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Incorporating the Going Business

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According to recent figures released by the Treasury Department, as reported by one of the well-known tax periodicals, more and more unincorporated businesses are changing to corporate form. During the years 1961 to 1964, the number of sole proprietorships decreased by about 49 thousand and the number of partnerships decreased by about 17 thousand, while the number of corporations increased by about 184 thousand.

Now, what might be some of the reasons for this shift in the form of doing business? Well, of course, we are all aware of the limited liability to individual stockholders afforded through the use of incorporation. Another reason might be additional fringe benefits available, such as deferred compensation through qualified pension and profit-sharing plans, medical payment plans, exempt sick pay, tax-free group life insurance, and health and accident coverage. Of course, limited tax-deductible retirement plans for the self-employed are now available to the businessman whose business is unincorporated but, generally speaking, they will be less beneficial than the corporation plans. In this regard, Revenue Ruling 66-218 makes it clear that a pension or profit-sharing plan for a Subchapter S corporation will not be denied approval just because shareholder-employees are eligible to participate in the plans. This means that shareholder-employees of Subchapter S corporations, in effect, get a current deduction from taxable income for contributions to such plans. A word of caution is in order at this point with respect to medical-payment plans covering only officer-stockholders of closely held corporations. A recent Tax Court case, Larkin,\(^1\) indicates possible trouble in this area and should be checked before employing such a plan. Sometimes the difference between income tax rates of individuals and those of corporations alone makes incorporation desirable, and usually enough business reasons can be shown to substantiate the incorporation. If Treasury figures are a true indication, the enactment in 1958 of Subchapter S of the Internal Revenue Code is the greatest single factor contributing to the increase in the number of cor-

\(^1\) Larkin, 48 TC No. 59.

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Our discussion today will be concerned with the incorporation of proprietorships and partnerships. For the most part, the same provisions will apply to both. In examining the subject, we shall look at specific Code and regulations sections, pertinent cases and revenue rulings, and some planning aspects. The planning aspects of this subject cannot be overemphasized, for, although it is quite a simple matter to incorporate tax-free, it is usually very difficult to liquidate the corporation without serious tax consequences. Generally speaking, the tax consequences of incorporation to both the transferor stockholders and the transferee corporation are within the control of the planner. Depending upon how the incorporation is structured, gain may not be recognized at all, it may be partially recognized, or it may be fully recognized; recognized gain may be all capital gain, all ordinary income, or part capital gain and part ordinary income. Sometimes we may find it difficult to convince proprietors or partners that they could have gain under any circumstances since they may feel they have the same property—assets and liabilities—after the incorporation as they did before, without realizing that what should be considered is the value of the stock received upon the exchange as compared with the basis of the assets exchanged therefor. Proprietors and partners may also be reluctant to accept the idea that the value of the stock is dependent not only upon the value of the tangible assets, but also upon intangibles, such as goodwill or going-concern value, patents, and trademarks.

SPECIFIC PROVISIONS

In the usual case, the incorporators want the transaction to be tax-free. IRC section 351 provides the means of doing this. It provides that no gain or loss will be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and if immediately after the exchange such person or persons are in control of the corporation. Control for this purpose is defined in Code section 368(c) as the ownership of stock possessing at least eighty per cent of the total combined voting power of all classes of stock entitled to vote and at least eighty per cent of the total number of shares of all other classes of stock of the corporation.\(^2\) If

\(^2\) IRC Sec. 368(c).
only stock is issued in the exchange, generally there are no problems. We should keep in mind, however, that the regulations provide that, for this purpose, stock rights to warrants are not stock or securities. The term "securities" is not defined in the Code, but there are a number of cases dealing with the definition of a security. Although there is no single characteristic determining whether or not an obligation of a corporation constitutes a security, the most important one appears to be the maturity. Accordingly, short-term obligations will not be considered securities.

Now, what is a short-term security? Here again, the courts have differing opinions. Generally speaking, it appears that obligations with maturities of less than five years will not be considered securities, those with maturities of ten years or more will be, and those between five and ten years are in a grey area, but probably would be considered to be securities.

Another problem relating to the issuance of corporate obligations is that of the so-called "thin corporation." Now we are not going to get into a lengthy discussion at this time of the many factors involved in determining whether or not a corporation is thin. We should examine briefly its implications, however. Here again there is no definition in the statute, and the numerous court cases in point have provided no clearly determinative factors. All of us are aware, I am sure, of the adverse effects of having a corporation so classified, i.e., loss of the interest deduction to the corporation coupled with dividend treatment of the payments received by the obligation holders. Suffice it to say that this problem should be carefully considered where corporate obligations are to be issued in connection with the exchange.

