return to §357(c) in problem 2-13 where §357(c)(3) is considered.

2-7. This variation raises an allocation question considered in Rev. Rul. 68-55. It allows students to play with a variety of possible outcomes. It also illustrates that a non-intuitive case where §362(e)(2) applies to a transfer by a shareholder even though the shareholder's aggregate basis in the assets does not exceed their aggregate value.

If the assets are aggregated, they have a combined basis and fair market value of $1,000. Consequently, the $500 of boot would not be taxable under §351(b) since boot is recognized only to the extent of gain. A's stock would take a $500 basis under §358 ($1,000 basis of transferred assets minus $500 cash received plus zero gain recognized). However, in somewhat similar areas, courts have adopted an asset-by-asset approach. See, e.g., *Williams v. McGowan*, 152 F.2d 570 (2d Cir. 1945). The Service has adopted the asset-by-asset approach in Rev. Rul. 68-55, set out on page 35.

If an asset-by-asset approach is used, how should the boot be allocated? Three possibilities are: (1) in proportion to basis; (2) among the built-in gain assets, in proportion to each asset's relative built-in gain; and (3) in proportion to fair market values. Under the first possibility $100 would be allocated to the gain property and $400 to the loss property. But since the loss property is worth only $300, presumably $200 would be allocated to the gain property (along with $500 of stock) and $300 to the loss property. This method has little to commend it except that the book value of the assets is certain where fair market value may not be.

The second possibility would allocate all $500 (and $200 of stock) to the gain property and $300 of stock to the loss property. See *Easson v. Commissioner*, 33 T.C. 963 (1960), *rev'd on other grounds*, 294 F.2d 653 (9th Cir. 1961). Under this method, A would recognize a $500 long- or short-term capital gain under §351(b) (if the asset is a capital asset) but A would recognize no loss on the loss asset. A's basis in the X stock would equal $1,000 ($200 basis of the gain asset, plus $800 basis of the loss asset, plus $500 gain recognized, minus $500 boot received). X corp. would take a basis of $700 in the gain asset and $800 in the loss asset under §362(a) (or have an aggregate built-in loss in those assets of $500). Thus, under §362(e)(2), assuming no election is made under §362(e)(2)(C), the basis of the loss asset would be reduced by $500, from $800 to $300. If that election were made, the loss asset would retain its $800 basis but A would reduce his basis in the X stock by $500, from $1,000 to $500, the stock's fair market value.

The third and most likely (and probably most desirable) possibility is an allocation in proportion to the fair market values of the assets. This possibility is also consistent with the Service approach in Rev. Rul. 68-55. Accordingly, in exchange for the gain asset, A would be considered to have received 70 percent ($700 out of $1,000 of property transferred) of the stock and cash, or $350 of each. For the loss property, A receives $150 of stock and $150 of cash. With respect to the gain property, A reports a $350 gain on the boot since his realized gain is $500. He would recognize none of the realized loss on the loss asset. A's basis in the X stock would equal $850 ($200 basis of the gain asset, plus $800 for the loss asset, plus $350 gain recognized, minus $500 boot received). Under §362(a), X Corp. would take a $550 basis in the gain asset ($200 basis in transferred asset plus $350 gain recognized) and an $800 basis in the loss asset) or have an aggregate built-in loss in those assets of $350). Thus, under §362(e)(2), assuming no election is made under §362(e)(2)(C), the basis of the loss asset would be reduced by $350, from $800 to $450. If that election were made, the loss asset would retain its $800 basis but A would reduce his basis in the X stock by $350, from $850 to $500, the stock's fair market value.

2-8. This variation applies the principle of *James* that relates to the control requirement of §368(c), specifically on the two-part control requirement. Although the transferors of property control 100 percent of the voting stock, they own zero percent of "all other classes of stock" of the corporation. The lawyer is not a transferor of property and is not part of the transferor group. Accordingly, §351 would not be available for any transferor and A would recognize the $700 realized gain, taking a $500 basis in the stock received while X Corp. would take a $1,000 basis in the property under §1012.

