Tax planning for corporate formation, Section 351 application, and choices in capital finance.

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ABSTRACT

The purpose of this case is to provide an applied understanding of tax planning for a specific business situation. A situation is analyzed in which students will have a chance to act as tax advisor for a budding business entity that is trying to determine the most tax advantageous vessel, through which, to organize a new business entity. Students then have a chance to analyze contributions to a corporation from prospective investors in the company in order to advise the clients (potential investors and corporate owner) on the most tax advantageous options for investing, while taking advantage of possible section 351 treatment under the Internal Revenue Code. The advantages and disadvantages of different capital structures are also discussed. Teaching notes discussing ways to incorporate this case into the flipped classroom are also presented.

Keywords: corporate formation, IRC section 351 application, capital structure, tax planning

INSTRUCTOR'S NOTES

There is some basic background knowledge that is assumed to be possessed by the students who will use this case study. The background knowledge is typical of what an accounting or tax student may learn in the first few weeks of a class covering the basics of Corporate Taxation.

There is a growing gap between the theoretical concepts taught in a classroom and the real-world information that is required to successfully perform basic job functions within a professional organization. Often, many classes within a business school curriculum generally, and within the field of accounting specifically, teach complicated applied subjects (such as taxation) in a theoretical manner. However, case studies have been shown to be effective at conveying complex, complicated material in an understandable way, and to facilitate informative classroom discussion that is on point, and to present students with a glimpse into real world decision-making (Kunselman and Johnson, 2004). This case study, and others like it, seek to transform the theoretical concepts discussed in textbooks into applied knowledge that students can take with them into the real world. The goal in this particular case study is for students to feel as if they have have a small glimpse into the type of thinking that is required in order to successfully apply the book knowledge of certain tax concepts that they have acquired to real life situations.

The concept of the flipped classroom is one that has been growing in popularity in the last 5-10 years. The basic premise is to have the lecture and book style learning done at home through podcasts, prerecorded lectures, and reading by the students and reserve class time for working through problems, while the professor/instructor serves as the subject matter expert, coach, and cheerleader for the students. It has been shown to be an especially effective style of learning for millennials (Phillips and Trainor, 2014). Case studies are very easy to implement in the flipped classroom and function well therein. This particular case can be seamlessly injected into a flipped classroom environment. A professor teaching an Introductory Corporate Taxation class will usually cover the applicable material needed to successfully complete this case in the first 2-3 weeks of class.

The case can be read aloud together in class and then students can be separated into small teams to work on the case specifics. Locations of appropriate explanatory textbook materials and appropriate code sections can be posted on the board for reference. After about 20-30 minutes of small group team work, the class can be reunited and teams can share their recommendations. The Instructor serves as a mediator for the final discussion, but also circulates throughout the classroom during the small group discussions and lends advice to teams struggling to find the next step. Recommended class time for case from start to finish is 1-1.5 hours.

THE CASE

Part I Facts

Dale Dawkins is an entrepreneur. He has discovered and patented an electrical process that will prolong the useful battery life of consumer hand-held electronics to well over a week of active use. He has invested nearly $200,000 of his own money into the process of perfecting and patenting the electrical process. It has taken him nearly five years of working 20 hours a week in his off-time to make this invention happen. He is now to the point of trying to commercialize his patent. In his regular job, he is an electrical engineer for Samson, a Korean retailer of high dollar electronics. He has been working for Samson for over 10 years and is considered by many relevant people, within and outside of the company, to be one of the best brains in the consumer electronics world.

Dale walked into the office of Everyday CPAs, LLC to speak with a tax partner. He is seeking tax advice regarding the organization of a business entity that he intends to use as a vessel to market his invention. His plan is to stop working his full-time day job in order to devote all of his time to his new invention and the business surrounding it. He has been filing 1040's and using a schedule C as an individual sole proprietor to record losses from his endeavors working on the process of getting his invention patented. At this point, he would like to know the best course of action to take while planning for the future.