For purposes of section 351 the performance of services for the corporation is not considered property. Now this is not to say that the issuance of stock for services will make section 351 inapplicable. On the contrary, if the persons transferring property in the exchange meet the eighty-percent-control test, section 351 will still apply to them. The person receiving stock for services will be deemed to have received ordinary income in the form of compensation to the extent of the fair market value of the stock. A somewhat related problem is the issuance of stock for "know-how," which includes such items as patents, trademarks, and formulae. At present, this area is somewhat unsettled; in some cases,
depending upon the facts, the stock may be considered as issued in return for property and in others it may be considered as issued for services. In any such anticipated transfer, careful study should be made of current developments with respect to this subject.

If money or other property, commonly referred to as "boot," is also received in connection with the incorporation, any gain to the stockholder will be recognized to the extent of the money or fair market value of the property received; however, no loss will be recognized.\(^5\) Included in this category are open accounts, demand notes, and short-term obligations not qualifying as securities.

Section 351(a) is applicable if the transferors are in control, by virtue of meeting the eighty-percent test, immediately after the exchange. Although the Code uses the words "immediately after," care should be exercised in permitting any transactions to occur within a short time after the exchange that would have the effect of reducing below the required eighty per cent the ownership of those who received stock in exchange for property. The Service may take the position that the test has not been met. The section also makes it clear that two or more transferors may be included in the transfer, and in any such case the transferors will be considered as a group so far as the eighty-percent-control test is concerned.

A disproportionate distribution of stock or securities will not of itself cause the exchange to be taxable. However, the regulations provide that the transaction will be examined to determine if in substance there has been a gift or compensation or if stock or securities have been used to satisfy obligations of the transferor.\(^6\)

In most cases, the incorporation of a going business will include the assumption of liabilities by the transferee corporation. Generally, this will not prevent the transaction from being within the provisions of section 351.\(^7\) If, however, in light of all the facts and circumstances, it appears that tax avoidance is one of the principal purposes, or if there is no bona fide business purpose in the transaction, the assumption of the liabilities will be treated as boot, and the gain will be recognized to that extent.\(^8\) Also, if liabilities in excess of transferors' basis are assumed by the transferee corporation, gain will be recognized to the extent of the

\(^5\) IRC Sec. 351(b).
\(^6\) Regs. 1.351-1(b)(1).
\(^7\) IRC Sec. 357(a).
\(^8\) IRC Sec. 357(b).
excess. In making this test, as to each shareholder, the aggregate liabilities assumed should be compared with the aggregate basis of assets transferred. Tax avoidance or lack of business purpose will usually be asserted where the debt arose from a transaction in which the transferor derived a personal rather than a business benefit from the use of the proceeds of the obligation. An example of this would be where an individual borrowed money, pledged an asset as collateral, used the proceeds for personal benefit, then shortly thereafter transferred the asset subject to the debt, to his newly formed corporation. It is important to note that in cases relating to tax avoidance or lack of business purpose, the total amount of liabilities assumed shall be considered boot and not just a particular liability considered as providing the means of tax avoidance or as lacking in business purpose.

There are at least two provisions relating to depreciable property that we should keep in mind. First is the provision holding that any gain is ordinary income realized from the sale or exchange of depreciable property between an individual and a corporation of which he owns, actually or constructively, more than eighty per cent of the value of the outstanding stock. This means, of course, that if any boot is received in a section 351 transaction, gain recognized will be ordinary income to the extent that it is attributable to depreciable property. Secondly, there is no depreciation recapture on a completely tax-free incorporation. However, if boot is considered to have been received in the exchange, there will be depreciation recapture to the extent the boot is attributable to the depreciable property. There are two recent cases of considerable interest pertaining to value of stock for purposes of the more than eighty-percent test mentioned above. The first, a Fifth Circuit decision, Parker v. U.S., held that an individual who owned eighty per cent of the stock of a corporation owned more than eighty per cent in value of the outstanding stock because he controlled the corporation; therefore, the gain he realized from the sale of depreciable property to the corporation was ordinary income. In a more recent case, Trotz v. Comm., the Tax Court took the opposite view and held that seventy-nine per cent of the outstanding stock constituted seventy-nine per cent of the value

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9 IRC Sec. 357(c).
10 IRC Sec. 357(b)(1).
11 IRC Sec. 1239.
12 IRC Secs. 1245(b)(3) and 1250(d)(3).
13 Parker, 19 AFTR 2d 1281.
14 Trotz, TC Memo 1967-139.
of the outstanding stock. We may hear more on this point in the future. We mentioned previously that there is no depreciation recapture in a tax-free incorporation. However, the potential recapture is carried over to the corporation and may be realized by it in a subsequent disposition.