You may want to use this problem to talk about various strategies to meet the qualification requirements under §351. For example, the lawyer could be given $100 of common stock, in which case the lawyer would still have $100 of compensation income, but A and B as transferors of property would satisfy the control test (1,000/1,100 of the voting power). However, it may be that A and B do not want to give the lawyer any vote. Would §351 apply if X Corp. distributes $100 of non-voting common stock to the lawyer? The non-voting common stock should be considered a second class of stock which the transferors of property do not control. What if the lawyer's voting rights are restrained by shareholder agreement, and the stock is identical in all other ways? Probably, the stock would not be a second class of stock and the transferors of property would satisfy the control test. See Rev. Rul. 73-611, 1973-2 C.B. 312, following *Parker Oil Co. v. Commissioner*, 58 T.C. 985 (1972). But the shareholders may not want to give the lawyer an interest in the earnings of the corporation if it is successful.

What if the lawyer purchases $10 of stock (either common or preferred) in addition to the $100 of preferred stock received for services? This question raises whether the lawyer makes an accommodation transfer. If the cash transferred is sufficient relative to the stock received for services (*i.e.,* it is not relatively small), the lawyer will be considered a transferor of property. What if instead of cash the lawyer issues his own note to the corporation in exchange for some stock and receives $100 of stock for services? Since a note is property for purposes of §351, the analysis should be the same as in the previous hypothetical. See *Alderman v. Commissioner*, 55 T.C. 662 (1971). One final method might be to issue enough preferred stock to A and B so that they own at least 80 percent of the preferred stock after the transaction even if the lawyer is not a transferor of property. For example, A and B might each receive $400 of preferred and $100 of common stock.

Problem 2-9. A liability is described in §357(c)(3) if the shareholder would have received a deduction for her payment of the liability or its payment would have created basis. §357(c)(3)(a)(i) and Rev. Rul. 95-74, 1995-2 C.B. 36.

2-9a. Because when T incurred the liability he took a basis in the equipment that included the liability amount, the liability is a not a §357(c)(3) liability. *See* §357(c)(3)(B) (providing that a §357(c)(3) liability does not include a liability the incurrence of which resulted in the creation or increase in basis).

2-9b If T owed $40,000 to his employee as reasonable compensation, under §162(a), he could deduct the liability when paid (if T was a cash method taxpayer) or when incurred (if he was an accrual method taxpayer). Thus, if T was a cash method taxpayer, the liability would be one that would be deducted when paid and would be described in §357(c)(3). (In fact, it represents the classic example of a §357(c)(3) liability.)

If, however, T was an accrual method taxpayer, the liability would be deducted when the all events test is met and economic performance occurs (*i.e.*, when the services are provided), not when payment is made. *See* §162(a); §461(h); Treas. Regs. §1.461-1(d)(2)(i). *But cf. id.* at (d)(6)(ii) (treating services as provided when payment is made in limited circumstances). Thus, the liability would not be a §357(c)(3) liability.

2-9c. Because the liability is contingent, it is not taken into account until paid. If T paid the liability to build the water treatment plant, he would take a basis in the plant that included the liability. *See* Rev. Rul. 95-74, 1995-2 C.B. 36. Thus, because his payment of the liability would create basis in an asset, the liability is a §357(c)(3) liability.

Problem 2-10. This problem applies § 362(e)(2). In either case, § 351 applies to the transfers assuming that Charles and Katie are members of a transferor group. Charles and Katie are each individuals therefore persons, they transfer property to a corporation (X Corp.), they receive X stock in exchange, and they own all X stock after the exchange, controlling X Corp.

2-10a. Because Charles and Katie receive solely X stock in the exchange, under §351(a), neither recognizes gain or loss on the exchange. Under §358(a), unless a §362(e)(2)(C) election is made, Charles takes a $13,000 basis in his X stock, while Katie takes a $3,000 basis in her X stock. Assuming that the land each transfers is a capital asset, because each takes an exchanged basis in the stock received, each tacks the holding period of the property transferred in the holding period of the stock received. §1223(1). Note that if the parcels of land that Charles transferred had different holding periods, he may take a split basis and holding period in each share of stock received (at least if it made a difference for tax purposes). Rev. Rul. 85-164.

