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TAX LAW: Tax Consequences of Contributing Property to a Corporation

By: Ronald A. Feuerstein

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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" means the ownership of 80% of the voting power of the voting stock of the corporation's voting stock and 80% 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% "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

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property transferred, plus gain recognized, minus "boot" received.

Example: Lauren transferred land, in which she had a basis of $12,000, to her 85%-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 gain recognized ($5,000), minus "boot" received ($5,000).

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.

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Billions at Stake for Copyright Holders in Digital Music Royalty Lawsuit

By Alain Lapter, Esq.

We've all heard stories of how young, starving musicians are "forced" to sign recording contracts with large record companies that many times leave them either penniless or with mountains of debt, all regardless of their success. Some of these contracts require the artists to reimburse the music producers for a myriad of fees, including all costs related to live shows and tours, marketing, legal expenses, etc. The artists are also forced to sign contracts that assign a significant amount of copyright and administrative control of the music over to the record producers, and that are often times extremely difficult and costly to terminate.

Many agreements also typically provide that the production company is permitted to recoup all costs, including recording costs, against the artist's share of royalties. Therefore, according to some estimates, artists may only end up with a royalty rate of 3% after all fees and costs are accounted for. The counter-point, of course, and perhaps understandably so, is that the production company is taking on arguably all of the risk in signing up a new artist and fronting the money to get a record produced and marketed. Furthermore, the majority of artists signed by these companies fail to make a product whereby the labels can recapture their financial outlay.

Wherever you come out on this topic, a federal lawsuit could pave the way for musicians to collect billions of dollars in unpaid digital music royalties. In 2009, F.B.T. Productions in Detroit, perhaps best known for working with Eminem, filed a lawsuit against some of the largest record labels, including Universal Music and Aftermath Records. In the suit, F.B.T. claims that the music labels violated the terms of an agreement, which provides for a payment of royalties equal to 50% of the Defendant's net receipts from the licensing of the artists' music. In erroneously calculating royalties, F.B.T. claims that the payments only amount to roughly a 12% royalty.

The case essentially comes down to a distinction between selling "copies" of products (e.g. CDs, DVDs, etc.) and selling a "license" to reproduce the digital content (e.g. the song). While record labels ship physical products to stores and customers, iTunes and other on-line music providers and sellers obtain a license from the record company to replicate and distribute the digital files. According to the terms of the agreement with F.B.T., and what can be considered common practice in the industry, is that while an artist gets 10%-15% in royalties based on sales of a physical product, they receive a 50% royalty when a label "licenses" the music to another entity. This disparity is rational, given the significant expense in manufacturing, warehousing and distributing physical products, as compared to licensing the song, which can be accomplished by simply transmitting a digital file to the licensee, which thereafter allows for the instantaneous download by a consumer.

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To provide some further context, since the launch of iTunes through the first quarter of 2011, total monies paid to record labels can be approximated at over $12 billion dollars. Labels typically receive 70% of all revenues made from digital downloads. Based on F.B.T.'s calculation, take 50% of the $12 billion dollars, less what the artists' have been paid to date, which equals $1.7 billion dollars, and you are left with $4.3 billion in unpaid royalties, and, therefore roughly $2.15 billion potentially owed to the artists.

Initially, the jury in the F.B.T. case sided with the record labels, agreeing with their contention that downloads though iTunes were no different from retail sales of CDs under the contract's "records sold" royalties provision. F.B.T. appealed the decision to the 9th Circuit arguing that the lower court erred in rejecting its pretrial motion to declare that the contracts' licensing provisions clearly applied to digital downloads. Last year, the 9th Circuit reversed the lower court's decision, noting that "[t]he agreements unambiguously provide that notwithstanding the records sold provision, Aftermath owed FBT a 50 percent royalty under the masters licensed provision… Because the agreements were unambiguous and were not reasonably susceptible to Aftermath's interpretation, the district court erred in denying FBT" its pretrial ruling."

Aftermath and the other record labels appealed the decision to the Supreme Court, which summarily rejected their argument, agreeing with the 9th Circuit that digital music, under the F.B.T. agreement, should be treated as a license and, thus subject to a 50% royalty. Not surprisingly, the decision has led record labels to amend their agreements with newer artists to include digital downloads within the definition of a sale, as opposed to a license.

Since this decision, the estate of Rick James has initiated a class action lawsuit against Universal Music, which may lead to massive settlements with potentially thousands of artists. These payouts will not only affect the artists, by lining their pockets with some cash, but will likely transform the landscape between the three major parties involved: artist, record label, on-line digital retailer. It is estimated that revenue derived from iTunes currently stands around $300 million/month, or roughly $3.6 billion/year. Twelve and a half percent of this revenue, based on my earlier calculations, equals about $38 million per month for the artist. This figure is certain to go up as the number of people downloading music digitally continues to increase worldwide, as does the price of the songs themselves.

Another wrinkle relates to the future of digital music and the almost antiquated notion of actually downloading anything onto a computer's hard drive. Simply, many on-line content providers and ISP, including Amazon, Apple, and Google are moving towards a more streamlined business model that centers on cloud computing capabilities. Cloud computing, in its purest and simplest form, permits users to access applications and data without having to download and install software on their own device or computer. Amazon is moving most aggressively toward providing a music platform that is entirely cloud-based. Therefore, rather than downloading Amazon's version of iTunes on your computer or hand-held device, a user would access his/her entire music (and video) library through the Internet. Of course, if the songs themselves reside on the cloud, nothing is actually downloaded on the user's computer.

Some have argued that this type of technology would, perhaps, bring us full circle with the definitional issues between sales and licenses. As David Kusek, Vice President of the Berklee College of Music, noted, cloud-based systems "will be commissioned under licenses, especially when you consider that multiple instances of files will be available on a PC, mobile device or streaming. The very idea of copies just does not make any more sense in the digital age."

While cloud computing technology may open up different avenues for revenue and marketing for artists, as well as diminish the arguably draconian recording contracts, several questions remain: how will these new licensing schemes that are based on cloud computing systems affect royalty payments? How are these songs being licensed especially if one "copy" of a song can live in the cloud and be accessed by hundreds of users?

Irrespective of what the future holds, the 9th Circuit ruling opens the door for a sizable redistribution of royalty payments to musicians - not that Eminem needs more money. It also, hopefully, helps create a more level playing field between two parties that need one another to succeed. With the exponential growth of digital music and the slow demise of records and CDs, the future of the recording industry will entail a much more streamlined and less expensive investment in the product. Musicians hope that technology will eventually lead to agreements that allow them to reap greater rewards for their hard work and ingenuity.

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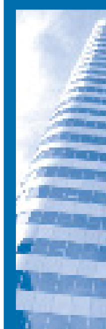

Meet our Attorneys - Anthony E. Cooch

Anthony E. Cooch (Tony) is a shareholder of the firm. He focuses his practice on business law, employment law, government contracts, bankruptcy and creditor's rights and civil litigation.

Tony is currently licensed to practice law in the Commonwealth of Virginia. He is a member of the Fairfax Bar Association and the Virginia State Bar. He also serves as a Firefighter/EMT with the Stonewall Jackson Volunteer Fire and Rescue Department in Manassas, Virginia. In addition, Tony is the co-founder of Stonebridge Title, LLC and Sunrise Valley Title, LLC.

Tony is the Lead Editor of the firm's employment blog, Virginia Employment Law Journal.

Tony earned a B.B.A. in Accounting with a concentration in Information Systems from James Madison University and was licensed as a Certified Public Accountant in 1995. After spending several years working in the private sector, Mr. Cooch returned to school and earned his J.D. from George Mason University School of Law.

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