

Chapter C:2

Corporate Formations and Capital Structure

Learning Objectives

After studying this chapter, the student should be able to:

1. Discuss the tax advantages and disadvantages of alternative business forms.
2. Apply the check-the-box regulations to partnerships, corporations, and trusts.
3. Recognize the legal requirements and tax considerations related to forming a corporation.
4. Discuss the requirements for deferring gain or loss upon incorporation.
5. Explain the tax implications of alternative capital structures.
6. Determine the tax consequences of worthless stock or debt obligations.
7. Identify tax planning opportunities in corporate formations.
8. Comply with procedural rules for corporate formations.

Areas of Greater Significance

It is important for the student to understand the tax consequences of forming a corporation, including the impact on both corporation and shareholder. The tax advantages and disadvantages of alternative forms of doing business should also be stressed.

Areas of Lesser Significance

In the interest of time, the instructor may determine that the following areas are best covered by student reading, rather than by class discussion:

1. Capital contributions.
2. Compliance and procedural considerations (Reporting requirements under Sec. 351).
3. Choice of capital structure.

Problem Areas for Students

The following areas may prove especially difficult for students:

1. Allocating basis in a partially tax-free incorporation.
2. Characterization of an instrument as debt or equity.
3. Understanding that the tax basis for property contributed to a corporation is different from the basis that is used for financial accounting purposes.

Highlights of Recent Tax Law Changes

The Tax Cuts and Jobs Act of 2017 has significantly changed tax rates. These changed rates alter many traditional decisions often made by individuals when selecting a business entity. Changes can make the C Corporation more useful compared to the S Corporation and increases the complexity of the decision-making process. The deduction for qualified business income, known as the Section 199A deduction, is a significant change that needs to be addressed as part of the decision-making process. With the current proposed tax law changes at the time of this edition's update, it is also good to suggest how proposed changes may impact decision making in the future.

Teaching Tips

1. Limited liability companies (LLCs) and limited liability partnerships (LLPs) have become more prevalent forms of doing business. Some discussion of LLCs and LLPs should take place here with particular emphasis on (1) the treatment of LLCs in the state where your school is located; and (2) the use of LLPs by the Big 4 accounting firms. More discussion on LLCs and LLPs takes place in Chapters C:9 and C:10.
2. Use Examples C:2-11 and C:2-12 to illustrate the rationale behind treating a Sec. 351 transaction as a nontaxable exchange. pp. C:2-12 and C:2-13. Some discussion might be incorporated about the fact that a corporate liquidation is not a tax-free transaction. As a result, it is inexpensive to create a corporation, but may be expensive to liquidate a corporation.
3. Table C:2-1 may be used as a format for presenting the tax consequences of a Sec. 351 transaction. p. C:2-11.
4. Use Example C:2-23 as an illustration of a prearranged disposition of stock that disqualifies a Sec. 351 transaction. p. C:2-16.
5. Tables C:2-2 and C:2-3 can be used as a format for presenting the advantages and disadvantages of issuing equity vs. debt. Point out that cash flow consideration may make equity more attractive than debt. pp. C:2-29 and C:2-30.

Lecture Outline

I. Organization Forms Available.

Businesses can be conducted in one of several forms. A brief summary of these forms will provide the students with an overview of some of the factors that enter into the business form decision.

- A. **Sole Proprietorships.** A sole proprietorship is a business owned by one individual and often is selected by individuals who are beginning a new business. The income and expenses are reported on a Schedule C of Form 1040 since a sole proprietorship is not a separate tax entity. All of the business assets are owned by the proprietor. Examples C:2-1 and C:2-2 illustrate the effect this will have on the amount of tax that will be paid on business income. A completed Schedule C and the related facts are included in Appendix B. These facts are used (with minor modifications) to illustrate the similarities and differences in the tax reporting process for a sole proprietorship, C corporation, partnership, and S corporation.

1. **Tax Advantages.** The tax advantages of doing business as a sole proprietorship are listed beginning on p. C:2-3.

