Chapter 4:

1. Gearty and Olinto organized The Worthington Corp., which issued voting common stock with a fair market value of $240,000. They each transferred property in exchange for stock as follows:

Property	Adjusted Basis	Fair Market Value	Percentage of The Worthington Corp. Stock Acquired
Gearty Building	$80,000	$164,000	60%
Olinto Land	10,000	96,000	40%

The building was subject to a $20,000 mortgage that was assumed by The Worthington Corp. What was The Worthington Corp.'s basis in the building?
a. $60,000
b. $80,000
c. $144,000
d. $104,000

Explanation

Choice "B" is correct.

As a general rule, the basis of property received by a corporation by a transferor/shareholder is the greater of the basis of the transferred asset in the hands of the transferor/shareholder, or the debt assumed by the corporation. Therefore, The Worthington Corp.'s basis in the building is the same as Gearty's basis immediately prior to its contribution to the corporation.

Choice "A" is incorrect. The Worthington Corp.'s basis in the building is computed separately from any debt that it assumes related to the building.

Choice "C" is incorrect. The Worthington Corp. uses Gearty's basis, not the building's fair market value, as its basis. Furthermore, the debt assumed by The Worthington Corp. does not affect the basis of the building to The Worthington Corp.

Choice "D" is incorrect. The Worthington Corp. uses Gearty's basis, not the building's fair market value, as its basis.

2. Angie and Brad form Cats Are Us, Inc. Angie contributes $120,000 cash for 60% of the stock. Brad contributes an asset with an FMV of $90,000 and an adjusted basis of $30,000 for 40% of the stock. Brad also receives $10,000 cash from the corporation. What is the corporation's basis in the asset received from Brad?
a. $10,000
b. $30,000
c. $40,000
d. $90,000

Explanation

Choice “C” is correct. Angie and Brad both contributed property (including cash), and they have 100% control of the corporation. Therefore the 80% test is met, and this generally is a nontaxable transaction. The corporation takes the carryover basis of $30,000 in the asset. This amount is increased by the $10,000 cash that the corporation paid to Brad. The total basis is $40,000.

Choice “A” is incorrect. $10,000 includes only the amount of cash the corporation paid to Brad.

Choice “B” is incorrect. $30,000 is the carryover basis of the asset. But this neglects to add in the $10,000 cash paid to Brad.

Choice “D” is incorrect. $90,000 is the FMV of the asset, which is not applicable to a nontaxable transaction.

3. Gearty and Olinto organized The Worthington Corp., which issued voting common stock with a fair market value of $240,000. They each transferred property in exchange for stock as follows:

Property	**Adjusted Basis**	**Fair Market Value**	**Percentage of The Worthington Corp. Stock Acquired**
Gearty Building	$80,000	$164,000	60%
Olinto Land	10,000	96,000	40%

The building was subject to a $20,000 mortgage that was assumed by The Worthington Corp. What was Gearty’s basis in The Worthington Corp. stock?
a. $164,000
b. $80,000
c. $60,000
d. $0

Explanation

Choice "C" is correct.

Gearty computes his basis as the basis of property and cash (none here) contributed, less the amount of any debt he is relieved of. Here he contributes property with an adjusted basis of $80,000, but the $20,000 debt he is relieved of must be subtracted, resulting in a net basis of $60,000. This can also be thought of as giving Gearty a basis equivalent to the amount of equity he had in the contributed building.

Choice "A" is incorrect. The basis of Gearty's stock is based on his basis in the contributed property, not its fair market value.

Choice "B" is incorrect. Gearty must subtract the $20,000 of debt he is relieved of from his $80,000 basis in the property to arrive at his basis in the stock.

Choice "D" is incorrect. Because Gearty contributed property with a basis above zero, his basis in the stock is greater than zero.

