Opportunities and Pitfalls Under Sections 351 and 721

Craig L. Rascoe
crascoe@williamsmullen.com

William M. Richardson
William & Mary Law School, wmrichardson@wm.edu

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Many practitioners think of Section 351,\(^1\) which applies to transfers of property to entities taxable as corporations, and Section 721, which applies to transfers of property to entities taxable as partnerships, as more or less identical provisions that produce substantially similar federal income tax consequences. This outline illustrates, primarily through a series of examples, that the two sections (coupled with ancillary provisions of the Internal Revenue Code) are actually quite different and often produce dissimilar tax consequences.

I. The Basics.

A. Contributions to Corporations.

1. Basic Statutory Scheme.

   a. Section 351: Non-recognition. No gain or loss is recognized by a transferor of “property” to a corporation solely in exchange for stock of the corporation, other than nonqualified preferred stock within the meaning of Section 351(g)(2), if, immediately after the transfer, the transferor and all other persons who transfer property to the corporation are in “control” of the corporation. Section 351(a). “Control” means the ownership of stock possessing at least 80% of the total voting power of all classes of voting stock and 80% of the number of shares of each class of nonvoting stock. Section 368(c): Rev. Rul. 59-259, 1959-2 C.B. 115. If Section 351(a) would apply but for the transferor’s receipt of consideration (including nonqualified preferred stock) other than qualified stock of the transferee corporation, the transferor recognizes any gain realized up to the fair market value of such other consideration (“boot”) but does not recognize any loss realized. Section 351(b). If a transferor transfers multiple properties and receives any boot in the transaction, the boot and the qualifying stock must be allocated pro-rata among the different

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\(^{1}\) Unless otherwise indicated, all references to Sections refer to Sections of the Internal Revenue Code of 1986 as amended
types of property transferred, and loss realized on the transfer of one property may not be offset against gain realized on the transfer of another property. Rev. Rul. 68-55, 1968-1 C.B. 140.

i. The stock counted for purposes of determining control includes nonqualified preferred stock, although it cannot be received without the recognition of gain. Nonqualified preferred stock generally is stock that is (A) limited and preferred as to dividends, (B) does not participate in corporate growth to any significant extent, and (C) either is putable to the issuer or a related person, must be purchased by the issuer or a related person, is callable by the issuer or a related person (and it is more likely than not on the issue date that the call will be exercised), or has a dividend rate that varies with reference to interest rates, commodity prices or similar indices. However, such a put, mandatory purchase obligation or call will not cause stock to be nonqualified preferred stock if the right or obligation may not be exercised within 20 years after the stock’s issue date or is subject to a contingency that makes the exercise a remote possibility. Section 351(g).

ii. For purposes of Section 351, “property” does not include services, debt of the transferee corporation not evidenced by a “security” (within the meaning of federal income tax law, not securities law), or interest on debt of the transferee corporation accrued during the transferor’s holding period for the debt. Section 351(d). Although the receipt of stock for services does not fall within Section 351’s non-recognition rule, a person who transfers property for stock as well as receiving stock for services is counted in the group of transferors for purposes of determining whether the transferor group owns stock constituting control of the transferee corporation. Treas. Reg. § 1.351-1(a)(2), Example (3).

iii. If a shareholder transfers property that has relatively small value compared to the value of the stock the shareholder already owns in the transferee corporation, that shareholder is not to be included in the group of transferors if the primary purpose of that shareholder’s transfer of property is to qualify exchanges of property by other persons for stock in the corporation under Section 351. Treas. Reg. § 1.351-1(a)(1)(ii). The IRS generally will not treat property as being of relatively small value compared to the value of the stock already owned if the fair market value of the property transferred is at least 10% of the fair market value of the stock already owned. Rev. Proc. 77-37, § 3.07, 1977-2 C.B. 568.
b. Section 357: Treatment of Transferred Liabilities. If the transferee corporation assumes a liability of the transferor, the assumption generally is not treated as boot. For this purpose, taking property subject to a liability generally is treated as an assumption of the liability. Section 357(a) & (d). If, however, the amount of liabilities assumed exceeds the transferor’s basis in the property transferred to the transferee corporation, the transferor generally must recognize gain equal to the excess of the liabilities assumed over the basis of the property. Section 357(c). For this purpose, the amount of liabilities assumed generally does not include a liability the payment of which would be deductible (for example, an account payable of a cash-basis taxpayer) or would be a distribution in liquidation of a partnership interest, unless the incurrence of a liability created or increased the basis of any property of the transferor. Section 357(c)(3). In addition, if the principal purpose of the transferor with respect to the assumption of any liability either was to avoid federal income tax on the transfer or was not a bona fide business purpose, then the total amount of the transferor’s liabilities assumed (not just the tainted liability) is treated as boot. Section 357(b); Treas. Reg. § 1.357-1(c).

c. Section 358: Transferor’s Basis in Stock Received. A transferor’s basis in stock of the transferee corporation received by the transferor in a Section 351 transaction generally is the same as the transferor’s basis in the property or properties transferred to the corporation, reduced by (i) the amount of money received as boot, (ii) the amount of liabilities assumed by the transferee corporation, excluding any liabilities not taken into account for purposes of applying Section 357(c), and (iii) the fair market value of any other boot received, and increased by the amount of any gain recognized by the transferor. Section 358(a)-(d). If after applying the preceding rules, the basis of the stock received exceeds its fair market value because, for example, the transferee corporation has assumed or otherwise has contingent liabilities not taken into account for federal income tax purposes, the basis of the stock received can be further reduced (but not below its fair market value) to take into account contingent liabilities of the transferor assumed in the transaction. This reduction, however, does not apply if the business (or substantially all the assets) with which the contingent liability is associated are transferred to the transferee corporation. Section 358(h).

d. Section 362: Corporation’s “Inside Basis”. The transferee corporation’s basis in the property transferred by the transferor in a Section 351 transaction generally is the same as the transferor’s basis, increased by the amount of any gain recognized by the transferor. Section 362(a). However, if the transferor recognizes gain as a result of the assumption of a liability, the transferee corporation’s increase to
the basis of the property to account for the gain recognized as a result of the liability assumption may not cause the corporation's basis to exceed the property's fair market value. Section 362(d). In addition, if the aggregate fair market value of the property transferred by a transferor in a Section 351 transaction is less than the aggregate basis of the property, the transferee corporation's basis in the transferred property is limited to the property's aggregate fair market value immediately after the transaction, unless both the transferor and the transferee corporation elect for the transferor's basis in the stock received in the transaction to be limited to its fair market value. Section 362(e)(2). This provision is intended to prevent the transferee corporation and the transferor from both obtaining a deduction for the same built-in loss upon subsequent dispositions of the property transferred and the stock received in the Section 351 transaction.

e. Section 1223: Holding Periods. A transferor's holding period for stock received in a Section 351 transaction (excluding nonqualified preferred stock) is the same as the transferor's holding period for the property exchanged for the stock, if the property was a capital asset or Section 1231 property (generally, real property and depreciable property used in a trade or business in the transferor's hands and held for more than one year). Section 1223(1). The holding period for stock received for property that is not a capital asset or Section 1231 property does not include the holding period of the transferred property. Consequently, where a transferor transfers some property that is a capital asset or Section 1231 property and other property that is not, the stock received will have a split holding period. Rev. Rul. 85-164, 1985-2 C.B. 117. The transferee corporation's holding period for property received in a Section 351 transaction includes the transferor's holding period for the property, because the corporation's basis in the property is determined by reference to the transferor's basis. Section 1223(2).

