

## QUESTION 2

### Hallie

Under IRC §351 a shareholder recognizes no gain or loss on the transfer of property to the corporation solely for stock and the transferor is in control of the corporation. IRC §368(c) defines control as ownership of stock possessing at least 80% of voting power and 80% of the shares of all classes. When Hallie transferred real estate to Newco she did so solely for stock and was the sole shareholder after the exchange, thus under §351 she would ordinarily recognize no gain.

Hallie's basis in the stock received is governed by IRC §358 which states that a shareholder's basis in stock received in a §351 transaction is equal to the basis in the property transferred subject to certain adjustments. One of those adjustments under IRC §358(d) is reduction of the basis by the amount received as an assumption of liabilities. Hallie's basis in Blackacre was \$650,000. The liability assumed on Blackacre was \$750,000. Under IRC §357(c)(a)(A) if the assumed liabilities exceeds the adjusted basis then the excess is treated as gain from the sale or exchange of the asset. Normally real estate is a capital asset, but Hallie is a broker-dealer in land and this was part of her inventory making the \$100,000 excess ordinary income rather than a capital gain. Hallie's stock basis will be \$0 and she will have to report \$100,000 of ordinary income.

### Isaac

Isaac received stock for services a situation governed by §351(d). Under IRC §351(d) stock issued for services is not considered issued for property and does not qualify for §351 non-recognition. Instead under IRC §83(a) stock transferred for

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services is taxed as income in the amount by which the stock's FMV exceeds the amount paid. This income is taxed as ordinary income and requires the payment of FICA and withholding taxes. Isaac paid \$7,000 for stock with a FMV of \$100,000 resulting in \$93,000 of ordinary income that he needs to report. Although the facts do not indicate that Isaac's becoming a shareholder was planned before Hallie's §351 transaction it should be noted that if the two transactions were part of the same plan that Hallie's transaction might lose its §351 nonrecognition protection as Hallie would no longer be a transferor with sufficient control under §368.

#### Newco

Under IRC §1032, Newco recognizes no gain or loss on the receipt of money or property in exchange for corporate stock. This means both Hallie's contribution of Blackacre and Isaac's \$7,000 contribution result in no gain or loss to Newco. In fact, Newco gets to deduct the \$93,000 difference between Isaac's contribution and the FMV of the stock he received as a business expense for compensation. IRC §362 governs the corporation's basis in the property received in a §351 transaction. Under §362 the corporation's basis is the transferor's basis increased in the amount of the gain recognized by the transferor on the transfer. Hallie recognized \$100,000 of gain on her transfer raising Newco's basis in Blackacre from a carry-over basis of \$650,000 to a new basis of \$750,000.

#### S-corp. Eligibility/Election

S-Corp eligibility is available to only certain entities. Under §1361(a) only a domestic small business corporation making a valid election may be an S-corp. IRC § 1361(b) sets forth the requirements to be a small business corp. The first requirement is that the corporation be a domestic corporation, with a related requirement that the

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corporation have no non-resident alien shareholders. Another requirement is that the corporation not have shareholders from more than 100 families, with the related requirement that all shareholders be individuals, except for a decedents' estates, most trusts, pension funds, charities and S-Corp parent corporations. There is also a requirement under IRC §1361(b)(2) that the corporation not be an ineligible corporations identifying as such ineligible corporations financial institutions using the reserve method of accounting for bad debts, insurance companies, corporations to which §936 applies and a DISC (Domestic International Sales Co.) or former DISC. The facts reveal no issues with only of these requirements at this point Newco appears to be an eligible domestic corporation with only 2 shareholders both of whom appear to be eligible shareholders. However, the final requirement for S-Corp eligibility is that the corporation have only one class of stock. Newco identifies two classes of stock- Class A and Class B, it is unclear what the difference is between the two classes of stock (other than the owner). Under IRC §1361(d)(4) differences in common stock voting rights are disregarded, thus if both A and B are classes of common stock differentiated solely by the voting rights carried with them Newco is eligible to make an S-Corp. election. If one is common stock and the other preferred then Newco is ineligible to make an S-Corp. election.

Assuming that Newco was eligible and that a proper election was made, that election would not take effect in 2006. IRC §1362(b)(1)(B) says that on or before the 15th day of the 3rd month of the taxable year an S-corp eligible entity may elect to receive S-Corp treatment in that year. In this case, Newco was formed, it appears, on March 1, 2006, the facts also tells us that Isaac became a shareholder on May 28, 2006, after the window to elect S-corp status for 2006 had passed. Assuming that

Newco is a calendar year reporter an S-Corp election made prior to the end of the calendar year would be effective under IRC §1362(b)(1)(A). Newco would even have until March 15, 2007 to make an S-Corp. election effective for 2007 under IRC §1362(b)(1)(B).