**Note on Section 351**

This note reinforces some of the concepts we covered in class. In particular, it focuses on the how the basis rules ensure that any gain not recognized in a section 351 transaction is preserved at both the SH and corporate levels. It also covers liabilities that are assumed in a section 351 transfer and highlights the role of basis in transactions in which basis is adjusted for transferred liabilities (357(c)(1) liabilities) and transactions in which basis is not adjusted (357(c)(3) liabilities). The basis/liability rules in sections 357 and 358 arise not only in section 351 transfers but also in reorganizations exchanges and transfers under section 368 (chapters 11 & 12).

**Example 1**

SH transfers property with a FMV of 100 and AB of 50 to a new wholly owned C corporation (X) in exchange for shares worth 100.

**Results**

SH realizes 50 on the exchange but recognizes 0 because of section 351(a). SH’s basis in the X shares is 50. Sec. 358(a)(1). X’s basis in the property is 50. Sec. 362(a). SH’s 50 of BIG in the property before the transfer is preserved in the shares (FMV =100; AB =50). X also has a BIG of 50 in the property. One gain (in the hands of SH) has now been converted into two gains, one at the SH level and the other at the corporate level.

**Example 2**

SH transfers property with a FMV of 100 and AB of 50 to a new wholly owned C corporation (X) in exchange for shares worth 90 and cash of 10.

**Results**

SH realizes 50 on the exchange but recognizes 10 of gain under section 351(b)—gain recognized to the extent of the boot. SH’s basis in the X shares is 50 (50 + 10 - 10). Sec. 358(a)(1)(A) and (B). X’s basis in the property is 60 (50+10). Sec. 362(a). SH recognized 10 of the 50 of BIG in the property, so there should be 40 of BIG remaining: the shares have an AB of 50 and a FMV of 90. X also has 40 of BIG in the transferred property. One gain (the 40 of BIG in the hands of SH) has now been converted into two gains, one at the SH level and the other at the corporate level.

**Example 3**

SH transfers property, which is subject to a liability of 40, that has a FMV of 100 and AB of 50 to a new wholly owned C corporation (X) in exchange for shares worth 60. X also assumes the liability of 40.

**Results**

SH realizes 50 on the exchange (value of shares plus assumption of liability) but does not recognize any gain. SH won’t recognize any gain on the transfer because the liability does not exceed the property’s AB of 50 (section 357(c)(1). The AB of the shares is 10 (50 – 40) under section 358(a)(1)(A)(ii) and 358(d)(1)—liability is treated as money received for purpose of determining basis. X’s basis in the property is 50. Sec. 362(a). Since no gain is recognized by SH, there should still be 50 of gain to be recognized: the shares have an AB of 10 and a FMV of 60. X also has 50 of BIG in the transferred property. One gain (the 50 of BIG in the hands of SH) has now been converted into two gains, one at the SH level and the other at the corporate level.

**Example 4**

SH transfers property, which is subject to a liability of 60, that has a FMV of 100 and AB of 50 to a new wholly owned C corporation (X) in exchange for shares worth 40. X also assumes the liability of 60.

**Results**

SH realizes 50 on the exchange (value of shares plus assumption of liability) and recognizes 10 gain under section 357(c)(1). The AB of the shares is 0 (50 – 60 + 10) under section 358(a)(1)(A)(ii), (B)(ii), and 358(d)(1). X’s basis in the property is 60 (50 + 10). Sec. 362(a). Since 10 gain is recognized by SH, there should still be 40 of gain to be recognized: the shares have an AB of 0 and a FMV of 40. X also has 40 of BIG in the transferred property.

**Example 5**

SH transfers property that has a FMV of 100 and AB of 50 to a new wholly owned C corporation (X) in exchange for shares worth 80. X also assume SH’s trade payable of 20.

**Results**

If SH sold the property and paid off the trade payable, it would have a gain of 50 and a deduction of 20.

Because the liability would give rise to a deduction, the liability is not treated as money received and SH does **not** have to reduce his basis in the X shares. Consequently, SH’s basis will be 50. Sections 357(c)(3), 358(a)(1), and 358(d)(2). X’s basis will also be 50.

Notice what has happened here: SH’s basis in the shares is 50, but they are only worth 80, the net value that was transferred to the firm. If SH sold the shares, he would recognize 30 of gain, not 50 of the BIG that went unrecognized in the incorporation. In essence, SH got a deduction for the 20 of payables when the property and liabilities were transferred because he didn’t have to reduce his basis in the X shares. Compare this result to the case where the liability was incurred to the purchase the property: the shares would have a basis of only 30 because the liability would be treated as money received under section 358(d)(1).

Also notice that SH got an economic deduction when he contributed the property and liability, and X will also get a deduction when it pays the liability.