2. Other Issues.

a. Step Transactions. If a purported Section 351 transaction is one of a series of pre-planned or otherwise related transactions, application of the step-transaction doctrine could apply to prevent the transaction from qualifying under Section 351. The issue most often raised in step-transaction cases involving purported Section 351 transactions is whether the transferor(s) satisfied the "control immediately after" requirement if there is a subsequent disposition of stock by the transferor or issuance of stock by the transferee corporation. See, e.g., Rev. Rul. 2003-51, 2003-1 C.B. 938. Consideration of the step-transaction doctrine is beyond the scope of this outline.
b. Transfers to Investment Companies. Section 351 does not apply to a transfer of property to an “investment company” if the transfer results in diversification for the transferor. Section 351(e)(1); Treas. Reg. § 1.351-1(c). An investment company is a regulated investment company, a real estate investment trust, or a corporation more than 80% of the fair market value of the assets of which are held for investment and consist of money, stocks, and other financial-type assets described in Section 351(e)(1)(B). Consideration of investment companies under Section 351(e)(1) is beyond the scope of this outline.

c. Transfers to Foreign Corporations. Under Section 367(a), transfers of property by a United States person to a foreign corporation generally do not qualify for non-recognition of gain (rather than loss) under Section 351, except in the limited circumstances provided in Section 367(a)(2) and (3) and the regulations thereunder. Consideration of Section 367 is beyond the scope of this outline.

d. Recapture Provisions. Various provisions of the Internal Revenue Code require the recognition of gain notwithstanding any other provision of the Code. Such provisions often contain an exception for a transfer of property in a Section 351 transaction. Thus, for example, the depreciation recapture rules of Sections 1245 and 1250 do not require the recognition of gain notwithstanding Section 351. Section 1245(b)(3); Section 1250(d)(3). That is not the case, however, for the transfer of a debt instrument acquired at a market discount. Consequently, gain representing accrued (but previously unrecognized) market discount is to be recognized notwithstanding Section 351. Section 1276(d)(1)(C). One must always examine the tax attributes associated with property transferred in a Section 351 transaction to determine whether gain might be required to be recognized notwithstanding Section 351. Additional consideration of this subject is beyond the scope of this outline.

e. Shift of Built-in Gain or Loss. Corporations and their shareholders are separate taxpayers, and built-in gains and losses for property transferred in a Section 351 transaction cease to be recognizable by the transferor of the property. As a result, it is possible to shift the tax burden associated with built-in gain, and the tax benefit associated with built-in loss, to the transferee corporation, although the shifting of built-in losses has been restricted by Section 362(e)(2). Where the transferor corporation is a C corporation, the shift away from the transferor is complete, because the transferor's basis in the corporation's stock will not be adjusted to reflect any subsequent gain or loss recognized by the corporation (except in the context of members of a group of corporations filing a consolidated return). In the case of a transferee corporation that is an S corporation, there is a
shift away from the transferor to the extent of the stock ownership of other persons, since the corporation’s recognized gains and losses will be taxable to, and will result in adjustments to the stock basis of, all the shareholders for the year in which the gain or loss is recognized.

f. Potential Recognition of Same Economic Gain More Than Once. The built-in gain or loss in transferred property generally is reflected in the transferor’s basis in the stock received in the Section 351 transaction. Consequently, where the transferee corporation is a C corporation, it is possible for the same economic gain to be subject to tax twice, once upon disposition of the property transferred to the corporation and once upon the transferor’s disposition of the stock received in the Section 351 transaction. Through Section 362(e)(2), Congress has restricted the potential for recognizing the same economic loss twice. It has not seen fit to restrict the potential for the recognition of the same economic gain more than once.

g. Overlap with Section 304. Section 304 applies to certain transfers of stock of one corporation controlled by the transferor(s) to another corporation also controlled by the transferor(s) for any consideration other than stock of the acquiring corporation. For purposes of Section 304, control refers to 50% of the voting power of a corporation’s stock or 50% of the total value of a corporation’s stock, and certain constructive ownership rules apply. Section 304(c). The principal effect of the application of Section 304 is to convert what otherwise would have been a sale of stock, entitling the transferor to recover basis and/or recognize capital gain, into a dividend to the extent of the non-stock consideration received by the transferor. If a transfer of stock from one corporation to another corporation is described in both Section 304 and Section 351, Section 304 generally overrides Section 351. Moreover, for purposes of applying Section 304, the assumption of liabilities by the transferee corporation is treated as a payment of non-stock consideration, except for certain assumptions of liabilities incurred by the transferor to acquire the transferred stock. Section 304(b)(3).

h. Consolidated Returns. For corporations that are members of an affiliated group that files a consolidated federal income tax return under Section 1502, the consolidated return regulations modify various rules that otherwise apply to Section 351 transactions. Consideration of the effect of the consolidated return regulations is beyond the scope of this outline.

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B. Contributions to Partnerships.

1. Basic Statutory Scheme.

a. Section 721: Non-recognition. No gain or loss is recognized by a partnership or any of its partners as a result of a contribution of property to the partnership in exchange for an interest in the partnership. Section 721(a).

b. Section 722: Partner's Basis in Partnership Interest Received. A partner's basis in a partnership interest acquired by a contribution to the partnership is the amount of money and the partner's adjusted basis in any property contributed plus the amount of gain (if any) recognized by the contributing partners under Section 721(b). Section 722.

c. Section 723: Partnership's "Inside Basis." The partnership's basis in property contributed to the partnership in exchange for a partnership interest is the contributing partner's basis in the property at the time of the contribution increased by any gain recognized by the contributing partner under Section 721(b) from the contribution. Section 723.

d. Section 1223: Holding Periods. A transferor's holding period for a partnership interest received in a Section 721 transaction is the same as the transferor's holding period in the property exchanged for the partnership interest if the property exchanged was a capital asset or Section 1231 property. Section 1223(1). The holding period for a partnership interest received in exchange for an asset that was not a capital asset or Section 1231 property does not include the holding period of the asset transferred. Where the transferor transfers some property that is a capital asset or Section 1231 property and other property that is not, the partnership interest will have a split holding period. This holding period is split based on the fair market values of the assets transferred in exchange for the partnership interest. Treas. Reg. § 1.1223-3. The transferee partnership's holding period for property received in a Section 721 transaction includes the transferor's prior holding period for the property. Section 1223(2).