Let us look now at some of the provisions relating to basis, both as to the transferor stockholder and as to the transferee corporation. If the stockholders receive only stock or securities, their basis will be the same as that of the property transferred; if boot is received, its basis will be its fair market value, and the basis of the stock or securities received will be the same as the property transferred, less the boot received and plus any gain recognized.\(^{15}\) If both stock and securities, or different classes of each, are received in the exchange, the total basis will be allocated to each on the basis of fair market value.\(^{16}\) In a tax-free incorporation, the basis of the assets in the hands of the corporation will be the same as it was in the hands of the transferors; if boot is given in the exchange, the basis is increased by the amount of gain recognized to the transferor.\(^{17}\) In cases where basis is increased because of recognized gain, it will be necessary to allocate the increase to the various assets transferred.

Next let us consider the provisions relating to the holding period of the stock or securities and any boot received by the transferor stockholders upon the incorporation and relating to the transferred assets in the hands of the corporation. If the property transferred was either a capital asset or property used in a trade or business, the holding period of the stock or securities received in exchange therefor includes the period during which the assets were held.\(^{18}\) If non-capital assets are transferred, the holding period of stock or securities received starts with the date of the exchange. If both capital and non-capital assets are transferred, it appears that an allocation must be made to determine the holding period of the stock received. The holding period of any boot received starts with the date of the exchange. To the corporation, the holding period of the property includes the period it was held by the transferors, whether or not the property is a capital asset.\(^{19}\)

\(^{15}\) IRC Sec. 358.
\(^{16}\) Reg. 1.358-2(b) 2.
\(^{17}\) IRC Sec. 362(a).
\(^{18}\) IRC Sec. 1223(1).
\(^{19}\) IRC Sec. 1223(2).
Section 367 should be mentioned just briefly, since it relates to our subject. There may be occasions when transfer of assets to a foreign corporation in exchange for its stock or securities is desirable. Section 367 provides in substance that to make such an exchange tax-free, a ruling that tax avoidance is not one of the principal purposes of the transfer must be obtained before the exchange. The Internal Revenue Service rigidly adheres to the provision requiring the obtaining of the ruling before the exchange; failure to do so can be fatal.

**OTHER PERTINENT ITEMS TO CONSIDER**

The question of what happens to the reserve for bad debts upon the transfer of a business is somewhat unsettled at this point. The Internal Revenue Service has taken the position\(^{20}\) that in connection with the incorporation of a sole proprietorship or a partnership under section 351, the amount of bad-debt reserve is to be taken into the income of the transferor to the extent that he received a tax benefit from additions to the reserve in prior years. The Tax Court in a recent case, *Estate of Schmidt v. Comm.*,\(^{21}\) upheld the Service's position. The Ninth Circuit Court of Appeals reversed the Tax Court, however, and held, in substance, that there is no income, whether the transfer be for cash or stock, unless the amount of the consideration exceeded the net amount of the receivables. That's good news for taxpayers in the Ninth Circuit, but I'm afraid that for the rest the announced position of the Service will continue to be asserted until more litigation settles the issue one way or the other.

Among the assets of the business being transferred might be installment obligations. A number of different types of transactions are considered to be disposition of such obligations, resulting in income being realized by the transferor at the time of the transfer. However, a transfer in connection with section 351 transactions is an exception to the general rule. The regulations\(^{22}\) provide that no gain will be recognized on such a transfer. In certain cases, this might be advantageous if the gain, when realized, will be ordinary income and the transferor is in a higher tax bracket than the corporation. On the other hand, if the gain will be capital gain when realized, it would appear that rarely would it

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\(^{21}\) Schmidt, 17 AFTR 2nd 242.
\(^{22}\) Regs. 1.453-9(c)(2).
be desirable to transfer the obligations to the corporation, even if the gain were to be taxed at twenty-two per cent to the corporation rather than at twenty-five per cent to the individual, for we must remember that the after-tax gain is still in the corporation and usually cannot be got out without additional tax cost.