Under §1032, X Corp. recognizes no gain or loss on its receipt of the land from Charles and Katie in exchange for X stock. Under §362(a), it takes a $3,000 basis in the land received from Katie. Under § 362(a), it would take a $10,000 basis and $3,000 basis in the parcels received from Charles. Thus, in the aggregate, it would take a $13,000 basis in assets worth only $10,000. Under §362(e)(2), assuming a §362(e)(2)(C) election is not made, X Corp. must reduce its basis in the loss asset by $3,000, from $10,000 to $7,000. If the election is made, it will take the bases in the assets determined under § 362(a), but Charles must reduce his stock basis by $3,000, from $13,000 to $10,000. Thus, either Charles or X Corp. can preserve the built-in loss, but not both. Note that §362(e)(2) applies on a shareholder-by-shareholder basis. Thus, it applies in this transaction even though the aggregate §362(a) basis of the assets transferred by Charles and Katie is less than their aggregate value. Whether or not the §362(e)(2)(C) election is made, X Corp. takes a transferred basis in the assets and tacks the transferors' holding periods for the assets. §1223(2).

2-10b. The results and analysis are the same as in problem 2-10a for Katie. Because Charles receives boot, §351(b) applies to Charles. Assuming that the boot received is allocated proportionately by value between the assets transferred (as provided in Rev. Rul. 68-55), Charles is deemed to receive X stock worth $3,000 and $3,000 cash (*i.e.*, 60% of the stock and cash) for the $7,000 basis land worth $6,000 and X stock worth $2,000 and $2,000 cash (*i.e.*, 40% of the stock and cash) for the $3,000 basis land worth $4,000. He will recognize none of his realized loss on the loss asset but will recognize his entire $1,000 realized gain on the gain asset (*i.e.*, the smaller of his $1,000 realized gain or the $2,000 boot received). Thus, under §358(a), unless a §362(e)(2)(C) election is made, Charles takes a $6,000 basis in his X stock ($10,000 aggregate basis in the land transferred, plus $1,000 gain recognized, minus $5,000 boot received). The holding period analysis is the same as set forth in problem 2-10a.

Under §1032 and general principles, X Corp. recognizes no gain or loss on its receipt of the land from Charles and Katie in exchange for X stock and cash. Under §362(a), it takes a $3,000 basis in the land received from Katie. Under §362(a), it would take a $7,000 basis and $4,000 basis ($3,000 basis to Charles plus $1,000 gain recognized) in the parcels received from Charles. Thus, in the aggregate, it would take an $11,000 basis in assets transferred by Charles, assets worth only $10,000. Under §362(e)(2), assuming a §362(e)(2)(C) election is not made, X Corp. must reduce its basis in the loss asset by $1,000, from $7,000 to $6,000. If the election is made, it will take the bases in the assets determined under §362(a), but Charles must reduce his stock basis by $1,000, from $6,000 to $5,000. Thus, either Charles or X Corp. can preserve the built-in loss, but not both. Note that §362(e)(2) applies even though the assets transferred by Charles did not have an aggregate built-in loss immediately before the transfer. Whether or not the §362(e)(2)(C) election is made, X Corp. takes a transferred basis in the assets and tacks the transferors' holding periods for the assets. §1223(2) **.**

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2-11. This problem introduces a fairly straightforward §351 transaction. It reviews many of the concepts at work in this area and may serve as review problems for the students.

Note that, unless otherwise stated, the factual variations of the general problem assume that X Corp. has only one class of stock outstanding.

Looking at the transaction as a whole, §351 will apply. A, B, C, and D each transfer property to X Corp. and receive stock in exchange. Assuming that their rights in X Corp. were defined before the first transfer and the transfers occur with "an expedition consistent with orderly procedure" (*see* Treas. Regs. §1.351-1(a)(1)), the four are members of a transferor group. Because they own all X stock after the exchange, they control X Corp. within the meaning of §368(c). Thus, §351 applies to each shareholders exchange.

A, who transfers cash for stock, realizes and recognizes no gain or loss on the transaction, whether or not §351 applies. A has simply purchased stock. A's basis in the stock will be $10,000 whether derived under §358 or §1012, and A's holding period commences on the receipt of the stock. X Corp. recognizes no gain on the issuance of stock under §1032 and the basis concept has no relevance to cash.