2. Other Issues.

a. Disguised Sales. Transactions between a partnership and a partner not acting in his capacity as a partner are not covered by Section 721. Section 707 and Treas. Reg. § 1.721-1(a). The contribution of an asset by a partner to a partnership followed by a distribution of cash to the contributing partner or the distribution of the contributed property to another partner may be treated as a sale of the asset or an interest in
the asset by the contributing partner to the partnership. Section 707(a)(2)(B).

b. Transfers of Liabilities. The transfer of liabilities or the transfer of assets subject to liabilities to a partnership in connection with a contribution of assets does not automatically result in income. The liabilities of a partnership are generally allocated among its partners, as provided in Section 752, and included in the partner's basis in his partnership interest. Therefore, the allocation of a portion of a contributed liability to another partner under Section 752 is treated as a cash distribution to the contributing partner which may result in gain. Transfers of liabilities incurred in anticipation of the transfer of the liability to a partnership (nonqualified liabilities) may also result in gain.

c. Transfers to Investment Companies. Section 721(a) does not apply to a transfer of property to a partnership which would be treated as an "investment company" (within the meaning of Section 351), if the partnership were incorporated. Section 721(b).

d. Contributions of Property With Built In Gain or Loss. If a partner contributes property to a partnership with a built in gain or loss at the time of the contribution, the built in gain or loss must be allocated to the contributing partner when the gain or loss is recognized by the partnership. Similarly, future depreciation and amortization deductions arising from contributed property with a built in gain or loss must be allocated among the partners taking the built in gain or loss into consideration. Section 704(c). The allocation of depreciation and amortization deductions under Section 704(c) is beyond the scope of this outline.

e. Character of Gain or Loss Recognized from Disposition of Contributed Property. The character of certain built in gains and losses may not be changed as a result of the contribution of the asset to a partnership. Any gain recognized by a partnership upon the disposition of unrealized receivables contributed to the partnership must be treated as ordinary income. Section 724(a). Any gain from the disposition of contributed inventory recognized within 5 years of the contribution of the property must be characterized as ordinary income. Section 724(b). Any loss recognized from the disposition of an asset contributed to a partnership within 5 years of the date of contribution that was a capital asset in the hands of the contributing partner must be characterized as a capital loss. Section 724(c).
f. Partnership Interests Received for Services. A capital interest in a partnership received for services is not covered by Section 721 and is a taxable event.

g. Recapture Provisions. As discussed in I.A.2.d, various provisions of the Code require the recognition of gain notwithstanding any other provision of the Code. The depreciation recapture rules of Sections 1245 and 1250 do not require the recognition of gain notwithstanding Section 721. Additional consideration of this subject is beyond the scope of this outline.

II. Formation Transactions.

A. Example 1. A and B are individuals who desire to form a new entity (“Newco”) to engage in business. A will contribute two assets: Property X, with a basis of $50 and fair market value (“FMV”) of $100, and Property Y, with a basis of $75 and FMV of $50, having a combined value of $150. B will contribute $150 in cash. A and B will each own a 50%, non-preferred, voting equity interest in Newco.

1. Tax consequences to A, B and Newco if Newco is a corporation.

a. Section 351 will apply to A, because both A and B will contribute property (the cash contributed by B is property for purposes of Section 351) to Newco solely in exchange for Newco stock, and they will own stock constituting control of Newco immediately after the transaction.

b. Having received no consideration other than Newco stock, A does not recognize any of his realized gain of $50 with respect to Property X or his realized loss of $25 with respect to Property Y. A’s basis in the Newco stock will be his aggregate basis of $125 in Properties X and Y, and his holding period for the Newco stock will include his holding period for those properties if they are capital assets or Section 1231 property.

c. Having contributed only cash to Newco, B did not realize any gain or loss. Consequently, B does not need to rely on Section 351 to prevent having a taxable event. Nevertheless, B is included in the transferor group for purposes of Section 351, thereby enabling A to take advantage of Section 351. B’s basis in his Newco stock is $150, and his holding period does not include his holding period for the cash contributed. While B does not have a taxable event, he may have a bad business deal. B has allowed A to shift a net gain of $25 ($50 of gain for Property X and $25 of loss for Property Y) to Newco. In effect, on an after-tax basis, Properties X and Y may be worth less
than their fair market value of $150, because of the embedded potential tax cost of the net unrealized gain.

d. Newco does not recognize any gain or loss on the acquisition of property (including cash) for its stock, not because of Section 351 but because of Section 1032. Because Section 351 applies, and because the aggregate basis of the properties transferred by A does not exceed the properties’ aggregate fair market value, Newco’s basis in the properties is the same as A’s basis, namely $50 for Property X and $75 for Property Y. Section 362(a). Newco’s holding period for each property includes A’s holding period for each property. Section 1223(2).

2. Tax consequences to A, B and Newco if Newco is taxable as a partnership.

a. Section 721 will apply to A and Newco because A will contribute property to Newco solely in exchange for a partnership interest in Newco. Section 721 does not require control of Newco by the contributing partners so the tax consequences to A are not dependent on B also contributing property to Newco for a partnership interest.

b. A does not recognize any of his $50 built in gain on Property X or his $25 built in loss on Property Y. A’s basis in his Newco partnership interest will be his aggregate basis of $125 in Property X and Y and his holding period will include his holding period for those properties if they were capital assets or Section 1231 property.

c. Section 721 also applies to Newco and no gain or loss is recognized by Newco on the receipt of Properties X and Y.

d. Having contributed only cash to Newco, B did not realize any gain or loss and does not need to rely on Section 721. B’s basis in his Newco partnership interest is $150 and his holding period does not include his holding period for the cash contributed.

e. Newco inherits A’s basis of $50 in Property X and his basis of $75 in Property Y. Section 723.

i. The built in loss on Property Y may only be taken into account for determining the amount of items allocated to A. Therefore, for the purpose of calculating items allocated to partners other than A, Newco’s basis in Property Y is $50, the FMV of Property Y on the date of contribution. Section 704(c)(1)(C).

ii. The built in gain of $50 on Property X and built in loss of $25 on Property Y must be allocated to A upon the sale of these
properties. Section 704(c). Therefore, B has not economically inherited any of the built in gain or loss on Properties X and Y as he would in a Section 351 transaction.

iii. If Property X or Property Y is depreciable property, Section 704(c) will require that depreciation deductions (and perhaps other items of ordinary income or deductions) be specially allocated by Newco between A and B to take into consideration the differences between the FMV on the date of the contribution of Properties X and Y and Newco’s inherited basis in the properties. The regulations under Section 704(c) are very flexible on how this may be accomplished.