In the usual incorporation of a sole proprietorship or partnership, there probably will be no investment credit recapture upon the transfer of the assets to the corporation. Final regulations provide that where the transferor transfers to a corporation substantially all the property used in the business, the transaction being a mere change in form of doing business and the transferor retaining a substantial interest in the business, there will be no recapture upon the transfer. For this purpose, the transferor will be considered to have retained a substantial interest if his interest after the transfer (1) is substantial in relation to the total interest of the other stockholders or (2) is equal to or greater than his interest prior to the transfer. Substantial boot received in a transfer might reduce the interest of the transferor by an amount great enough to cause his interest retained to be considered not substantial and therefore great enough to trigger recapture at the time of the transfer. Although recapture may not take place at the time of the transfer, the potential recapture remains until such time as the asset giving rise to the credit has been held for its estimated useful life, starting with the date of acquisition by the transferor. If the asset is disposed of by the transferee corporation before the close of such estimated useful life, appropriate recapture will apply to the transferor stockholder. Furthermore, there will be recapture to the transferor stockholder if he ceases to retain a substantial interest in the business. Notice that in both these instances of recapture the impact is on the stockholder and not on the corporation, in contrast to depreciation recapture, which falls on the corporation.

Generally, the same provisions relating to the incorporation of a sole proprietorship will apply to the incorporation of a partnership. However, if during the existence of the partnership there has been a transfer of partnership interest as the result of a sale or death, there may be some problems relating to the basis of assets transferred to the corporation. If there has not been such a transfer, the basis of the assets in the

\[^{23} \text{Prop. Reg. 1.47(3)(f).} \]
\[^{24} \text{Prop. Reg. 1.47(3)(f)(5)(i).} \]
\[^{25} \text{Prop. Reg. 1.47(3)(f)(5)(ii).} \]
hands of the corporation will be the same as the basis to the partnership, regardless of whether the assets are transferred by the partnership or the partnership is first liquidated and the assets transferred to the corporation by the former partners. The result may be different if there has been a transfer of partnership interest by sale or death. Section 743 provides in substance that a partnership may elect to adjust the basis of partnership assets by the excess of the price paid for a purchased interest, or by the excess of the fair market value of an interest acquired because of death, over the basis to the transferor. If the election is made it will make no difference whether the partnership assets or partnership interests are transferred to the corporation. If the election has not been made, however, it will make a difference. If the assets are transferred, their basis in the hands of the corporation will be the same as in the hands of the partnership. If the partnership interests are transferred, the basis of the assets will be the basis of the transferred partnership interests. In either case, the basis of the stock or securities received by the former partners will be the basis of their partnership interest reduced by any boot received and increased by any gain recognized.

Incorporation of a cash-basis proprietorship or partnership carries with it some additional items to be considered. Where accounts receivable are transferred, they will have a zero basis and the corporation will have taxable income upon their collection. The transferor will not have income at the time of the transfer. Depending upon the circumstances, these results may or may not be the most advantageous; in some cases it might be preferable to have the collection of the receivables be income to the individuals rather than to the corporation. A more serious problem relates to the transfer of liabilities of the corporation. If this is done, neither the transferor stockholder nor the transferee corporation will be entitled to a deduction upon payment of the liabilities.

PLANNING

The timing of the incorporation can be very important, particularly from the standpoint of bunching of income. This can be a serious matter in incorporating a partnership that is on a fiscal year different from that of its partners. A transfer of all the partnership interests to a corporation or the liquidation of a partnership followed by a transfer of the assets to a corporation will be a termination of the partnership for tax purposes. Because a partner reports his partnership income in his tax-
able year within which the fiscal year of the partnership ends, such a termination may cause more than twelve months of partnership profits to be taxed in one year. This problem can be avoided if the incorporation takes place (1) at the end of the fiscal year of the partnership or (2) at a date that would cause the short year ending upon a date of termination to end within the taxable year of the partners following the year in which the last full year of the partnership income was reported. If a proprietorship or partnership is engaged in construction and is reporting income on the completed-contract method, there may be a bunching of income. The percentage of income earned on the contracts to the date of the transfer will be reportable by the transferors. A possible solution to this problem is not to transfer the uncompleted contracts to the corporation, but instead to retain them for completion by the proprietor or partnership. This may also delay the termination of the partnership. Care should be exercised, however, in deciding to retain these assets if there is a substantial potential investment credit recapture, since the transferor might not be considered to have transferred substantially all his assets in the exchange and might thereby subject himself to recapture provisions upon the transfer. A rather obvious timing consideration for the proprietor, before transferring the business to a corporation, is to determine how much of the income, if any, of the year of incorporation he wants to be taxable to him individually.

Selecting the fiscal year of the corporation is important. Consideration should be given to ending it when the corporation has earned its first $25,000 of income. To do this makes the first $50,000 earned by the corporation subject only to normal tax, which is at the rate of twenty-two per cent. We should also keep in mind the possibility that the corporation might elect Subchapter S treatment and should consider what effect the fiscal year of the corporation will have on the stockholders.