4. Gearty and Olinto organized The Worthington Corp., which issued voting common stock with a fair market value of $240,000. They each transferred property in exchange for stock as follows:

Property	**Adjusted Basis**	**Fair Market Value**	**Percentage of The Worthington Corp. Stock Acquired**
Gearty Building	$80,000	$164,000	60%
Olinto Land	10,000	96,000	40%

The building was subject to a $20,000 mortgage that was assumed by The Worthington Corp. What amount of gain did Gearty recognize on the exchange?

a. $0
b. $20,000
c. $84,000
d. $104,000

Explanation

Choice "A" is correct.

Because the debt assumed by the corporation ($20,000) is less than Gearty's basis in the asset ($80,000), the gain does not result to Gearty. The formation of a corporation under these circumstances is a nontaxable event. Thus, Gearty would report zero gain upon the formation of the corporation.

Choices "B", "C", and "D" are incorrect. Because the formation of this corporation is a nontaxable event, no gain or loss would be recognized/reported by Gearty.

5. Ron, David, and Mary formed Widget, Inc. Ron and David each received 40% of the stock, and Mary received the remaining 20%. Ron contributed land with an FMV of $70,000 and an adjusted basis of $20,000. The corporation also assumed a $30,000 liability on the property. David contributed land with an FMV of $30,000 and an adjusted basis of $15,000. David also contributed $10,000 in cash. Mary received her stock for services rendered. She would normally bill $20,000 for these services. What is Ron’s basis in the corporate stock received?

a. $0
b. $20,000
c. $40,000
d. $70,000

Explanation

Choice “A” is correct. This generally is a nontaxable transaction for Ron and David because together they met the 80% control test. Mary does not count toward the 80% test because she received her stock for services rendered. Ron’s basis in the corporate stock received is $20,000 adjusted basis of the land minus $30,000 liability assumed + $10,000 gain recognized due to liabilities in excess of basis = $0.

Choices “B”, “C”, and “D” are incorrect, based on the above explanation.

6. Ron, David, and Mary formed Widget, Inc. Ron and David each received 40% of the stock, and Mary received the remaining 20%. Ron contributed land with an FMV of $70,000 and an adjusted basis of $20,000. The corporation also assumed a $30,000 liability on the property. David contributed land with an FMV of $30,000 and an adjusted basis of $15,000. David also contributed $10,000 in cash. Mary received her stock for services rendered. She normally would bill $20,000 for these services. What is Mary’s basis in the corporate stock received?
a. $0
b. $10,000
c. $15,000
d. $20,000

Explanation

Choice “D” is correct. This generally is a nontaxable transaction for Ron and David because together they met the 80% control test. Mary does not count toward the 80% test because she received her stock for services rendered. Mary’s basis in the corporate stock received is simply the $20,000 FMV of the services rendered.

Choices “A”, “B”, and “C” are incorrect, based on the above explanation.

7. Ron, David, and Mary formed Widget, Inc. Ron and David each received 40% of the stock, and Mary received the remaining 20%. Ron contributed land with an FMV of $70,000 and an adjusted basis of $20,000. The corporation also assumed a $30,000 liability on the property. David contributed land with an FMV of $30,000 and an adjusted basis of $15,000. David also contributed $10,000 in cash. Mary received her stock for services rendered. She normally would bill $20,000 for these services. What is Ron’s taxable gain as a result of this transaction?
a. $0
b. $10,000
c. $20,000
d. $30,000

Explanation

Choice "B" is correct.

In a corporate formation, the corporation's basis in the transferred assets is the carryover adjusted basis from the shareholder, $500 + $30,000 = $30,500.

Choice "A" is incorrect. This answer does not take into account Stone's basis in the cash she contributed.

Choice "C" is incorrect. This answer utilizes the property's fair market value as the corporation's basis; it should be the property's adjusted basis.

Choice "D" is incorrect. This answer utilizes the property's cost basis as the corporation's basis; it should be the property's adjusted basis.