B. Example 2. Same facts as in Example 1, except the FMV of Property X is $250 and A also transfers to Newco liabilities of $150.

1. Tax consequences to A, B and Newco if Newco is a corporation.

a. The assumed liabilities of $150 exceed A’s aggregate basis of $125 for Properties X and Y. Consequently, although Section 351 applies, A must recognize gain to the extent of the $25 excess of liabilities over basis. Section 357(c). A’s gain realized on the transfer of Property X is $200. Thus, he must recognize the entire $25 of “excess liabilities” as gain. The character of the gain will depend on the character of Property X in A’s hands. A’s basis in his Newco stock will be equal to his aggregate basis in Properties X and Y ($125), minus the amount of liabilities assumed ($150), and increased by the amount of gain recognized ($25), leaving a basis of zero for the stock. A’s holding period for the stock will be the same as it was in Example 1.

b. The tax consequences to B are the same as in Example 1. However, B’s economic deal may be even worse than in Example 1, because Newco has succeeded to a net unrealized gain of $150 (the $200 of gain for Property X, minus the $25 of gain recognized on the transfer of Property X, and minus the $25 of built-in loss for Property Y).

c. The consequences to Newco are the same as in Example 1, except that Newco’s basis in Property X is increased by the amount of A’s recognized gain of $25, resulting in a basis of $75 for Property X.

2. Tax consequences to A, B and Newco if Newco is taxable as a partnership.

a. The liabilities of a partnership are allocated among its partners as provided in the regulations under Section 752. Any increase in a partner’s share of liabilities is treated as a cash contribution by the partner to the partnership and any decrease in a partner’s share of
partnership liabilities is treated as a cash distribution from the partnership to the partner. Sections 752(a) and (b). The combination of Sections 722 and Section 752 results in a partner’s share of partnership liabilities being included in his basis in his partnership interest.

b. Assuming the $150 of liabilities transferred to Newco by A are nonrecourse to A or B they will be allocated 50% to A and 50% to B.

i. The transfer of the liabilities results in a reduction of $75 of A’s liabilities. This reduction is treated as a cash distribution to A of $75. Because the deemed distribution to A does not exceed his basis in his Newco partnership interest, no gain is recognized by A. A’s resulting basis in his partnership interest is $50 ($125 basis in Property A and Property B less the $75 distribution). Section 752(b) and Section 722. A’s holding period for the interest will be the same as in Example 1.

ii. B’s basis in his interest in Newco is $225 ($150 cash contribution plus $75 increase in his share of partnership liabilities). B’s holding period in for the interest will be the same as in Example 1.

c. If the liabilities transferred to Newco by A are “nonqualified liabilities,” the transfer of the liabilities to Newco will result in the transfer of Property X and Property Y to Newco being treated in part as a sale of an interest in Property A and Property B to Newco under Section 707. Treas. Reg. 1.707-5(a). In this case, A’s net reduction in liabilities of $75 will be treated as consideration received by A in exchange for a sale of a 25% interest ($75/$300 = 25%) in Property X and Property Y resulting in A recognizing 25% of the built in gain on Property X and 25% of the built in loss on Property Y (assuming A and B are not related and A does not otherwise constructively own any of B’s interest in Newco). A’s basis in the portion of his Newco interest received for the transfer of the nonqualified liabilities will be increased by the net gain recognized. A’s holding period for the portion of the interest in Newco received for the transfer of the nonqualified liabilities will not include his holding period in Properties X and Y. His holding period for the remaining Newco interest received will be the same as in Example 1.

i. Nonqualified liabilities are liabilities incurred in anticipation of a transfer to a partnership.

A. Liabilities incurred more than 2 years before the transfer and that encumbered the property throughout the 2 year period are qualified liabilities. Treas. Reg. § 1.707-6(i)(A).
Liabilities incurred within 2 years of a transfer to a partnership are presumed to have been incurred in anticipation of the transfer and are thus presumed to be nonqualified liabilities. Reg. § 1.707-7.

B. Liabilities incurred within 2 years but not incurred in anticipation of the transfer and that have encumbered the property since it was incurred are qualified liabilities. Treas. Reg. § 1.707-6(i)(B).

C. Liabilities allocated to capital expenditures related to the transferred property are qualified liabilities. Treas. Reg. § 1.707-6(i)(C).

D. Liabilities incurred in the ordinary course of the trade or business are qualified liabilities if all the material assets used in the trade or business are transferred to the partnership. Treas. Reg. § 1.707-6(i)(D).

ii. If A owns directly or indirectly more than 50% of the capital or profits interests in Newco, the loss on Property Y will be disallowed by Section 707(b).

d. If all liabilities transferred by A to Newco are qualified liabilities, Newco’s basis and holding period for Properties X and Y will be the same as in Example 1. If the liabilities are nonqualified liabilities, Newco’s basis in the portion of each asset treated as purchased by Newco will be increased or decreased by the gain or loss recognized by A with respect to such property and its holding period with respect to that portion of the asset will begin on the date of the contribution.

C. Example 3. Same facts as in Example 1, except C will receive a 25% interest in Newco in exchange for services to be provided to Newco.

1. Assume C’s 25% interest is the same type of ownership as the interests received by A and B.

a. Tax consequences to A, B, C and Newco if Newco is a corporation.

i. Because C does not transfer property to Newco, C’s 25% stock interest in Newco prevents the transferors of property (A and B) from owning stock constituting control of Newco (80%). As a result, Section 351 does not apply to the transaction.

ii. Because Section 351 does not apply, A must recognize his gain of $50 on the transfer of Property X. He also should be able to
recognize his loss of $25 on the transfer of Property Y, provided that A is not related to B or C and does not otherwise constructively own any of their Newco stock for purposes of applying Section 267(a)(1), which disallows losses from the sale or exchange of property between persons described in Section 267(b). Under Section 267(b) an individual and a corporation are related if the individual owns more than 50% in value of the corporation’s stock. A’s holding period for his Newco stock will not include his holding period for either Property X or Property Y, nor will his holding period for the Newco stock include his holding period for either property.

iii. Because the tax consequences to B are not dependent on the application of Section 351, the consequences to B are the same as in Example 1. However, B has an improved economic deal, because A has not shifted any tax burden to Newco.

iv. Having received Newco stock in exchange for services, C has compensation income equal to the fair market value of the Newco stock received. (This assumes that the stock is not subject to a risk of forfeiture for purposes of Section 83.) C’s basis in the Newco stock will also be its fair market value.