Profits may qualify for the 20% qualified business income deduction (Section 199A Deduction), which is the most significant change under the TCJA of 2017 to be emphasized. This deduction is allowed through the 2026 tax year.

2. **Tax Disadvantages.** The tax disadvantages of operating as a sole proprietorship are listed beginning on p. C:2-3.

- B. **Partnerships.** A partnership is an unincorporated business carried on by two or more individuals or other entities. A partnership is a tax reporting, non-taxpaying entity, which acts as a conduit. All items of income, expense, gain, loss, and credit flow through to the partners' tax returns. A partnership must file a Form 1065 annually. Each partner receives a Schedule K-1 (Form 1065), which provides the information that must be reported on the partner's tax return. Examples C:2-3 and C:2-4, p. C:2-4, illustrate the effect of partnership income and loss on an individual partner's tax liability. Only those partnerships maintaining a fiscal year under the Sec. 444 reporting period rules must make tax payments based on the amount of income deferral. A completed Form 1065 and the related facts are included in Appendix B.

A partnership can be either a general partnership or a limited partnership. In a general partnership, each partner has unlimited liability for partnership debts. In a limited partnership, at least one partner must be a general partner, and at least one partner must be a limited partner. Limited partners are liable only to the extent of their investment plus any amount that they commit to contribute to the partnership if called upon.

1. **Tax Advantages.** A partnership is exempt from taxation. Marginal tax rates of the individual partners may be lower than the marginal corporate tax rate on the same income historically, but this may not be the case as of the TCJA of 2017 to present day. p. C:2-4.

Pass through income may qualify for 20% of qualified business income deductions.

No double taxation is inherent in the use of the partnership form. Profits are taxed only when earned. Generally, additional taxes are not imposed on withdrawals.

Losses generally can be used to offset income from other sources. A positive basis adjustment is made when income is earned by the partnership and taxed to the partners. This reduces the gain recognized when a sale or exchange of the partnership interest occurs. No such basis adjustment occurs with a C corporation.

2. **Tax Disadvantages.** All profits are taxed when earned even though reinvested in the business. Marginal tax rates of the partners may be greater than the applicable marginal tax rate if the income is taxed to a corporation. Additional disadvantages can be found on p. C:2-4.

A partner is not an employee. Employment taxes must be paid on a partner's self-employment income from the partnership.

Some tax-exempt fringe benefits are not available to partners.

The partnership's taxable year generally must conform to that of its partners or be a calendar year unless a special election is made to use a fiscal year. pp. C:2-4 and C:2-5.

- C. **C Corporations.** A C corporation is a separate entity that for tax years beginning after December 31, 2017 is taxed at 21% on taxable income. A C corporation must report all its income and expenses and compute its tax liability on Form 1120 (U.S. Corporation Income tax Return). A completed Form 1120 appears in Appendix B. Shareholders are not taxed on the corporation's earnings unless these earnings are distributed as dividends, and qualified dividends are taxed at the shareholder's tax rate for long-term capital gains at a rate that depends on the individual's tax status and level of taxable income. In addition, an incremental 3.8% tax rate applies to net investment income for taxpayers whose modified AGI exceeds \$200,000 (\$250,000 for married filing jointly). Net investment income includes, among other things, interest, dividends, annuities, royalties, rents, and net gains from the disposition of property not used in trade or business, all reduced by deductions allocable to such income or gains. In contrast, a C Corporation's capital gains are taxed at the same 21% tax rate as its other income.

1. **Tax Advantages.** Shareholders employed by the corporation are treated as employees for fringe benefit purposes. As employees they are eligible to receive deductible salary payments. This allows them to adjust their compensation (within limits) to cause the income to be taxed partly on the corporate return and partly on the shareholders' returns, to minimize their overall tax liability.

A C corporation is allowed to utilize a fiscal year. There are restrictions on using a fiscal year that apply to personal service corporations unless a special election is made under Sec. 444 by the corporation. p. C:2-6.

2. **Tax Disadvantages.** Double taxation occurs when dividends are paid or the corporation's stock is sold or exchanged.

