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TAX-FREE INCORPORATION

— by Neil E. Harl*

For several years, relatively little change had been made in the rules governing the tax-free exchange of property to a corporation.[1] The questions raised in the 1970s about how to handle basis allocation between stock and debt securities had been answered.[2] The problems of distinguishing debt and equity securities had not been resolved but that issue seemed to be less of a burning concern with IRS than it was until the proposed regulations issued in 1980[3] were revoked in 1983 before becoming final.[4]

The Omnibus Budget Reconciliation Act of 1989,[5] however, has added a startling new dimension to some tax-free corporate exchanges: debt securities issued in a tax-free exchange are treated as boot.[6] Because gain is recognized in a tax-free exchange to the extent of boot received by the transferor,[7] the 1989 amendment means there's gain to be recognized in most cases if debt securities are issued. The discussion below examines *how much* of the value of debt securities issued will likely be treated as gain.[8]

Basic requirements. The fundamental requirements of a tax-free exchange otherwise were left unchanged by the 1989 legislation. To qualify for a tax-free exchange with neither gain nor loss recognized by shareholders on the transfer of property, two conditions must be met—(1) the transfer must be solely in exchange for stock in the corporation[9] and (2) the transferors as a group must be "in control of the corporation immediately after the exchange."[10] This requires that the transferors of property end up with at least 80 percent of the combined voting power of all classes of voting stock and at least 80 percent of the total number of shares of all other classes of stock.[11] A shift in ownership of stock among the transferors after the exchange does not necessarily deny Section 351 exchange treatment.[12]

The income tax basis of stock received by the transferors of property is the basis of property transferred, less boot received and plus gain recognized, if any.[13] As noted above, gain must be recognized to be extent of boot received by the transferor.[14] In determining the amount of gain recognized where several assets are transferred to a corporation, each asset must be considered separately in exchange for a portion of each category of consideration received.[15]

If the corporation assumes a liability of the transferor or takes property subject to a liability, such as a mortgage, the amount of the liability is treated as "money received" and reduces the basis of stock received.[16] If the sum of the liabilities assumed or taken subject to by the corporation exceeds the aggregate basis of assets transferred, a taxable gain is incurred as to the excess.[17] The gain is allocated among all assets transferred on the basis of their respective fair market values with the gain characterized as capital gain or ordinary income depending on the nature of the asset to which allocated.[18]

Apparently, taxable gain cannot be avoided by giving the corporation a personal promissory note for the difference.[19] Such a note appears to have a zero basis.

Implications of the 1989 amendment. Until the 1989 enactment, the basis of property transferred was allocated among the various classes of stock and securities in proportion to the fair market values of stock and securities received.[20]

The key question is how basis is to be allocated now that debt securities are treated as boot.[21] There appear to be two different ways basis could be handled. Thus far, there is no guidance as to which represents the IRS position.

> **Example:** A taxpayer transfers farmland with a fair market value of $1,000,000 and an income tax basis of $800,000 to a newly formed corporation in exchange for $200,000 of 9 percent, 15 year debentures and $800,000 of corporate common stock.
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> **Possibility I:** If one were to apply literally the regulations now in place, the $800,000 of basis for the transferred property would be allocated to the extent of $160,000 to the debt securities and $640,000 to the stock. Then the remaining value of the debt securities ($40,000) would be treated as boot.
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> **Possibility II:** The other approach – and the one more likely to represent the IRS position – would involve allocating all of the basis of $800,000 to the corporate stock and none to the debt securities. Then the entire face amount of the debt securities ($200,000) would be treated as boot. With this approach, the basis available for allocation would be allocated to the stock up to the value of the stock. Any remaining basis would likely be allocated to the debt securities, thus reducing the amount to be recognized as gain under the "boot" rule.

Quite clearly, Possibility II results in much less favorable treatment for the taxpayer. With stock in closely-held corporations rarely sold, the added basis to

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the stock is of relatively little significance. In both instances, the debt securities end up with a basis equal to face value. That would mean that debt securities could be redeemed at face value with no recognition of gain. Previously, redemption (or sale) of debt securities produced the same relative gain as corporate stock issued at the same time in a tax-free exchange.