b. Tax consequences to A, B, C and Newco if Newco is taxable as a partnership.

i. Unlike Section 351, Section 721 does not require a transferor group that is in control of Company. Therefore, Section 721 still applies to the transfers of assets to Newco by A and B and their tax consequences are the same as in Example 1.

ii. The tax consequences of the receipt of an interest in Newco by C depends on whether the interest is a capital interest or a profits interest. Generally, a partner receiving an interest for services is treated as receiving a capital interest if the interest he receives entitles him to a share of the existing value of the partnership assets. Assuming the interest received by C is a capital interest the receipt of the interest will be treated as taxable compensation to C. Treas. Reg. §1.721-1(b)(1); Section 83. If the interest is not subject to a risk of forfeiture, the receipt of the capital interest will be immediately taxable.

iii. Newco will be entitled to a compensation deduction for the amount recognized as income by C. This deduction should be allocated between A and B according to their partnership interests to ensure
that A, B and C receive the anticipated business deal of awarding C a 25% capital interest.

2. Assume C's 25% interest has only 10% of the voting power.

a. Tax consequences to A, B, C and Newco if Newco is a corporation.

   i. Because the Newco stock issued to C represents not more than 20% of the voting power of all the Newco stock, the stock issued to A and B in exchange for property meets the control requirement of Section 351. Their stock, combined, possesses 90% of the voting power of the Newco stock, and there is no nonvoting Newco stock. Consequently, Section 351 applies to the transfer of property by A to Newco, and the tax consequences to A and B are the same as in Example 1.

   ii. The tax consequences to C are the same as in the preceding Example 3.1 (C has compensation income).

   iii. The consequences to Newco are the same as in Example 1, except for Newco's compensation deduction for the value of the stock issued to C.

b. Tax consequences to A, B, C and Newco if Newco is taxable as a partnership.

   i. Same as tax consequences in Example 3.1.

3. Assume C's 25% interest has no voting power.

a. Tax consequences to A, B, C and Newco if Newco is a corporation.

   i. Because C has received nonvoting stock and has not transferred property to Newco, A and B do not own stock constituting control of Newco. Control requires the ownership of 80% of each class of nonvoting stock, as well as 80% of the voting power of all voting stock. Consequently, Section 351 does not apply to A's transfer of property to Newco.

   ii. The tax consequences to the parties are the same as in Example 3.1, except that the fair market value of the nonvoting stock issued to C may be less than the voting stock issued to C in Example 3.1. If so, than the amount of his compensation income and the amount of Newco's compensation deduction would be less than in Example 3.1.
b. Tax consequences to A, B, C and Newco if Newco is taxable as a partnership.

i. Same as tax consequences in Example 3.1.

4. Assume C’s 25% interest is an interest only in future profits.

a. Tax consequences to A, B, C and Newco if Newco is a corporation.

i. Whether Section 351 will apply should depend on how C’s 25% interest in future profits is documented. If it is documented as a right to future bonuses or as “phantom stock,” it should not be considered stock for purposes of Section 351 or for purposes of Section 83. In contrast, if the profits interest is not documented as some form of compensation but instead as an equity interest in Newco, then the profits interest likely would be considered a class of nonvoting stock for purposes of Sections 351 and 83, thus preventing Section 351 from applying to A’s transfer of properties to Newco.

ii. If the profits interest is properly documented as a compensation arrangement, then Section 351 should apply to A’s transfer of properties to Newco, and the tax consequences to the parties should be the same as in Example 1. In addition, C should not have any compensation income and Newco should not have any compensation deduction until C actually or constructively receives payment from Newco of amounts based on the future profits. However, Newco and C must take care to make sure that the vesting and payment terms are structured in a way that does not result in deferred compensation to which Section 409A could apply. If the profits interest instead takes the form of an equity interest in Newco, Section 351 should not apply, and the tax consequences to the parties should be the same as in Example 3.1.

b. Tax consequences to A, B, C and Newco if Newco is taxable as a partnership.

i. Generally, the receipt of a pure profits interest is not a taxable event; however, what constitutes a profits interest is unclear. Under Rev. Proc. 93-27, 1993-2 CB 343, a profits interest is a partnership interest other than a capital interest. A capital interest is defined as an interest that would entitle the partner to a distribution if all the partnership’s assets were sold at FMV and the proceeds were distributed in liquidation of the partnership. Rev. Proc. 93-27 does not apply if (1) the service partner sells the
partnership interest within 2 years of receipt, (2) the interest relates to a substantially certain and predictable stream of income from partnership assets or (3) the interest is a limited partnership interest in a publicly traded partnership.

ii. In 2005, Proposed Regulations were issued which reject the theory that the receipt of a partnership interest for services is not a taxable event. Under the Proposed Regulations, a partner receiving a profits interest is excluded from taxation only if the partnership and all the partners elect a safe harbor under which the value of the partnership interest transferred is treated as being equal to the liquidation value of the interest. Notice 2005-43, 2005-1 CB 1221, was also issued which included a proposed revenue procedure that provides additional rules relating to the safe harbor in the Proposed Regulations.

5. Assume C receives only an option to purchase a 25% interest in Newco for an exercise price equal to the FMV of the interest on the date the option is received.

a. Tax consequences to A, B, C and Newco if Newco is a corporation.

i. C's option does not constitute Newco stock. Consequently, the existence of that option should not prevent Section 351 from applying to A's transfer of property to Newco unless the step-transaction doctrine could be applied to treat the issuance of stock to C upon exercise of the option as part of the same transaction as A's transfer of property to Newco. Although the IRS typically takes into account stock options in determining whether to issue a ruling that Section 351 will apply to a proposed transaction, see Rev. Proc. 83-59, § 4.05.5(g), 1983-2 C.B. 575, the step-transaction doctrine should not apply to an option with an exercise price equal to the fair market value of the stock on the date of grant. See American Bantam Car Company v. Commissioner, 11 T.C. 397 (1948), aff'd per curiam, 177 F.2d 513 (3d Cir. 1949), cert. denied, 339 U.S. 920 (1950).

ii. Because the option issued to C should not be considered stock, the consequences to the parties should be the same as in Example 1, except that C will have compensation income, and Newco a compensation deduction, if and when C exercises the option and the fair market value of the stock received is greater than the exercise price. Treas. Reg. § 1.83-7.

b. Tax consequences to A, B, C and Newco if Newco is taxable as a partnership.
i. The receipt of the option to acquire an interest in Newco is not a taxable event to C or Newco. Accordingly, the tax consequences should be the same as in Example 3.1 except C's income and Newco's deduction will arise when the option is exercised. The amount of the income and deduction will be the equal to the difference between the option price and the fair market value of the interest in Newco received at the time of the exercise of the option. Treas. Reg. § 1.83-7.