B has a realized gain of $30,000 under §1001(a). Under §1001(c), the gain must be recognized unless there is a provision to the contrary, and §351 provides nonrecognition. Under §358, B will take a $50,000 basis in the stock received. Under §1223(1), B tacks the assets' holding period on to the holding period of the stock received, assuming that the land and building are capital or §1231 assets. X Corp. recognizes no gain or loss on the exchange of its stock for the land and building under §1032. It will take an aggregate $50,000 basis in the land and the building under §362(a). Its basis in each asset will be the same as B's basis. X Corp. tacks on B's holding period for the asset under §1223(2). Even if the building is subject to depreciation recapture under §1245 or §1250, B recaptures no depreciation under either section, because §351 applies to the exchange and B receives no boot and recognizes no gain. §1245(b)(3) and §1250(d)(3). Note, however, that X's basis in the building continues to reflect any depreciation deductions taken by B, so that §1245 or §1250 may apply to X's subsequent disposition of the building.

C has a $9,000 realized gain under §1001(a), but recognizes only $5,000 of that gain. Although §351(a) does not apply to C's exchange because C receives boot, §351(b) applies, and C's recognized gain equals the smaller of his realized gain ($9,000) and the value of the boot received ($5,000). (Some students have a hard time seeing why §351(b) provides for that comparison, and this problem offers the chance to show how §351 and §1001 interrelate. Note that when §351 refers to gain, it is to *realized* gain, as defined in §1001(a).) C takes a basis in the stock received of $1,000 under §358 ($1,000 basis of transferred property minus the $5,000 cash received plus the $5,000 gain recognized). The $1,000 basis preserves C's realized but unrecognized $4,000 gain. C cannot tack the holding period under §1223(1) since the inventory is not a capital or §1231 asset. X Corp. recognizes no gain or loss on the exchange of its stock for a portion of the inventory (§1032) and also recognizes no gain or loss on its purchase of the remainder of the inventory for cash. It takes a basis in the inventory of $6,000 under §362(a) (the $1,000 basis of transferred property plus the $5,000 gain recognized by C).

You may want to point out that the cash received and the gain recognized are not the same if the shareholder realizes on loss on the exchange or if she realizes a gain less than the cash received. For example, if C had a basis of $8,000 in the inventory, C would recognize a $2,000 gain and would take a basis in the X Corp. stock of $5,000 -- $8,000 basis of the transferred property minus the $5,000 cash received plus the $2,000 gain recognized.

As a variation of C's exchange, X Corp. could transfer its stock worth $5,000 plus land worth $5,000 to C in the exchange. The results to C would essentially the same as described above. In addition, C would take a $5,000 basis in the land (§358(a)(2)), and C's holding period for the land would commence on the receipt of the land. The results to X Corp. would also be the same, except that X Corp. would recognize gain to the extent its basis in the land was less than $5,000 but it would not recognize loss if its basis in the land exceeded $5,000. §351(f).

D realizes a $5,000 loss under §1001(a), a loss not recognized because of §§1001(c) and 351(b)(2). Assuming that D and X Corp. do not make a §362(e)(2)(C) election, D will take a $10,000 basis in the X stock, preserving her $5,000 realized but unrecognized loss ($15,000 basis of transferred property plus zero gain recognized minus $5,000 cash received). D can tack her holding period for the machinery on to the holding period for the stock under §1223(1) if the machinery is a capital or §1231 asset. X Corp. recognizes no gain or loss on the exchange of its stock and cash for the machinery (§1032) and its basis in the machinery depends on whether §362(e)(1) or (2) applies to the exchange. (One of those provisions will apply because X Corp. would otherwise take a built-in loss basis in the machinery under §362(a).) Section 362(e)(1) applies if gain or loss on the machinery is not subject to tax in D's hands immediately before the transfer but is subject to tax in X Corp.'s hands immediately after the transfer. §362(e)(1)(B). If §362(e)(1) applies, X Corp. takes a fair market value ($10,000) basis in the machinery and, apparently, its holding period for the period begins at the time of the transfer, since its basis in the machinery is not, in whole or in part, the same as D's basis. *Cf.* §1223(2). If §362(e)(2) applies and D and X Corp. do not make a §362(e)(2)(C) election, X Corp. takes a $10,000 basis in the machinery (the $15,000 basis determined under §362(a) reduced by the $5,000 built-in loss). Because X Corp. takes a basis in the machinery determined by reference to D's basis, it should be able to tack D's holding period. §1223(2). D and X Corp. may elect under §362(e)(2)(C) for the built-in loss to be eliminated at the shareholder level, rather than the corporate level. If they make this election, X Corp. would take a $15,000 basis in the machinery under §362(a) and tack D's holding period for the machinery under §1223(2). D would take a $5,000 basis in the X stock ($10,000 basis (as determined under §358(a)) reduced by the $5,000 built-in loss).