Effective dates. The 1989 amendment treating debt securities as boot is effective for transfers after October 2, 1989, in taxable years ending after that date.[22] For property transfers by a C corporation, the effective date is July 11, 1989, unless the 80% test of I.R.C. § 1504(a)(2) is met.[23]

Advantages of debt securities. As a planning matter, the key question now is the importance of debt securities in accomplishing business and estate planning objectives.[24] In general, there have been eight reasons for using debt securities – (1) interest is income tax deductible, dividends are not (except in S corporations); (2) debt securities reduce the amount of investment needed to acquire control of the corporation; (3) debt securities provide assured income to the holders (such as parents in retirement); (4) interest income is not earned income and does not affect social security benefits in retirement; (5) for off-farm heirs, after the deaths of the parents, debt securities can provide greater assurance of income, less fluctuation in principal value and less right to participate in management than corporate common stock; (6) for on-farm heirs, changes in corporate net worth are magnified as the entire change is reflected in shifts in value of capital stock (providing, possibly, greater motivation and incentive to the on-farm heirs); (7) the opportunity for redemption of debt securities at maturity with consequent removal of capital from the corporation without treatment as a dividend is greater than with redemption of corporate stock; and (8) fixed principal debt securities represent a way to "cap" or "freeze" the value represented by the debt securities.

Planning solutions For some individuals, a second class of stock (except in S corporations) may be a practical substitute for debt securities. The better alternative, however, may be to issue debt securities for cash *in a separate transaction*. If sufficient cash is not available, the necessary borrowing could be done in advance of incorporation with a mortgage or other security interest placed on property transferred to the corporation if required by the lender. Then sometime well after completion of the incorporation process, the cash is transferred to the corporation in exchange for debt securities. Care should be taken to assure that the level of liabilities does not exceed the basis of the property transferred.[25] That is a greater possibility with creation of sufficient cash for later issuance of the desired level of debt securities.

FOOTNOTES

1 See generally 7 Harl, **Agricultural Law** ch. 53 (1990).
2 Id., § 53.03[3].
3 Prop. Treas. Reg. §§ 1.385-1 through 1.385-12, 45 Fed. Reg. 18963-18973.
4 T.D. 7920, Nov. 2, 1983.
5 Pub.L. 101-239, Sec. 7203, 103 Stat. 2333 (1989), amending I.R.C. § 351(a),(b),(d),(g).
6 *Id.*
7 I.R.C. §§ 351(b), 358(a)(1)(A).
8 See notes 20-21 *infra* and accompanying text.
9 I.R.C. § 351(a).
10 I.R.C. § 351(a), 368(c).
11 *Id.*
12 Rev. Rul. 79-194, 1979-1 C.B. 145.
13 I.R.C. § 358(a)(1).
14 I.R.C. §§ 351(b), 358(a)(1)(A).
15 Rev. Rul. 68-55, 1968-1 C.B. 140.
16 I.R.C. § 358(d).
17 I.R.C. § 357(c). See Owen v. Comm'r, 89-2 U.S.T.C. ¶ 9476 (9th Cir. 1989) (liabilities secured by personal guarantee for which guarantors remained liable not excluded); George H. Beaver, T.C. Memo. 1980-429 (entering of loans on corporate books and use of corporate funds to repay sufficient for assumption). See also Ltr. Rul. 8331035, April 28, 1983 (upon incorporation of farm partnership by two equal partners each would recognize gain to extent their respective shares of partnership liabilities exceeded adjusted basis of their respective interests in partnership). But see Lessinger v. Comm'r, 872 F.2d 519 (2d Cir. 1989), rev'g, 85 T.C. 824 (1985) (no gain recognized on transfer of taxpayer's sole proprietorship assets and liabilities to taxpayer's wholly owned corporation).
18 See Rev. Rul. 68-55, 1968-1 C.B. 140.
19 Rev. Rul. 68-629, 1968-2 C.B. 154. But see Lessinger v. Comm'r, N. 17 *supra* (shareholder's contribution of own note eliminated gain).
20 Treas. Reg. § 1.358-2(b). See Rev. Rul. 85-164, 1985-2 C.B. 117 (aggregate basis of property transferred to corporation must be allocated between stock and securities received in proportion to relative fair market values of each class). See also GCM 39418, Oct. 10, 1985.
21 See note 6 *supra* and accompanying text.
22 OBRA, Pub. L. 101-239, Sec. 7203, 103 Stat. 2333 (1989).
23 *Id.*
24 See 7 Harl, *supra* note 1, § 52.03[1], for a discussion of the advantages and disadvantages of debt securities.
25 See note 17 *supra* and accompanying text.

Reminder: The next issue of Agricultural Law Digest will be published July 6, 1990 and will contain developments since this issue.