Shareholders can generally not withdraw money from the corporation without tax consequences. Distributions are taxable as dividends to the extent of earnings and profits.

Net operating losses have limited benefit to shareholders. They can be carried back (only if incurred before 2021) or carried over to offset income in future years. This can be a significant disadvantage for start-up companies that may have to wait several years before they can recognize benefit from a loss, and make other business entities much more attractive.

Capital losses provide no benefit in the year that they are incurred. They can only be used to offset capital gains. p. C:2-6.

- D. **S Corporations.** S corporations are corporations that elect to be taxed as a partnership. Generally, no tax is paid by the corporation. Instead, all items of income, deduction, gain, loss, and credit flow through to the individual shareholders. Corporate rules apply unless overridden by the Subchapter S provisions. A completed Form 1120S (U.S. Income Tax Return for an S Corporation) is included in Appendix B.

1. **Tax Advantages.** S corporations are generally exempt from taxation. The shareholders pay tax at their marginal tax rates, which are generally lower than the C corporation's marginal tax rate. See the **Tax Strategy Tip** on p. C:2-7.

Pass through income may qualify for the 20% qualified business income deduction. It is important to note that there are many limitations to this deduction.

Losses pass through to shareholders and generally can be used to offset income earned from other sources. Passive loss rules may limit loss deductions to shareholders. (See Chapter C:11.)

Capital gains are taxed to individual shareholders as though they were earned by the individual. An individual may be able to offset these gains with capital losses from other sources or have them taxed at their own capital gains rates.

Capital losses flow through separately to the shareholders and can be used to offset other capital gains and to a limited extent ordinary income. Shareholders can contribute or withdraw money from the S corporation without adverse tax consequence. Profits are taxed as earned. The earnings are generally not taxed a second time when distributed as dividends.

A positive basis adjustment is made when income is earned by the S corporation and taxed to the shareholders. This reduces the gain recognized when a sale or exchange of the S corporation stock occurs. No such basis adjustment occurs with a C corporation.

2. **Tax Disadvantages.** All the corporation's profits are taxed when earned, whether distributed or not. Distributions generally are made to at least cover the taxes paid by the shareholders on their share of the corporation's earnings.

If the shareholders' marginal tax rates exceed those for a C corporation, the capital that remains for reinvestment may be reduced.

Tax-free fringe benefits are generally not available to shareholders. When provided, they are deductible by the corporation and taxable to the shareholder as compensation. Shareholders are treated as employees for purposes of social security taxes.

An S corporation generally must select a calendar year as its tax year unless a special election is made under Sec. 444 to use a fiscal year.

- E. **Limited Liability Company.** A limited liability company (LLC) combines the best features of a partnership and corporation even though it is neither. It is taxed like a partnership while providing the limited liability of a corporation, but also provides the option to be taxed as a corporation.
- F. **Limited Liability Partnership.** Many states also have statutes that allow a business to operate as a limited liability partnership (LLP). This partnership form is particularly attractive to professional service partnerships, such as public accounting firms. Under state LLP laws, partners are liable for their own acts and

the acts of individuals under their direction. LLP partners are not liable for the negligence or misconduct of other partners. p. C:2-8.

- G. A side-by-side comparison of the tax and nontax attributes of C corporations, partnerships, and S corporations is presented in Appendix F. It might be helpful to periodically refer to this comparison throughout Chapters C:2 through C:11.

II. Check-the-Box Regulations.

Unincorporated businesses are able to choose whether to be taxed as a partnership or corporation. The rules are commonly referred to as “check-the-box” regulations. Treasury Regulations provide that an unincorporated business with two or more owners is taxed as a partnership unless it elects to be taxed as a corporation. An unincorporated business with one owner may elect to be taxed as a corporation or be disregarded as a separate entity and be taxed directly to the owner on a Schedule C. This election is not available to corporations, trusts, or certain special entities such as Real Estate Investment Trusts, Real Estate Mortgage Investment Conduits, or Publicly Traded Partnerships.