6. Assume the 25% equity interest received by C is not vested and will not vest for 3 years and then only if C is still employed by Newco.

a. Tax consequences to A, B, C and Newco if Newco is a corporation.

i. Whether Section 351 applies to A's transfer of property to Newco may depend on whether C makes an election under Section 83(b) to recognize income upon receipt of the Newco stock issued to C, rather than when the stock becomes vested, if it ever does. If C makes a Section 83(b) election, then the stock will be considered outstanding for federal income tax purposes, and consequently A and B together will not own stock constituting control of Newco for purposes of Section 351. If C does not make a Section 83(b) election, the Newco stock issued to C will not be considered outstanding for federal income tax purposes. A and B together would own all the "outstanding" stock of Newco, and thus control of Newco. Nevertheless, it is possible (perhaps likely) that the step-transaction doctrine could be applied to prevent A's transfer of property to Newco from qualifying under Section 351 if the stock issued to C vests.

ii. If C makes a Section 83(b) election, the tax consequences to the parties will be same as in Example 3.1. If C does not make a Section 83(b) election, the tax consequences to A, B and Newco are not clear. The consequences may be the same as in Example 1, but it is possible they still would be the same as in Example 3.1, except for the compensation income and deduction events for C and Newco upon the vesting of the stock.

b. Tax consequences to A, B, C and Newco if Newco is taxable as a partnership.

i. It has been unclear whether tax consequences of the receipt of an interest in a partnership by a service provider was determined by Treas. Reg. 1.721-1(b) or Section 83; however, under either authority, the amount and timing of income is the same. Accordingly, C's interest in Newco will be taxable to C when it
becomes fully vested. Treas. Reg. 1.721-1(b)(1); Treas. Reg. § 1.83-3(b). The amount of income will be the FMV of the interest at the time it vests. Newco may deduct the amount recognized as income by C at the time it is recognized.

ii. If the receipt of the interest is subject to Section 83, C may make a Section 83(b) election and recognize the income upon receipt of the Newco interest.


iv. If C makes a Section 83(b) election, the tax consequences to the parties should be same as in Example 3.1. If C does not make a Section 83(b) election, the tax consequences to the parties should be the same as in Example 1, except for the compensation income and deduction events for C and Newco upon the vesting of the interest.

III. Expansion Transactions.

A. Example 4. Same facts as Example 1, except it is 2 years later and D (an individual) is to transfer Property Z with a basis of $50 and FIVI of $100 to Company (formerly Newco) for a 20% non-preferred, voting equity interest in Company.

1. Tax consequences to A, B, D and Company if Company is a corporation.

   a. Because the stock received by D does not constitute control of Company, and because D is not a member of a larger transferor group that in the aggregate is in control of Company, Section 351 will not apply to D’s transfer of Property Z. As a result, D will recognize gain of $50 on the transfer of Property Z. D’s basis in the stock received in exchange will be its fair market value ($100), and D’s holding period for the stock will not include D’s holding period for Property Z.

   b. A and B do not experience any tax consequences as a result of D’s transfer of Property Z to Company. Company does not recognize any gain on the receipt of Property Z in exchange for stock in the corporation. Company’s basis in Property Z will be its fair market value, and Company’s holding period for Property Z will not include D’s holding period for Property Z.
2. Tax consequences to A, B, D and Company if Company is an LLC taxed as a partnership.

   a. Unlike Section 351, Section 721 does not require a transferor group that is in control of Company. Therefore, the transfer of Property Z by D to Company will qualify for non-recognition treatment under Section 721 and will not be taxable to D. D's basis in the interest received from the Company will be $50 (his basis in Property Z) and his holding period in the interest received will include his holding period for Property Z if Property Z was held by D as a capital asset or Section 1231 property. Section 722 and Section 1223(1).

   b. Company does not recognize any gain on the receipt of Property Z. Section 721. Its basis in Property Z will be $50 and its holding period includes D's holding period in Property Z. Section 723 and Section 1223(2). The built in gain of $50 on Property Z must be allocated to D upon the sale of Property Z by Company. Section 704(c).

   c. A and B do not recognize any gain or loss as a result of the transfer of Property Z to Company and their basis and holding periods are unaffected by the transfer. Because distributions by a partnership to its partners upon liquidation are generally based on capital accounts, the capital accounts of A and B must be revalued to reflect the current fair market value of Properties X and Y as permitted by Treas. Reg. § 1.704-1(b)(2)(iv)(f) to lock-in any current appreciation or depreciation in the values of Properties X and Y for their benefit. This revaluation of their capital accounts is not taxable to A or B and Company's tax basis in Properties X and Y is unchanged. When Property X or Property Y are sold by Company or the unrealized gain or loss at the time of the revaluation is otherwise realized, the gain or loss at the time of the revaluation must be allocated to A and B. Section 704(c).

B. Same facts as in Example 4, except D's basis in Property Z is $150 instead of $50.

1. Tax consequences to A, B, D and Company if Company is a corporation.

   a. The tax consequences are the same as in Example 4, except that D will recognize a loss of $50 on the transfer of Property Z, if D does not constructively own other stock of Company that would cause them to be related under Section 267(b).
2. Tax consequences to A, B, D and Company if Company is an LLC taxed as a partnership.

a. The tax consequences for A, B and D are the same as in Example 4 except D's basis in his interest in Company will be $150.

b. Company's basis in Property Z will be $150; however, the built-in loss of $50 may only be taken into account for determining the amount of items allocated to D. Therefore, for the purpose of calculating items allocated to partners other than D, Company's basis in Property Z is $100. Section 704(c)(1)(C). Otherwise, the tax consequences to Company are the same as in Example 4.

C. Same facts as in Example 4, except in the same transaction A and B transfer cash to Company in exchange for an additional 1% non-preferred, voting equity interest each. What if the additional equity interest to A and B is 5% each? What if only A transfers cash and receives a 10% non-preferred, voting equity interest?

1. Tax consequences to A, B, D and Company if Company is a corporation.

a. For each of A and B, a transfer of cash for an additional 1% equity interest should be considered of relatively small value compared to the value of their prior 50% interests. As a result, they should be disregarded as transferors, and Section 351 should not apply to D's transfer of Property Z. The tax consequences thus should be the same as in Example 4.

b. Because of the expanded value of Company, the value of a new 5% interest in Company should exceed 10% of the value of a 50% interest before the expansion. See Rev. Proc. 77-37, § 3.07, 1977-2 C. B. 568. Consequently, A and B should be considered transferors along with D, and the transferor group will have control of Company. Accordingly, Section 351 should apply to D's transfer of Property Z, D should not recognize the $50 of gain realized on the transfer of Property Z, and Company's basis in Property Z should be $50. Thus, the potential tax liability associated with the built-in gain of $50 would be transferred to Company.

c. If only A transfers cash to Company and receives an additional 10% equity interest, that additional interest clearly will be great enough that A will be treated as a transferor along with D. However, because A's prior 50% interest will be less than 50% after the expansion transaction, the total percentage of Company stock owned by A and D will be less than 80% (less than 50%, plus 10% plus 20%). Hence,
Section 351 will not apply to D’s transfer of Property Z, and the tax consequences will be the same as in Example 4.