You may want to ask the students what would happen if D sells her property to A prior to the §351 exchange with A then contributing the machinery and D the cash. If the transaction is respected, D will recognize the loss, A will take a $10,000 cost basis in the property and X Corp. will take a $10,000 basis in the property after the §351 transaction. If the sale and transfer are "mutually interdependent," the Service will undoubtedly step the transactions together and deny the loss deduction.

2-11a. This variation focuses on §351(g), and more information is needed to resolve this variation. You may want to draw out that information from students. Section 351 causes certain "nonqualified preferred stock" to be treated as boot if received in a §351 transaction. Such nonqualified preferred stock must first be "preferred stock" within the meaning of §351(g)(3)(A) and then must be nonqualified as specified in §351(g)(2)(A), subject to the limitations in §351(g)(2)(B)–(C). In general, such nonqualified preferred stock is subject to a redemption right or obligation within 20 years or has a dividend rate that references interest rates or an equivalent index. Note that although §351(g) is less than clear (the Conference Report is clear), nonqualified preferred stock is treated as stock for purposes of qualifying a transaction under §351. However, if a person receives nonqualified preferred stock in her exchange, §351(a) does not apply to the exchange and §351(b) applies only if she receives qualified stock in the exchange. Thus, if a person receives solely nonqualified preferred stock in an exchange, the exchange is not governed by §351. Accordingly, if the preferred stock B receives is nonqualified preferred stock, B recognizes an overall $30,000 gain under §1001(c) and X Corp. takes an $80,000 basis in the land and building under §362(a). If that stock is not nonqualified preferred stock, §351(a) applies to B's exchange, with the consequences to B and X Corp. described above.

For purposes of §351(g), stock is "preferred" only if it is both preferred *and* limited. §351(g)(3)(A). Further, stock is not "preferred" in this sense if it can share in future growth of the corporation by being converted into some other class of stock. Thus, taxpayers wishing to avoid application of §351(g) should be able to do so by using a class of stock that either is not preferred (i.e., does not come ahead of common stock as to the payment of dividends or upon liquidation) or is not limited (i.e., that participates to some significant extent in the growth of the company). This definition of "preferred" is much more restrictive than that used in the context of §§305 and 306.

Even if stock is both preferred and limited, it is not "disqualified" preferred stock unless it contains a feature described in §351(g)(2). If the preferred stock must be redeemed, it is disqualified. §351(g)(2)(A)(ii). If redemption is not mandatory but merely optional, the test is more complex. If the holder of the preferred stock can demand redemption, the stock is disqualified, §351(g)(2)(A)(i), but if it is the corporation that can insist on redemption, then the stock is disqualified only if (as of the issue date), it is more likely than not that the redemption will occur, §351(g)(2)(A)(iii). However, these redemption provisions are relevant only if they can be exercised within 20 years of issuance of the stock and the redemption is not subject to a contingency which makes the likelihood of redemption remote. §351(g)(2)(B). In addition, special provision is made for redemptions related to death, disability, or change of employment status. §351(g)(2)(C).

Finally, preferred stock is disqualified if the dividend rate on the stock varies with interest rates, commodity prices, or similar measures. Such preferred stock, by paying a periodic return tied to interest rates or some similar measure and offering no share in the growth of the corporate venture, is considerably closer to straight debt than to common stock on the debt/equity spectrum.

2-11b. This variation raises both the property and control issues discussed in *James*. B must recognize income of $80,000 on the receipt of stock under §61(a)(1). You may want to ask students whether X Corp. must recognize gain on issuing stock with a basis of zero and a fair market value of $80,000 in exchange for services. See *United States v. Davis*, 370 U.S. 65 (1962). Section 1032 deals with exchanges of stock for property but not services, although Treas. Regs. §1.1032-1(a) classifies services as property for purposes of §1032, thereby giving X Corp. nonrecognition. Thus, this problem emphasizes the importance of the regulations. Moreover, X Corp. can deduct $80,000 under §162 if the expense is an ordinary and necessary compensation expense. See Rev. Rul. 62-217, 1962-2 C.B. 59.