An eligible entity may affirmatively elect its classification on Form 8832 [Entity Classification Election]. Examples C:2-8 and C:2-9, p. C:2-8, illustrate the default rules. If an entity makes an election to change its classification, it cannot again change its classification by election during the 60 months following the effective date of the election. There are tax consequences to the changing of classifications. When applying check-the-box regulations, taxpayers must also check whether or not their state will treat an entity in a consistent manner for state tax purposes. p. C:2-8.

III. Legal Requirements and Tax Considerations Related to Forming a Corporation.

The legal requirements for forming a corporation depend on the laws of the state in which the corporation is incorporated. These laws provide for legal capital minimums, incorporation fee, franchise tax, and corporate tax rules. Most corporations are incorporated in the state in which they commence business. Articles of incorporation must be filed. A fee is charged for incorporation and an annual franchise tax is collected. It is important to note that these fees and taxes can be substantial, and should be a consideration prior to formation.

IV. Tax Considerations in Forming a Corporation.

Property, money, or services are transferred to the corporation in exchange for a debt or equity interest. Tax consequences may occur for both the shareholder, debtholder, and the corporation. Example C:2-10 on p. C:2-10 illustrates these tax consequences for the corporation and its shareholders.

At this point you may wish to use Table C:2-1, Overview of Corporate Formation Rules. This summary is found on p. C:2-11 of the text and is a good tool to be used to explain each of the parts of the incorporation transaction. Book-tax accounting issues are discussed later in this chapter.

V. Section 351: Deferring Gain or Loss upon Incorporation.

No gain or loss is recognized when property is transferred to a corporation solely in exchange for stock provided that immediately after the exchange, the transferors are in control. Recognition of gain or loss is deferred through adjustment of the shareholder's basis in the stock. (See Example C:2-11 on p. C:2-12.) The requirements for nonrecognition treatment are discussed below.

- A. **The Property Requirement.** Property must be transferred to the corporation in an exchange transaction. Property includes money, and almost any other kind of property including installment obligations, accounts receivable, inventory, equipment, patents, and other intangibles representing “know-how,” trademarks, trade names, and computer software.

Excluded from the property definition are services received in exchange for stock in a corporation, indebtedness of the transferee corporation that is not evidenced by a security, and interest on an indebtedness of the transferee corporation that accrued on or after the beginning of the transferor's holding period for the debt.

- B. **The Control Requirement.** The transferors as a group must be in control immediately after the exchange. Control is ownership of at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock. Only stock received for property is counted when determining if control has been received. Stock received for services does not count for purposes of determining control unless property is also contributed.

A transfer of property to an existing corporation will be tax-free only if an 80% interest in the corporation is acquired, or existing shareholders also transfer enough additional property to the corporation to permit the 80% requirement to be satisfied by the transferors as a group.

Transferors must be in control of the corporation immediately after the exchange. The exchanges do not need to be simultaneous, but must be agreed to beforehand and executed in an expeditious and orderly manner.

- C. **The Stock Requirement.** No gain or loss is recognized by transferors who exchange property solely for transferee corporation qualifying stock. Voting or nonvoting stock may be received by the transferors. Nonqualified preferred stock is preferred stock that has one of the following characteristics: 1. The shareholder can require the corporation to redeem the stock. 2. The corporation is required to redeem the stock. 3. The corporation has the right to redeem the stock, and is more likely than not to do so, or 4. The dividend rate on the stock varies in relation to interest rates or other such indices. However, nonqualified preferred stock is treated

as boot. Stock rights or stock warrants are not considered stock for purposes of Sec. 351. p. C:2-16.

At this point, you may wish to review with the students by referencing Topic Review C:2-1, which provides a concise overview of the requirements of Sec. 351. This review is found on p. C:2-17 in the text.

- D. **Effect of Sec. 351 on the Transferors.** If all the requirements of Sec. 351 are met, the transferors do not recognize any gain or loss on contribution of their property to the corporation. The receipt of property other than stock does not completely disqualify the transaction from coming under Sec. 351. However, the receipt of property other than stock may cause the exchange to be partly taxable.