After having an interview with him, he has made the following relevant statements about his company and his priorities with respect to the organization, he would like to: (1) start producing the batteries that his new patented process has made possible; (2) become the biggest supplier of batteries to all of the major players in the handheld consumer electronics world, including but not limited to: his future former company, Samson; Orange, Inc; and Doors, Inc.; (3) in order to facilitate goals (1) and (2), he realizes that he needs to get some capital by either taking on some partners or shareholders, or getting some loans or some other form of capital financing; (4) in addition to the capital raising possibility of taking on shareholders or partners, he believes having someone else with an equity interest in the company that has substantial business knowledge (especially financial knowledge); (5) he would like the business entity to be as simple as possible because he has a profound distrust of lawyers (generally) and would prefer to minimize the legal fees associated with the business formation; (6) he has acquired substantial wealth in his career so far (after having some stock options vest this past year), he would like to protect this wealth so that his liability within the business entity is limited to the capital that he invests; (7) he is interested in having the flexibility to withdraw profits from the company because he is constantly on the lookout for future opportunities, and although he believes this entity will be hugely successful, he is concerned about the liquidity of his capital investments as well as company profits; (8) he does not, under any circumstances, want to have to reorganize the company again while he is associated with it, he listed this as one of his most important priorities in the organization; (9) he would prefer to minimize tax liability but realizes that his other stipulations may cost him tax dollars, with that being said, he would like the minimum tax liability possible, given the other constraints.

Part I Questions

1. Assume that you are the tax partner who interviewed Dale, which type of business entity would you recommend that he use? Why? Explain the advantages and disadvantages of each of the possible ways to organize the business using Dale's list of priorities.

2. Giving appropriate consideration to the recommendations made in Question 1, what type of capital financing structure would you recommend for Dale to use to reach his goals now and in the future? Explain the advantages and disadvantages of each possible capital financing option, give specific attention to the tax advantages and disadvantages.

3. Assume that you gave Dale your advice from Questions 1 and 2 in person. Knowing the importance of the advice you are giving him, draft a professional letter that sets out the important highlights of your advice.

Part II Facts

The facts in Part II should be taken as one possible scenario that occurred as a result of the advice given from the Part I scenario. It should not be assumed that the accepted course of action from the above scenario that is referenced in Part II is the only correct answer for part I.

After receiving advice from Everyday CPA's, Dale formed a corporation under the laws of the State of Delaware. Upon formation, Dale transferred the patent rights from his invention to the corporation, Daleware, Inc. He also transferred $100,000 in cash into the corporation's name as well as some stock that he held. He transferred the patent, the cash, and 500 shares of Bazillion, Inc. to the corporation in exchange for all 10,000 shares of common stock in Daleware, Inc.

Dale has recently been soliciting offers to buy his company's stock in exchange for cash and other property that Dale has indicated his company will need in order to be successful in the manufacture and sale of batteries using his new technology. Dale has specific things that he needs from potential investors in his company. It is a closely held corporation, and he has no intention of going public anytime in the near future. So, he wants to make sure that the people, to whom, he sells his stock can contribute not only to the capital needs of the company, but also to the intellectual capital of the company. Dale has hand-picked the people that he would like to be investors in his company. Each one has agreed to also lend their intellectual capital to the company, but one investor (a lawyer) has insisted that any legal services that he provides will need to be compensated in cash or equity.

Dale has the following needs/stipulations in the deal: (1) Daleware needs land to build an office building and factory (a construction loan has been secured for building the buildings as soon as the land is secured); (2) Daleware needs a minimum of $1,000,000 in cash to start production on the batteries once the office building is built (Daleware has purchase orders from the three biggest producers of cell phones to be completed as soon as possible); (3) Dale has said that he will give up, at most 90% of the company, but he would like to give up as little as possible. He has also said that he doesn't want to give any one investor more of the control than he retains; (4) Daleware needs legal services to combat a patent infringement that has occurred; (5) Daleware would be willing to accept raw materials that could be used in the production process in exchange for stock; (6) Dale has received offers from 5 different entities to purchase 100% of his stock, the average of these offers was $10 million dollars; (7) In spite of the $10 million dollar valuation of the company (based on these outside offers), Dale has said that he would accept an exchange of property for stock from his hand-picked investors that imputed a value of $5 million to the overall company.

Dale has given you the above information about his requirements in the deal. He has also advised the potential investors that Everyday CPA's is very knowledgeable about taxes and business in general. Dale recommended to each potential investor that each should meet with you to discuss the potential tax consequences of the exchanges that they would like to make in order to invest in the company. Each has agreed. In the initial meeting, you met with the 4 potential investors to discuss some preliminary details. You have advised them of the possibility of not having to recognize gain on transfers of property to the corporation through the use of Section

351 of the Internal Revenue Code (Transfer to Corporation). All are very interested in the prospect. You have agreed to meet with each one of them individually to advise each on structuring his/her initial investments so as to minimize his/her tax liability on the transfer.