B's failure to qualify under §351 will affect A, C and D. Now the transferors of property do not satisfy the control test immediately after the exchange under §§351(a) and 368(c). A will have no gain on his purchase of stock and will take a $10,000 basis in the stock under §1012. C will recognize the realized $9,000 gain and will take a $5,000 basis in the stock under §1012. X Corp. will take a $10,000 basis in the inventory under §1012. C will recognize a $5,000 loss and will take a $5,000 basis in the stock received. X Corp. will take a $10,000 basis in the machinery. Note that under §1032, X Corp. recognizes no gain or loss on its acquisition of property for its stock. There is no tacking of holding periods for any party.

2-11c. This variation raises some of the issues discussed in *Kamborian*. Although B transfers property, she may have made an accommodation transfer. If B is so treated, she will not be considered to receive stock in exchange for property and thus will not be a member of the transferor group. Then, A, C, and D will not control X Corp., and their exchanges will not be described in §351 with the consequences described in 2-11b.

Among other requirements, a person makes an accommodation transfer if she receives stock which is of a relatively small value compared with the value of the stock already owned or to be received for services. Treas. Regs. §1.351-1(a)(1)(ii). Rev. Proc. 77-37, 1977-2 C.B. 568, provides a 10-percent ruling "safe harbor" under which a person is not treated as making an accommodation transfer if the property transferred has a value equal to at least 10 percent of the value of the stock already owned or to be received for services. B meets this safe harbor, because the property transferred has a value equal to one-third of the value of the stock that she will receive for services. Thus, B is considered a transferor, all of the stock she received counts for purposes of the control test, and the control test is met (since A-D own all X stock). Accordingly, A, C and D will be treated as described in the general discussion of this problem. B must recognize gain to the extent of the $60,000 of stock received for services rendered. That stock will have a basis of $60,000. §1012. B's $8,000 realized gain on the transfer of property is not recognized under §351, and B will take a $12,000 basis in the X stock received in exchange under §358, while X Corp. will take a $12,000 basis in the property under §362(a).

2-11d. Because debt instruments received under §351 constitute boot, B is taxable to the extent of B's $30,000 gain under §351(b). The character of the gain is determined by the nature of the underlying property. If the land and building are capital assets, the gain will be a capital gain. However, B can report the gain on the installment method under §351(b) and §453(a). (If gain on the disposition of the building is subject to recapture, the recapture gain must be taken into account in the year of the transfer under §453(i).) B's basis must be allocated between the note and the stock. B's basis will be $40,000 in the stock received and $10,000 in the note. See Prop. Treas. Regs. §1.453-1(f)(3)(ii). The basis in the note will preserve the $30,000 gain. X Corp will initially have a $50,000 basis in the property received, increasing its basis in the property as B recognizes gain by the amount of that gain. §362(a); Prop. Treas. Regs. §1-453-1(f)(3)(ii).

Note however that §453(g) may defeat installment reporting because B transferred depreciable property to X Corp. and will be a greater than 50% owner of X Corp. But §453(g) may not apply because B was not a greater than 50% owner of X Corp. *at the time* of transfer. Also, §453(g)(2) will allow installment reporting on transfers of depreciable property to controlled entities provided that tax avoidance is not a principal purpose for the transaction. Arguably, in this transaction, the principal purpose is corporate formation not tax avoidance. (However, the Service could still find that tax avoidance is *a* principal purpose.)

If the instrument does not bear an appropriate interest rate, some of the gain that otherwise would constitute capital gain and that otherwise would be deferred will be ordinary income that will accrue in accordance with §§1272-1274.

2-11e. This variation focuses on the control requirement. More particularly, it considers what transfers are properly taken into account as part of the same transaction in applying §351. *See* Treas. Regs. §1.351-1(a)(1) (providing that the phrase "immediately after the exchange" does not require simultaneous transfers "but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure"). If both sets of transfers are considered to be part of the same transaction, the results are the same as in the general discussion of problem 2-11. If they are treated as two separate transactions, the first transfer will qualify under §351 since A, C and D own 100 percent of the X Corp. stock (20,000 shares out of 20,000 shares) after the transfer. B's transfer also will qualify under §351 since B owns 80 percent (80,000 shares out of 100,000 shares) after her transfer.