Property other than stock that is received is considered **boot**. Gain is recognized to the extent of the lesser of (1) the transferor's realized gain or (2) the amount of money plus FMV of the nonmoney boot property received. A loss is never recognized. The character of the gain depends upon the type of the property transferred. (See Example C:2-24.) Where several properties are transferred, a "separate properties approach" is used. (See Example C:2-25.)

- E. **Basis of Stock Received.** The basis of the stock received in a Sec. 351 exchange is the adjusted basis of the property transferred plus any gain recognized by the transferor minus (1) any money received (including liabilities transferred to the corporation that are treated like money) and (2) the FMV of any nonmoney boot property that is received. (See Example C:2-26.)

- F. **Tax Consequences to Transferee Corporation.** The transferee corporation needs to determine the amount of gain or loss (if any) it must recognize and the basis of property or services acquired. No gain or loss is recognized by a transferee corporation exchanging stock or debt instruments for property. A transferee corporation must **recognize** gain (but not loss) if it transfers appreciated property to a transferor as part of a Sec. 351 exchange. (See Examples C:2-29 and C:2-30.)

If the transaction is taxable to the transferor, the basis of the property acquired is its acquisition cost.

Topic Review C:2-2 presents a summary of the tax consequences of a tax-free asset transfer to the transferor and the transferee corporation and may be referred to at this point to summarize the more important material relating to partially tax-free in corporations. This review is presented on p. C:2-20.

- G. **Assumption of the Transferor's Liabilities.** The assumption of liabilities does not cause the transferor to recognize part or all of his realized gain unless (1) the transfer is made for a tax avoidance purpose or there is no bona fide business purpose for the acquisition and/or assumption of the debt, or (2) the liabilities assumed are in excess of the basis of the properties transferred.

The most important factor in determining whether a tax avoidance purpose is present is the length of time between the incurrence of the liability and the transfer of the liability to the corporation. Liabilities are considered to have a business purpose if the liabilities are incurred in the normal course of business or in the course of acquiring business property. If no business purpose is found, all of the liabilities assumed or acquired are considered boot.

If the total amount of liabilities transferred to a controlled corporation by a transferor exceeds the total adjusted basis of all properties transferred by the transferor, the excess liability is a gain that is taxable to the transferor. (See Example C:2-37.)

The term liabilities for a cash or hybrid method of accounting transferor does not include (1) any amount that would give rise to a deduction when paid or (2) any amount that is payable to a retired partner or to liquidate a deceased partner's interest. (See Example C:2-38.)

Topic Review C:2-3 presents a summary of the liability assumption and acquisition rules of Sec. 357 and may now be used to review this material with the students. This review is presented on p. C:2-25.

H. **Other Considerations in a Sec. 351 Exchange.**

1. **Recapture of Depreciation.** If a Sec. 351 exchange is nontaxable, no depreciation recapture is required. The transferor's recapture potential is transferred to the transferee corporation. (See Example C:2-39.)
2. **Computing Depreciation.** When a shareholder transfers depreciable property to a corporation in a Sec. 351 transaction, the corporation must continue to use the same depreciation method and recovery period with respect to the shareholder's basis in the property. An allocation of the depreciation for the year that includes the transfer date must be made between the transferor and transferee. If a basis adjustment occurs because the transferor recognizes a gain, a second depreciable asset is created which is generally depreciated as a new asset under the MACRS rules. (See Example C:2-40.)
3. **Assignment of Income Doctrine.** This doctrine is a judicial requirement that income be taxed to the person who earns it. This doctrine does not apply to a Sec. 351 exchange if the transferor transfers substantially all the business assets and liabilities to the corporation and a business purpose exists for the transfer. Accounts receivable take a zero basis in the corporation's hands and are included in income when collected. (See Example C:2-42.)

VI. Choice of Capital Structure.

A. **Characterization of Obligations as Debt or Equity Capital.** The tax laws provide an incentive for closely held corporations to maximize the amount of allowable interest deductions. Where debt financing resembles equity obligations, the form of the transaction will be ignored and debt will be reclassified as common or preferred stock. No single factor is controlling in determining when reclassification will occur. A corporation generally can deduct its interest expense but cannot deduct dividends it pays, which creates an incentive to use more debt and less equity in its capital structure.