8. In year 1, Stone, a cash basis taxpayer, incorporated her CPA practice. No liabilities were transferred. The following assets were transferred to the corporation:

Cash (checking account)	$ 500
Computer equipment:	
Adjusted basis	30,000
Fair market value	34,000
Cost	40,000

Immediately after the transfer, Stone owned 100% of the corporation's stock. The corporation's total basis for the transferred assets is:
a. $30,000
b. $30,500
c. $34,500
d. $40,500

Explanation

Choice "D" is correct.

Carr has no taxable income because he transferred appreciated property to Flexo in a transaction that qualifies as nontaxable.

Choices "A", "B", and "C" are incorrect. Beck and Carr have no taxable income because they transferred appreciated property to Flexo. However, Adams' contribution of services is not "property" for this purpose, so the receipt of stock by Adams is taxable.

9. Adams, Beck, and Carr organized Flexo Corp. with authorized voting common stock of $100,000. Adams received 10% of the capital stock in payment for the organizational services that he rendered for the benefit of the newly formed corporation. Adams did not contribute property to Flexo and was under no obligation to be paid by Beck or Carr. Beck and Carr transferred property in exchange for stock as follows:

	Adjusted Basis	Fair Market Value	Percentage of Flexo Stock Acquired
Beck	$ 5,000	$20,000	20%
Carr	60,000	70,000	70%

What amount of gain did Carr recognize from this transaction?
a. $40,000
b. $15,000
c. $10,000
d. $0

Explanation

Choice "C" is correct.

The formation of a corporation under these conditions is a nontaxable event. Clark's basis will be the $60,000 cash he contributed plus the $50,000 adjusted basis of the non-cash property for a total of $110,000.

Choice "A" is incorrect. Clark contributed both cash and property. Thus, Clark's basis in Jet's stock is greater than zero.

Choice "B" is incorrect. The amount of cash that Clark contributed must also be considered in determining Clark's basis in the Jet stock.

Choice "D" is incorrect. When property is contributed to form a corporation, it is contributed at its adjusted basis, not at its fair market value.

10. Clark and Hunt organized Jet Corp. with authorized voting common stock of $400,000. Clark contributed $60,000 cash. Both Clark and Hunt transferred other property in exchange for Jet stock as follows:

	Adjusted Basis	**Fair Market Value**	**Percentage of Jet Stock Acquired**
Clark	$ 50,000	$100,000	40%
Hunt	120,000	240,000	60%

What was Clark's basis in Jet stock?
a. $0
b. $100,000
c. $110,000
d. $160,000

Explanation

Choice "C" is correct.

The formation of a corporation under these conditions is a nontaxable event. Clark's basis will be the $60,000 cash he contributed plus the $50,000 adjusted basis of the non-cash property for a total of $110,000.

Choice "A" is incorrect. Clark contributed both cash and property. Thus, Clark's basis in Jet's stock is greater than zero.

Choice "B" is incorrect. The amount of cash that Clark contributed must also be considered in determining Clark's basis in the Jet stock.

Choice "D" is incorrect. When property is contributed to form a corporation, it is contributed at its adjusted basis, not at its fair market value.

11. Ron, David, and Mary formed Widget, Inc. Ron and David each received 40% of the stock, and Mary received the remaining 20%. Ron contributed land with an FMV of $70,000 and an adjusted basis of $20,000. The corporation also assumed a $30,000

liability on the property. David contributed land with an FMV of $30,000 and an adjusted basis of $15,000. David also contributed $10,000 in cash. Mary received her stock for services rendered. She normally would bill $20,000 for these services. What is David's basis in the corporate stock received?

a. $0
b. $10,000
c. $25,000
d. $40,000

Explanation

Choice "C" is correct. This generally is a nontaxable transaction for Ron and David because together they met the 80% control test. Mary does not count toward the 80% test because she received her stock for services rendered. David's basis in the corporate stock received is the $15,000 adjusted basis of the land + $10,000 cash contributed = $25,000.

Choices "A", "B", and "D" are incorrect, based on the above explanation.