2-11f. If the transfers are considered part of the same transaction, the results are the same as in the general discussion of problem 2-11. If D's transfer is separate from the others, A, B and C will qualify under §351 since they will own 100 percent of the X stock (95,000 out of 95,000 shares of stock) immediately after their transfers. D's transfer will not qualify under §351, allowing D to recognize the $5,000 loss while X Corp. takes a $10,000 basis in the machinery transferred under §1012.

Whether the D's transfer is considered to be separate from the others depends on factors such as the time between transfers, pre-transaction agreements, the scope of any pre-transfer discussions (in the absence of a formal agreement), the business relationship of the assets transferred, and relationship of the transferors, among other things.

2-11g. This variation illustrates the issue raised in *Kamborian*. If B is an accommodation transferor, B and C cannot be a transferor group and C's transfer cannot qualify under

§351. If B is not an accommodation transferor and B and C are considered to be a transferor group, C's exchange will qualify under §351, because B and C together will own 87,000 out of 102,000 X shares (or more than 85% of the X shares). To be an accommodation transferor, B must transfer property that has a relatively small value compared with the X stock B already owns and the primary purpose of the transfer must be to qualify C under §351. *See* Treas. Regs. §1.351-1(a)(1)(ii). The value of the property B transfers ($2,000) is only 2½% of the total value of the X stock B already owns, a percentage less than the 10% ruling safe harbor in Rev. Proc. 77-37, 1977-2 C.B. 568, but more than the relevant percentage in *Kamborian* (about 0.84%). Nevertheless, the Service probably would consider B's purchase to be insubstantial, so that it would consider B to be an accommodation transferor, unless B's primary purpose in acquiring the additional shares was something other than qualifying C's exchange under §351. Note that if B had purchased 8,000 X shares for $8,000, B would have met the 10% ruling safe harbor of Rev. Proc. 77-37, 1977-2 C.B. 568.

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2-12. This problem is intended to focus on the issues raised in *Peracchi*.

2-12a. Assuming that §357(b) does not apply, T must recognize a gain of $200,000 on the exchange under §357(c). T's basis in the X Corp. stock received, which has a fair market value of $470,000 is $0 under §358. See §358(d). Under §362(a), X Corp. will take a $400,000 basis in the real property and $100,000 basis in the IBM stock. Note that §362(e) does not apply to the transfer, because X Corp. does not take an aggregate basis in the transferred property under §362(a) that exceeds the property's aggregate value.

2-12b. The result is the same as in Problem 2-12a even if T remains secondarily liable or guarantees payment of the debt. This analysis assumes that under all of the facts and circumstances, X is expected to satisfy the liability. *See* §357(d) (describing the amount of a liability considered assumed).

2-12c. If T contributes $200,000 of additional cash to X Corp., then under §357(c) T would have no gain on the §351 transfer. Note that in this case T would receive $670,000 of X Corp. stock, which would have a basis of $0 under §358.

2-12d. The result should be the same as in problem 2-12c regardless of the identity of the lender. The critical fact is that T's borrowing from X is unrelated to the §351 transaction.

2-12e. This variation raises the *Peracchi* issue. T would like to treat this variation in the same manner as in problem 2-12d. From T's perspective, it is as if X Corp. made a loan of $200,000 to T who then contributed the cash along with the other assets to X Corp. in a §351 transaction. Viewed in this manner, the total bases of the assets transferred by T is $500,000, avoiding gain under §357(c). Despite *Peracchi* and *Lessinger*, the Service continues to argue that T's note has a $0 basis. Even if *Peracchi* applies, we would need to develop the facts to determine whether there was at least a realistic possibility that creditors may enforce T's obligation to X (which under *Peracchi* appears to be a relatively low threshold).

2-13a. This problem addresses §357(c)(3). Since T meets all of the requirements, §351 governs the transaction. Under §357(c)(1), it first appears as though T will recognize $300 of ordinary income since the assumed liabilities of $300 exceed the zero adjusted basis in the accounts receivable. However, §357(c)(3) excludes the accounts payable from being taken into account under §357(c)(1), because T would have deducted $300 if it had paid the payable. Consequently, T has a $1,000 realized gain but no recognized gain. T's basis under §358 in the $700 of stock it received is $0 ($0 basis in transferred property minus $0 cash received, see §358(d)(2), plus $0 gain recognized). X Corp. takes the receivables with a $0 basis under §362(a).