B. Debt Capital.

1. **Issuance of Debt.** C Corporations with average gross receipts for the previous three years exceeding \$30 million (in 2024) are limited in the interest deduction to the sum of (1) businesses interest income; (2) 30% of adjusted taxable income; and (3) floor plan financing interest for corporate tax payers who sell motor vehicles. Interest expense greater than the sum of these three items carries over to the next tax year, subject to the limitation in that year. The carry over period is indefinite. To arrive at adjustable taxable income, a C Corporation calculates taxable income without regard to (1) any item of income, gain, deduction, or loss not properly allocable to a trade or business; (2) any business interest or business interest income; (3) any net operating loss deduction; and (4) any deduction allowable for depreciation, amortization, or depletion taken in years before 2023. C Corporations with average gross receipts of \$29 million or less are not limited in their business interest deduction. In contrast to business interest expenses, the corporation cannot deduct dividends paid on equity security.
2. **When Interest Is Paid.** Interest paid on debt is deductible by the payor. Dividends paid on stock are not deductible by the corporation. Noncorporate investors who borrow funds in order to make an investment in a C corporation will find that the interest expense incurred to carry such an investment is generally subject to the investment interest limitation; unless the investment is a passive activity and the interest expense comes under the passive activity limitation rules.
3. **When an Indebtedness Is Satisfied.** Repayment of an indebtedness is not considered an exchange transaction. An obligation that is repaid by a corporation does not result in a gain or loss being recognized by the creditor. The satisfaction of a debt instrument (e.g., note, bond, or a debenture) is an exchange for the holder of a debt instrument and gain or loss will be recognized if the amount received is different from the asset's basis.

Table C:2-2 presents the tax advantages and disadvantages of using debt in the capital structure. This table may be found on p. C:2-29. You may want

to discuss the case presented in the box on p. C:2-31 concerning extremely long-term debt issued to raise capital by a corporation.

- C. **Equity Capital.** The reasons for use of multiple classes of stock are found on p. C:2-29. Because of the many different types of equity issues that are possible, all tax and nontax advantages of each type cannot be listed. Table C:2-3, Tax Advantages and Disadvantages of Using Stock in the Capital Structure, is found on p. C:2-30.

D. **Capital Contributions by Shareholders.** A corporation does not recognize any income when it receives money or property as a capital contribution from a shareholder. If additional contributions are made without additional stock being issued, the payments are regarded as an additional price paid for the existing stock. (See Example C:2-44.)

E. **Capital Contributions by Nonshareholders.** If the nonshareholder making such a contribution is a customer, potential customer, governmental entity, or civic group, the contributed property's FMV generally is gross income for the corporation (i.e., it is taxable). Capital contributions made by other nonshareholders are excluded from the corporation's gross income (i.e., it is nontaxable). The corporation's basis for property received as a nonshareholder capital contribution is zero. This precludes the corporation from deducting depreciation or other capital recovery amounts for the property.

VII. Worthlessness of Stock or Debt Obligations.

- A. **Securities.** A debt or equity investment that is evidenced by a security and that becomes worthless results in a capital loss for the investor on the last day of the tax year in which the worthlessness occurs.

Ordinary loss can be reported in some situations. An example of this would be securities that are held by dealers as inventory. A domestic corporation is also permitted to claim an ordinary loss in connection with the worthlessness of a security of an affiliated corporation.

The Sec. 1244 rules permit an ordinary loss to be claimed for qualifying stock issued by a small business corporation that is sold, exchanged, or becomes worthless. Ordinary loss treatment is only allowed an individual who was originally issued the stock, or by a partner in a partnership that was originally issued the stock, and whose distributive share includes the losses for the corporate stock. If a shareholder contributes additional money or property to a corporation after acquiring Sec. 1244 stock, the amount of ordinary loss recognized upon the sale, exchange, or worthlessness of the Sec. 1244 stock is limited to the shareholder's capital contribution at the time the shares were issued. The ordinary loss is limited to \$50,000 (or \$100,000 if the taxpayer is married and files jointly). Losses in excess of the dollar ceiling are capital losses.