The following list contains the name and relevant information about the potential investors:

1. Mike Pitts is an electrical engineer. He worked at Energized, Inc. for 15 years helping to design their batteries. He currently owns a company that synthesizes a metal blend used in making batteries. In addition to his substantial intellectual capital, Mike has the following assets available for possible use in the exchange for 20% of the outstanding shares of Daleware stock:
   (a) $200,000 cash;
   (b) a 100-acre plot of land (zoned industrial/commercial), subject to a $100,000 mortgage valued at $950,000 (free and clear);
   (c) 1 metric ton of a proprietary metal blend that is the type Daleware will use in its production facility. The amount here is fixed and worth $300,000. Mike has said that if he uses this asset to exchange for stock, he will need $100,000 in cash in addition to whatever stock he gets to pay salaries and Accounts Payable in his company for producing the metal.

   Mike has a window of opportunity of 1/31/2015 to 4/30/2015 during which he is willing to make this deal happen. If it cannot be done before then, he will pull out and pursue investment elsewhere.

2. Cindi Jenkins is a patent attorney. She is a personal friend of Dale and was approached as a potential investor after Dale became aware that there was patent infringement activity going on and that it would likely cost approximately $250,000 in legal fees to litigate it. Cindi has agreed to invest and to also represent the corporation in the patent infringement case. However, Cindi requires that the $250,000 in legal fees be in exchange for a portion of the stock that she is to receive. She will also invest up to $500,000 in cash and would also like to exchange $400,000 of accounts receivable that she had purchased from a third party. The accounts receivable are valued at $250,000. Cindi is tied up on current work assignments until 3/31/2015 and does not want to commit to the deal until she has cleared her work calendar. She is seeking 20% of the stock of Daleware, Inc.

3. Zip Zipplar is a marketing expert. He has worked with all the leading handheld electronics companies. The marketing company that he owns and operates is very successful. He also owns a 50% interest in a company that produces bricks. He would like to contribute the following in exchange for 20% of the outstanding shares of Daleware stock:
   (a) Up to $500,000 in cash;
   (b) $750,000 worth of bricks (but he also wants 100 shares of Bazillion, Inc. (valued at $250,000) if he contributes his bricks.

   Zip has availability in his brick factory from 2/15/2015-03/07/2015 and estimates that it will take 3 weeks to produce the $750,000 worth of bricks. Zip needs an agreement done before he puts the brick order in, but is willing to have the deal go into effect upon delivery of the bricks to Daleware.

4. Kozer Sisay owns a company that owns the patent to, and manufactures a cutting edge polymer used in the outer cases of 4 out of 5 of the top selling cell phones on the market. It will also be used in making the new battery technology that Daleware, Inc. is set to produce. However, Dale knows and has discussed with Kozer that a new patented technology is about to come onto the market that will make Kozer's products and company totally obsolete. All parties privy to the information estimate that it will take 12-18 months for the new polymer to hit the market. The only assets that Kozer has to contribute to the corporation are his products. Dale has agreed to trade stock to Sisay in exchange for his product, but Dale wants $2,500,000 worth of product (going by the current FMV) because he knows that the value will be 0 whenever the new product comes out. Kozer has agreed to those terms in exchange for 20% of the outstanding shares of Daleware, Inc. Kozer just wants to get the deal done as soon as possible so that the FMV of his product does not decline or totally disappear before the deal is done.

Dale has agreed to all of these proposals as written above and each of the potential investors has come to you to find out if there is a way to structure the deal so that each of them can fully use their Section 351 eligibility.

Part II Questions

1. Is there a way to structure the deal that prevents all parties from being forced to recognize any gain on the transfers for stock? If so, write out the exact transactions that would need to occur. Also, does timing matter to the deal? Why or why not?

2. If there is not a way to structure the deal that eliminates all recognition of gain or loss under Section 351, which transactions minimize the gains and losses recognized on the individual exchanges (from the individuals' perspective and from the corporate perspective) and what would the required recognitions be?

3. Using the optimal deal structure from a tax standpoint. List the basis in the stock for each exchanger of property for stock and the corporation's basis in the property received.

References

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Transfer to Corporation Controlled by Transferor, 26 U.S. Code Section 351.