2. Tax consequences to A, B, D and Company if Company is an LLC taxed as a partnership.

a. The tax consequences to A, B, D and Company are the same as in Example 4.

D. Same facts as Example 4, except D will become an employee of Company and he would receive a smaller equity interest if he were not to be an employee.

1. Tax consequences to A, B, D and Company if Company is a corporation.

a. The fact that part of the stock in Company received by D is compensation for services will not affect the potential applicability or inapplicability of Section 351, as described in III.A.1, III.B.1, and III.C.1. Because D does transfer property, all of the stock received by D is taken into account in determining whether the control requirement of Section 351 is satisfied. Treas. Reg. § 1.351-1(a)(2), Example (3).

b. However, D will have compensation income for the value of the portion of the stock received for services, and Company generally will have a corresponding compensation deduction.

2. Tax consequences to A, B, D and Company if Company is an LLC taxed as a partnership.

a. The receipt of a portion of the interest in Company for services also will not affect the potential applicability of Section 721 as described in III.A.2, III.B.2 and III.B.3. The portion of the interest received by D for services generally has the tax consequences described in Example 3.

IV. Business Combinations.

A. Example 5. Same facts as Example 1, except it is now 4 years later and A and B wish to combine Company with Target LLC, which is owned equally by individuals E and F. Target LLC is taxed as a partnership. It has high value, low basis assets and has negative capital of $100, which is reflected as negative capital accounts of $50 each of E and F. They are to own 40% (20% each) of the equity interest, which will be the same type of interest owned by A and B, in the combined entity.
1. Tax consequences if Company is a corporation and Target LLC merges into Company.
   a. Because only 40% of the stock of Company will be issued in exchange for property in the merger and the property's transferor does not own any additional Company stock, the merger cannot qualify as a Section 351 transaction. In addition, because an entity taxable as a partnership cannot be a party to a "reorganization" under Section 368, the merger cannot qualify as a tax-free reorganization. Section 368(b). As a result, it will be a taxable transaction to Target LLC and, therefore, to E and F.
   b. The taxable merger of a target entity into another entity is treated as a sale of assets by the target entity, followed by a liquidating distribution of the consideration for which its ownership interests are exchanged in the merger. See Rev. Rul. 69-6, 1969-1 C.B. 104. Here, Target LLC is to be treated as selling all its assets for consideration consisting of the assumption of its liabilities plus the fair market value of 40% of Company’s stock. Because its liabilities exceed the basis of its assets by $100, Target LLC will recognize gain of $100 plus the fair market value of the stock received. That gain will be taxable to E and F. They should not recognize any additional gain on the receipt of the liquidating distributions consisting solely of stock in the corporation. Section 731(a). Their basis in the stock received will be the same as their basis in their partnership interests (i.e., membership interests in Target LLC), which (after taking into account Target LLC’s gain recognized on the transfer of its assets in the merger) should equal the fair market value of the stock received, provided Target LLC’s inside basis for its assets is the same as their outside basis for their partnership interests before the merger. Target LLC will neither realize nor recognize any gain on the deemed liquidating distribution of the stock received in the merger. Section 731(b).
   c. Company is treated as purchasing the assets of Target LLC for consideration equal to the amount of Target LLC’s liabilities assumed plus the fair market value of the 40% stock interest issued in the merger. It will have a basis in those assets equal to their purchase price, and its holding period for the assets will not include Target LLC’s holding period for the assets.

2. Tax consequences if Company is an LLC taxed as a partnership and Target LLC merges into Company.
   a. The merger of Target LLC into Company is treated as a continuation of Company and a termination of Target LLC because A and B will
own more than 50% of the capital and profits of the continuing LLC. Section 708(b)(2)(A). As a result, the tax year of Target LLC will end on the date of the merger. Company will be the continuing entity and its tax identification number, tax year, elections and other tax attributes will apply to the surviving entity. Treas. Reg. § 1.708-1(c)(1).

b. Under Treas. Reg. § 1.708-1(c)(3)(i), the transaction will be treated as if Target LLC contributed its assets to Company under Section 721 and then distributed the interest in Company received to E and F in cancellation of their interests in Target LLC subject to Section 731. This treatment is referred to as an “assets-over” transaction.

c. The liabilities of Target LLC and Company will be reallocated among A, B, E and F as provided in Section 752. Any increase in a partner’s share of liabilities will be treated as a cash contribution by the partner to Company which will increase the partner’s basis in his partnership interest. Any reduction in a partner’s share of liabilities will be treated as a cash distribution to the partner decreasing his basis in his partnership interest. Accordingly, A and B’s basis in their partnership interests in Company after the merger will be the same as their basis prior to the merger increased or decreased by any cash deemed to have been contributed or distributed to them as a result of the reallocation of liabilities. Similarly, E and F’s basis in their interests in Company will be the same as their basis in Target LLC prior to the merger increased or decreased by any cash deemed to have been contributed or distributed to them. Section 752, Section 722 and Section 732(b). Because E and F have negative capital accounts in Target LLC, gain could result if the deemed cash distribution to them exceeds their basis in their interest in Target LLC.

d. E and F’s holding period in their interests in Company will include their holding period in their interests in Target LLC. Section 1223(1). A and B’s holding period in their interests in Company will not be affected by the merger.

e. Company will inherit Target LLC’s basis and holding period in the Target LLC assets. Section 723 and Section 1223(2).

f. The combination of two partnerships may be treated as if Target had distributed its assets to E and F and they had contributed the assets to Company (an “assets-up” transaction) but only if E and F are treated as owners of the assets under state law. Treas. Reg. § 1.708-1(c)(3)(ii). Assets-up treatment is generally not available in a traditional state law merger.
i. An assets-up transaction results in the surviving partnership's basis in the assets being equal to the partners' outside basis in their interest in the terminated partnership. This would be an advantage if the partners' outside basis was greater than the partnership's inside basis in the assets, perhaps because a partnership interest was purchased at a premium over book value and no Section 754 election was made.

B. Same facts as Example 5, except the combination is effected by forming a new subsidiary of Company with Company transferring its assets and liabilities to the subsidiary in exchange for a 60% interest in the subsidiary and Target LLC merging into the new subsidiary for 40% of the equity interest. All the equity interests in the subsidiary are of the same type.