The corporation will be a new taxpayer and accordingly will be entitled to a number of elections, which include selecting (1) an over-all method of accounting—cash or accrual; (2) the method of reporting instalment sales; (3) the percentage-of-completion or completed-contract basis; (4) a policy of accounting for intangible development cost (whether to expense currently or to capitalize); (5) the treatment of bad-debts reserve or specific write-off; (6) the depreciation methods to be used; and (7) the basis of inventory pricing.

Section 1244 provides a special tax break for losses suffered with respect to the stock of a small-business corporation, as defined in section 1244(c)(2). Many corporations come under the definition. Any loss up to $25,000 on a separate return, or $50,000 on a joint return, will be allowed as a non-capital loss rather than as a capital loss. Strict compliance with the provisions of the Code are necessary for the stockholders to avail themselves of this benefit, however. Section 1244 stock is stock issued for money or other property (other than stock and securities) under a definite plan. The plan must be in writing; it must state in dollars the maximum amount that will be received for the stock; it must state the period during which the stock will be offered, which cannot be more than two years after the adoption of the plan, and the stock must be issued during that period. There is a special limitation on the amount of ordinary loss that would be allowed with respect to stock acquired in a section 351 exchange where the transferred assets have a fair market value less than their basis. In such a case, the loss, which would otherwise be ordinary, is reduced by the amount of the difference between the fair market value of the assets and their basis.

A newly formed corporation can elect to write off its organization expenses ratably over a period of not less than sixty months. Included in such expenses are legal and accounting fees, incorporation fees, expenses of organization meetings, etc. All expenses must have been incurred before the end of the first taxable year, and the election must be made in a timely filed return.

In most cases a minimum amount of cash should be transferred to the corporation. More cash can always be put in without any difficulty, but withdrawal normally has adverse tax consequences. Consideration should also be given to withholding certain assets, such as real estate, patents, copyrights, and the like, and leasing them to the corporation. This may prove beneficial in the future in at least two circumstances. First, the stockholder might have an opportunity to sell them at a gain that would not be subjected to double taxation, and, second, in the event the corporation were liquidated, the value of these assets would not be included in its assets in determining the stockholders' gain or loss upon the liquidation.

A recent Tax Court decision, Enola C. Hartley, may afford an op-

27 IRC Sec. 1244(d)(1)(A).
portunity for some cautious planning. In this case, the taxpayer, in one transaction, transferred all business assets, except accounts receivable, to a newly formed corporation in exchange for stock. In another transaction, she sold the accounts receivable to the corporation and took its short-term note for the face amount of the receivables. The Service, as might be expected, contended that both transactions were in substance parts of one transaction and that the short-term note therefore represented taxable boot. The Tax Court, in what to many might be a surprising decision, sustained the taxpayer in holding that the transactions were not related and that there was no tax resulting from either.

At the time of incorporating the going business, consideration should be given to the use of more than one corporation. Of course, to be assured of the tax benefits that might result from the use of multiple corporations, there would have to be good business reasons for doing so.

In connection with the incorporation of a cash-basis business, the liabilities normally should not be transferred to the corporation, since no deduction upon payment will be allowed to either the corporation or the stockholder. Sufficient accounts receivable could be withheld to provide funds for payment of them.

In some cases, it may be advantageous to make the incorporation, intentionally, a taxable event rather than tax-free under section 351. The result usually desired is to get a step-up in basis of depreciable assets at the expense of a capital gains tax to the incorporators. The introduction of depreciation recapture through sections 1245 and 1250, however, has reduced, if not eliminated, this potential benefit. Furthermore, it is not always easy to make the incorporation taxable. Failure to meet the eighty-per-cent-control test appears to be an easy thing to accomplish, but that is not always true. Where an obvious effort is being made to fail the eighty-percent test through a disposition of more than twenty per cent of the stock shortly after the incorporation, we might expect the service to attempt to show that in substance part of the assets were transferred before incorporation and that all assets were then exchanged for stock, thereby meeting the eighty-percent test. Of course, if more than twenty per cent of the stock is issued to someone as compensation rather than in exchange for property, it appears that the eighty-percent test will not have been met. The incorporation of a going
business can be made a taxable transaction, but to be so requires the same careful planning, as does a tax-free incorporation.

**SUMMARY**

We have been discussing a number of provisions relating to a single objective, the incorporation of a going business, which proved to be a rather broad subject. In conclusion, I should like again to emphasize the careful consideration that should be given to making the decision to incorporate and the planning that should be done to carry out that decision. Lack of careful planning may result in unnecessary tax liabilities.