- B. **Unsecured Debt Obligations.** Shareholders may make loans to corporations. The type of loss that can be claimed on these advances depends on the nature of the loan. If the advance is treated as paid-in capital, the amount of the loan increases the worthless securities loss on the stock.

A loan made to a corporation that is not evidenced by a security can be deducted under either the business or nonbusiness bad debt rules. Most unsecured advances are considered to be made outside the shareholder's trade or business. If a noncorporate shareholder makes the loan, it will generally be considered a nonbusiness bad debt that is a short-term capital loss.

VIII. Tax Planning Considerations.

Sec. 351 treatment is mandatory, not elective, if the provisions are met. In some cases shareholders may wish to recognize gains or losses. In order to accomplish this, one of the provisions necessary for the application of Sec. 351 must be violated. (See Example C:2-50.)

IX. Compliance and Procedural Requirements.

Every person who receives stock, securities, or other property in an exchange qualifying under Sec. 351 must attach a statement to his tax return for the period that includes the date of the exchange. A list of the required information for the transferor is found on p. C:2-36. The transferee corporation must attach a statement to its tax return for the year in which the exchange takes place. A list of the transferee corporation's required information is found on p. C:2-36.

Court Case Briefs

Charles E. Wolfe v. U.S., 612 F. Supp 605 (DC Mont, 1985) aff'd. 798 F.2d 1241 (9th Cir., 1986).

The taxpayer, Charles E. Wolfe, was the sole shareholder and president of Wolfe & Company, a corporation which leased tractor-trailers. Mr. Wolfe also operated an “over-the-road” trucking business as a sole proprietorship. The corporation incurred a large federal tax bill which was paid by Mr. Wolfe personally when the corporation was unable to pay. Mr. Wolfe contended that he should not be held personally liable for the tax liability of the corporation.

The main issue was whether the corporation was the alter ego of Mr. Wolfe. If so, then the Internal Revenue Service could “pierce the corporate veil” and look to Mr. Wolfe’s personal assets for satisfaction of the corporate tax liability. The court considered eleven factors, including level of ownership and control of the corporation, commingling of personal and corporate funds, common books and records, distribution of earnings and profits, and representation of corporate-personal relationship. In this case, the facts represented a classic case of a shareholder so dominating corporate affairs such that the corporation and the shareholder did not appear to have separate identities.

Therefore, the Service could pierce the corporate veil and look to the personal assets of the sole shareholder for payment of the taxes. Further, neither economic difficulties nor employee’s illness constituted reasonable cause for failure to file or pay tax.

American Bantam Car Company v. CIR, 11 T.C. 397 (1948), aff’d. per curiam 177 F.2d 513 (3rd Cir., 1949).

This is a leading case in the determination of whether a transfer to a corporation is a tax-free transfer to a controlled corporation under the Code Sec. 351. This case is based on Section 112(b)(5) of the Revenue Act of 1936, the precursor of Code Sec. 351.

In this case, property was transferred to the newly formed American Bantam Car Company in exchange for stock of the corporation by three individuals, who immediately after the transfer owned greater than an 80% interest in the corporation. Subsequent to this transfer, the corporation entered into agreements with underwriters for the public offering of stock of the corporation, which if such offering had resulted in sufficient sales, would have reduced the interests of these three initial shareholders, based on the voting rights endowed upon the stock in the articles of incorporation.

The issue before the court was whether these transactions were all part of an integrated plan, thereby eliminating tax-free exchange treatment under Section 112(b)(5) or whether they were actually separate transactions. The court looked at four factors in making their decision: 1) intent of the parties, 2) mutual interdependence of steps, 3) time element, and 4) ultimate result. There is a detailed analysis of each factor and a summary of prior court cases in this case. The court held that the transactions were indeed separate and that the transfer of assets to the corporation should be treated as a tax-free exchange. Therefore, the basis of the assets for the corporation was their basis in the hands of the transferors on the date of the exchange.