1. Tax consequences if Company is a corporation and the new subsidiary is a corporation.

a. Company and Target LLC are both transferors of property to the new subsidiary corporation. Because they will own stock constituting control of the new corporation, Section 351 will apply to the transaction. Target LLC's deemed distribution of the 40% stock interest received to E and F will not cause the transaction to fail the "control immediately after" requirement. Rev. Rul. 84-111, 1984-2 C.B. 88.

b. Because Target LLC's liabilities assumed by the transferee corporation exceed the aggregate basis of the assets transferred by Target LLC, Target LLC (and thus E and F) will recognize gain to the extent of the excess of liabilities over basis. Section 357(c). No additional gain should be recognized by Target LLC or E and F on the deemed liquidating distribution of the stock received in the merger. Section 731.

c. Company will not recognize any gain or loss on the transfer of its assets and liabilities to the new subsidiary, provided that its liabilities transferred do not exceed the basis of its assets transferred. Section 351.

d. The new subsidiary will succeed to Company's basis in the assets transferred by Company, and its holding period for those assets will include Company's holding periods for the assets. In the case of the assets transferred by Target LLC, the basis of the assets will be increased by the amount of gain recognized by Target LLC. Section 362(a).
e. Because Company will own less than 80% of the stock of the new subsidiary, they will not be able to file a consolidated federal income tax return. Section 1504(a)(1) (requiring a parent corporation to own 80% of the voting power and 80% of the equity value of a subsidiary's stock, excluding certain preferred stock, for the two corporations to file a consolidated return). However, dividends from the new subsidiary to Company generally should qualify for an 80% dividends-received deduction, if Company is not an S corporation. Section 243(a) & (c). Hence, unless Company were an S corporation, the tax inefficiency of having a new, taxable corporation might be offset by the benefit to E and F of not having a fully taxable transfer of assets from Target LLC to the new subsidiary.

2. Tax consequences if Company is a corporation and the new subsidiary is an LLC taxed as a partnership.

a. Prior to the merger of the new subsidiary and Target LLC, the new subsidiary will be wholly owned by Company and, accordingly, will be disregarded for tax purposes. Treas. Reg. § 301.7701-3(b)(1)(ii). The merger of the Target LLC into the new subsidiary will result in the formation of a new partnership for tax purposes.

b. The tax consequences to E, F and Target LLC will be the same as in Example 5.

c. Company will be treated as contributing its assets to a new partnership in a Section 721 transaction. Company's basis in its interest in the new subsidiary will be equal to its aggregate basis in Property X, Property Y and any other assets transferred plus its share of any liabilities of the new subsidiary, including the former liabilities of Target LLC. Its holding period for its interest in the new subsidiary will include its holding period for Property X and Property Y, and any other assets transferred, if such assets are capital assets or Section 1231 property.

C. Same facts as Example 5, except the combination is effected by forming a new holding company ("Holdco") with A and B each transferring their equity interests in Company to Holdco for 30% equity interests in Holdco and E and F each transferring their interests in Target LLC for 20% equity interests in Holdco. All the equity interests in Holdco are of the same type.

1. Tax consequences if Company is a corporation and Holdco is a corporation.

a. For purposes of applying Section 351, A, B, E and F are a transferor group, and the group will own control of Holdco after the transaction. Accordingly, Section 351 will apply to each of A, B, E and F (as to A
and B, the transaction also may qualify as a reorganization under Section 368(a)(1)(B)).

b. Under Section 351(a), A and B will not recognize any gain or loss on the transfer of their Company stock to Holdco. However, because E and F will be relieved of the partnership liabilities allocated to them pursuant to Section 752 and the regulations thereunder, they will recognize gain equal to their negative capital accounts. Section 357(c); Rev. Rul. 80-323, 1980-2 C.B. 124.

c. Holdco will succeed to the basis of A and B in their Company stock. Section 362(a). Company’s basis in its assets will not be affected.

d. The transfer of all the membership interests in Target LLC to Holdco will result in a tax termination of the Target LLC partnership under Section 708(b)(1)(B). In addition, because Target LLC will have only one owner, it will become a disregarded entity treated as a division of Holdco, unless an election is made for it to be treated as a corporation after its acquisition by Holdco. Treas. Reg. § 301.7701-3(b). Holdco’s basis in the assets of Target LLC will be determined by reference to E’s and F’s bases in their partnership interests in Target LLC, increased by the gain they recognize on the transfer of their partnership interests to Holdco. See Rev. Rul. 84-111 (Situation 3); Section 362(a).

e. If Holdco is a C corporation, Holdco and Company will be eligible to file a consolidated return. If Holdco is an S corporation, it could elect for Company to become a qualified subchapter S subsidiary and, thus, be treated as a division of Holdco. However, that would cause the transfer of the Company stock by A and B to Holdco to be recharacterized as a transfer of assets by Company in exchange for Holdco stock and the assumption of liabilities, followed by a distribution of the Holdco stock to A and B. Rev. Rul. 76-123, 1976-1 C.B. 94; Treas. Reg. § 1.1361-4(a). While the overall transaction still would qualify under Section 351, that section would not prevent the recognition of gain by Company and A and B when the Holdco stock deemed received by Company is distributed to A and B. The recharacterized transaction, though, could qualify as a reorganization under Section 368(a)(1)(D), in which case the deemed liquidation would not result in the recognition of gain or loss.

2. Tax consequences if Company is a corporation and Holdco is an LLC taxed as a partnership.

a. Section 721 will apply to each of A, B and Holdco.
b. A and B will not recognize any gain or loss on the transfer of their Company stock to Holdco. Section 721(a).

c. Holdco will succeed to the basis of A and B in their Company stock. Section 723. Company’s basis in its assets will not be affected.

d. Target LLC will become a disregarded entity unless an election is made for it to be treated as a corporation after its acquisition by Holdco. Treas. Reg. § 301.7701-3(b).

e. The contribution of all of the interests in Target LLC to Holdco followed by liquidation of Target LLC for tax purposes results in the transfer of the Target LLC interests to Holdco being subject to the partnership merger rules under Section 708(b)(2)(A). Because E and F will not be treated as having received Target LLC’s assets and liabilities under state law, the transfer of the Target LLC interest must be treated as an assets-over transaction. Treas. Reg. 1.708-1(c)(5) Example (4). E and F will have the same tax consequences as in Example 5; however, because Company will remain a separate corporation, its liabilities will not be included in the liabilities of Holdco that are allocated among A, B, E and F as partners of Holdco. Accordingly, the reallocation of Target LLC’s liabilities will result in a deemed distribution to E and F which will most likely result in gain to E and F.

f. Holdco will inherit Target LLC’s basis in the Target LLC assets. Section 723.

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