Tax Law: Tax Consequences of Contributing Property to a Corporation

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Tax law has a number of important rules that apply when one contributes appreciated property to a corporation. In general, if one transfers property to a corporation in exchange solely for the corporation's stock, and immediately after the transfer, the transferor, together with all other persons who also transferred property as part of the same transaction, are in "control" (defined below) of the corporation, the transferor will not recognize gain or loss. However, it is significant to note that persons who receive stock for services do not count towards the control requirement, even if they also transfer a nominal amount of property.

A transferor's cost basis for the contributed property carries over to the corporation and also becomes the transferor's basis for the stock received. However, if the corporation's carryover basis for all the property one has transferred is more than the property's fair market value immediately after the contribution, the corporation's basis is reduced to the property's fair market value under a carryover basis limit rule. If this rule applies, the transferor and the corporation can jointly elect to apply the basis reduction to the cost basis of the stock received by the transferor, instead of the corporation's basis in the property. When property the transferor will be contributing has declined in value, these special rules are relevant.

"Control"

"Control" means the ownership of 80 percent of the voting power of the voting stock of the corporation's voting stock and 80 percent of the number of shares in each class of non-voting stock. One important exception is that a transferor who has entered into a binding commitment to dispose of stock to be received for the transfer of property does not count towards the 80 percent "control" requirement.

If the persons transferring the property (together) do not "control" the corporation immediately after the transfer, each transferor recognizes gain or loss equal to the difference between his or her basis in the transferred property and the value of the stock received. Note, however, that even if loss is recognized, it will not necessarily be deductible.

"Boot"

Even if the "control" test is met, a transferor may still have to recognize gain if the transferor receives cash or property ("boot") other than stock of the transferee in exchange for the transferor's property. Debt securities are treated as "boot" for this purpose, as are certain types of redeemable or adjustable-rate preferred stock.
If the transaction includes the receipt of "boot," the transferor will recognize the lesser of (a) the gain realized as to the property (i.e., the excess, if any, of the amount received (including the value of the stock received) over the transferor's basis in the property transferred), or (b) the cash and other "boot" received. The transferor's basis in the stock is the basis the transferor had in the property transferred, plus gain recognized, minus "boot" received.

**Example:** Lauren transferred land, in which she had a basis of $12,000, to her 85 percent-controlled corporation in exchange for stock worth $20,000, plus $5,000 in cash (boot). Of her realized gain of $13,000 ($25,000 − $12,000), Lauren must recognize $5,000, which is the lesser of the gain and the amount of "boot" received. Lauren's basis in the stock she gets is $12,000 - the basis she had in the land, plus $5,000 gain recognized, minus the $5,000 "boot" received.

If "boot" is property other than cash, the amount of "boot" is the fair market value of the property. This value also becomes the shareholder's basis for the "boot" property. The corporation's basis for the transferred property is increased by the gain recognized by a transferor, subject to the above basis limit rule.

**Assumption of debt**

If, as part of a transaction described above, the transferee corporation assumes, or takes property subject to, liabilities (for example, if the property transferred is encumbered by a mortgage), the liabilities are ordinarily not treated as taxable "boot" received by the shareholder, but are treated as "boot" in determining basis. However, if the liabilities exceed the shareholder's basis for the property, gain will ordinarily be recognized by the shareholder. An example of the effect of a mortgage where gain is not recognized by the transferor is as follows:

**Example:** Josh contributes land to his controlled corporation in exchange solely for stock. The land was subject to a $4,000 mortgage. Josh's basis in the land was $10,000 and its value was $20,000. Josh still does not recognize any gain because boot is not received for these purposes. Josh's basis in the stock he gets, however, is just $6,000 - the $10,000 basis he had in the land, minus the $4,000 debt (treated as "boot" for basis purposes).

If a significant portion of the properties transferred to a corporation are marketable stock or securities, including interests in a regulated investment company (RIC) or a real estate investment trust (REIT), it could be a transfer to an "investment company" on which gain would be recognized, thereby invoking another set of complex rules.

**Conclusion**

If you are contemplating transfer of property to a corporation, it would be wise to seek review of the transaction by tax counsel if there will be other transferors, if the property has declined in value since you acquired it, if there is a plan to transfer any stock that will be received in the transaction, if the property is subject to debt or other liabilities, or if you are transferring marketable securities.