2-13b. In this variation, the accounts payable would not be deductible when paid by an accrual basis taxpayer. Accordingly, T would be taxable on $300 under §357(c)(1) and would take a $0 basis in the $700 worth of X stock received. This variation illustrates why §357(c)(3) did not apply in *Peracchi*.

2-13c. Under *Hempt Bros. v. United States*, 490 F.2d 1172 (3d Cir. 1974), X Corp. will get a deduction when it pays the $300 account payable and will be taxable on the payment of the receivables. *See also* Rev. Rul. 80-198, 1980-2 C.B. 113 (approving the result in *Hempt Bros.* but cautioning that income or deductions may be reallocated where appropriate under §482).

This pattern can be recharacterized as if X Corp. borrowed $300 from T's creditor and distributed the $300 of cash (along with $700 of stock) to T who then uses the proceeds to discharge his obligation. Viewed in this manner, T would recognize his $1,000 realized gain to the extent of the $300 boot. However, T's deemed payment to the creditor would be deductible under §162, which would offset the income. Under this recharacterization, T's basis would be $0 under §358 ($0 basis in transferred property minus $300 cash received plus $300 gain recognized). X Corp. would take the receivables with a basis of $300 and on making the $300 payment for the assumed liabilities, X Corp. would have no deduction since it had no income between this recharacterization and the actual treatment outlined in the prior paragraph. The recharacterization gives X Corp. $300 of basis in the receivables but denies the $300 deduction. Section 362(a) gives X Corp. a zero basis, but *Hempt Bros.* gives X Corp. a deduction. Which treatment makes more sense? Arguably, the recharacterization does. Section 357(c)(3), in effect, allows T to accrue the account payable as an offset against the amount by which the liability exceeds T's zero basis. Having given T the effect of a deduction, why should X Corp. get the same deduction later on? Similarly, because T has effectively recognized $300 of income (the excess of liability over basis), X Corp. should receive a $300 step-up in basis.

2-14. This problem is a simplified representation of *Bradshaw*. Before discussing how to determine whether §351 will apply or whether the transfer will be treated as a contribution to capital, it may be useful to show what the stakes are. In this situation, as in *Bradshaw*, the taxpayer may hope that §351 does not apply.

If §351 does not apply and the real estate is a capital asset in T's hands held for more than one year, T will realize and recognize a $400,000 long-term capital gain. However, under §453, T will recognize that gain when the note is paid off in five years.

Interest payments would be includible as ordinary income by T and deductible by X Corp. If the note does not bear a market rate of interest, there may be original issue discount to be accrued by T over the five-year period. X Corp. will take the real estate with a basis under §1012 of $500,000. When X Corp. sells the developed single-family dwellings, it will recognize $500,000 of ordinary income in the aggregate.

If the debt instruments are so speculative that they are treated as stock, T would recognize no gain on the §351 transfer and would take a $100,000 basis in the "stock." §358. X Corp. would take the real estate with a carryover basis of $100,000 under §362. Upon development and sale, X Corp. would have $900,000 of ordinary income in accordance with §1221. The purported interest payments would be treated as nondeductible §301 distributions. Moreover, the retirement of the instruments would be evaluated under §302 and probably would result in qualified dividend income to T, taxed at the same rate as long-term capital gain (assuming that T is an individual).

If the debt instruments are so speculative that they are ignored altogether, the transaction will be treated as a contribution to capital. T will increase his stock basis by $100,000. X Corp. will have no gain on the contribution under §118 and will take a carryover basis of $100,000 under §362(a). Presumably, any periodic payments will be treated as dividend payments on T's underlying stock. It is not clear how the retirement of the notes will be treated since they are being ignored under this capital contribution analysis. If capital gains treatment results under §§1271 and 1001, the basis of the notes is $0. Dividend treatment is another possibility. X Corp. will have $900,000 of ordinary income upon sale of the single-family dwellings.

The discussion in *Bradshaw* suggests what factors will determine if the sale is to be respected. Two important factors are whether the "price" of the property was reasonable and whether the notes gave their holders the level of risk usually undertaken by noteholders. Because of judicial difficulty drawing this line, from time to time Congress has considered the idea of making all transfers from significant shareholders to their corporations subject to §351 even if the form of the transaction is a sale.