Corporate Tax
Bogdanski
Spring 2018

Exam Answer Outlines

Question 1

Part A

Corp recognizes no gain or loss on the issuance of stock to Amy in exchange for property. IRC § 1032. The same result applies to the issuance of the debenture to Amy. If the debenture is true debt, Corp is merely borrowing money; if the debenture is classified as stock, the transaction is covered by IRC § 1032. Corp recognizes no gain on its issuance of stock to Bibi.

Upon receipt of Corp stock, Bibi has compensation income – ordinary income – under IRC § 83(a). The amount of the income is the fair market value of the stock, $250,000. This becomes Bibi's basis in the stock. Assuming that the work Bibi performs does not generate a long-term benefit that requires capitalization, Corp can immediately deduct under IRC § 83(h) the same amount that Bibi must include in gross income under IRC § 83(a).

A threshold question for Amy is whether her exchange with Corp is covered by IRC § 351. If her transaction and that of Bibi are part of an integrated plan, then Amy is not eligible for nonrecognition under IRC § 351 because immediately after the exchange, Amy, who is the only party transferring property to Corp, does not have "control" (as defined in IRC § 368(c)) of Corp. "Control" would require Amy to own at least 80 percent of Corp's voting stock, and after Bibi's transaction, she owns only 800 of the 1,200 outstanding shares, or 66.67 percent

If Amy's transaction does *not* qualify for nonrecognition treatment under IRC § 351, Amy recognizes $500,000 of gain on the exchange of Blackacre for the $1,000,000 worth of stock and debentures. Her basis in her Corp stock under this analysis would be $800,000. Amy might qualify for installment reporting of the $500,000 gain, assuming that the debenture is treated as true debt and Blackacre was not dealer property in her hands. If Amy does not employ installment reporting, all of her gain would be recognized at the time of the exchange, and her basis in the debenture would be $200,000. The gain recognized by Amy on Blackacre would be capital gain – unless the property is depreciable in the hands of Corp, in which case the gain would be ordinary income under IRC § 1239 because Amy and Corp are related. Corp's basis in Blackacre would be $1,000,000.

If Amy's transaction *does* qualify for nonrecognition treatment under IRC § 351 (because it is viewed independently of Bibi's transaction), Amy recognizes gain to the extent that the debenture is treated as true debt, and therefore "boot." However, the debt bears two badges of disguised equity: subordination and contingent payments. If the debt is classified as stock, then it is not "boot" and Amy recognizes no gain on the exchange, assuming that it is not part of any integrated plan with Bibi's transaction. If the debenture is true debt, Amy recognizes $200,000 gain – the lesser of her realized gain or the amount of the "boot." Depending on the nature of

Blackacre in Amy's hands, this $200,000 gain may be eligible for installment reporting. (Amy may elect out of installment reporting.) If IRC § 351 applies, Amy's basis in the stock she receives is a carryover basis from Blackacre, $500,000. IRC § 358. Corp's basis in Blackacre would be determined under IRC § 362 – a carryover basis of $500,000 from Amy, plus any gain as she recognizes it.

The payments that Corp makes to Amy on the debenture are principal and interest if the debenture is true debt, but dividends if the debenture is classified as stock and Corp has earnings and profits. Interest is gross income to Amy and deductible by Corp, subject to the deduction limitation of IRC § 163(j). Any dividends paid to Amy or Bibi are likely to be taxed to them at favorable capital gain rates.

Part B

An election under IRC § 1362(a) would make Corp an S corporation. The validity of Corp's election may be questioned, however. First, if either Amy or Bibi is a nonresident alien (or if both are), the election is ineffective. Second, the debenture issued to Amy may be classified as a second class of stock, which would also render Corp ineligible for S corporation status. IRC § 1361(c)(5) provides a safe harbor for "straight debt," but the debenture appears not to qualify for such treatment because it is "contingent."

If the S corporation election is valid, it can take effect as of the start of Corp's first taxable year, so long as the election is filed within two and a half months from the start of that first taxable year. Here, it appears that Corp's first taxable year began when it first had a shareholder, on January 20, 2018. Thus, filing of the election on March 25, 2018 is timely for the first taxable year.

Under the S corporation election, all tax items recognized by Corp "pass through" and are taxed, pro rata, to Amy and Bibi. This would result in each of the shareholders being taxed on one half of Corp's profits in 2019 and 2020. Amy and Bibi may be eligible to deduct up to 20 percent of their "pass-through" income each year under IRC § 199A.

Question 2

Lco, as an unincorporated entity with a single owner, is disregarded for federal tax purposes. The 400 RST shares held by Lco are treated as being owned by Tito.

The redemption of the 400 shares raises issues under IRC § 302. If the transaction is treated as an exchange under IRC § 302(a), then Tito can use the $200,000 basis in the RST stock to offset the $400,000 consideration received from RST, and have a capital gain of $200,000 on the exchange. Tito uses the installment method to report this gain, unless he elects out of the installment method.

If the redemption is not covered by IRC § 302(a), then the $400,000 proceeds of the redemption are treated as a distribution with respect to RST's stock, covered by IRC § 301. Such

distributions are treated as a dividend, not eligible for installment reporting, to the extent of RST's current or accumulated earnings and profits. The amount of the distribution is $400,000 – the $50,000 cash Tito receives plus the $350,000 fair market value of the promissory note.

RST has no current earnings and profits, and the taxpayers are allowed to offset a portion of the current year's $100,000 deficit in earnings and profits against the $400,000 accumulation. The portion allowed is the amount of earnings and profits attributable to the period between January 1 and July 1. RST can compute this portion by either closing its books on an interim basis on July 1, or prorating the entire year's deficit to the pre-redemption period, here, half the year. Because the distribution would be greater than the dividend, a portion of it would be tax-free to Tito, reducing his basis in his RST stock. The dividend portion would be taxed as gross income to Tito at favorable capital gain rates. If the redemption does not qualify as an exchange, Tito's basis in the RST stock would shift to Wilma, Doll, and Trust No. 1.

Does the redemption qualify as an exchange, covered by IRC § 302(a)? Due to constructive ownership of stock under IRC § 318, the redemption does not qualify under IRC § 302(b)(1) or IRC § 302(b)(2), It could qualify as a complete termination of the shareholder's interest under IRC § 302(b)(3), but only if the conditions of IRC § 302(c)(2) are satisfied. This would require Tito to file an agreement with the IRS to refrain from having any interest in RST for 10 years, other than an interest as a creditor. A landlord is treated as being a mere creditor provided that the rent being charged to the corporation is fair market rent.

If Tito files the agreement, he must satisfy the IRS that his gift to Doli, five years prior to the redemption, did not have as one of its principal purposes the avoidance of federal income tax. IRC § 302(c)(2)(B).

Alternatively, the redemption would qualify as an exchange if it constitutes a partial liquidation of RST, regardless of Tito's stock ownership. However, the facts do not indicate that the redemption is a partial liquidation.

Interest received by Tito on the promissory note is ordinary income. RST can deduct the interest, subject to the deduction limitation of IRC § 163(j).

There are no tax consequences to Doli. Section 305(c) authorizes the IRS to tax Doli to the extent that the redemption has the same effect as a stock dividend taxable under IRC § 305(b). Although the redemption has the effects of increasing Doli's actual percentage ownership of the company and of distributing cash to Tito, the regulations under IRC § 305(c) make clear that an isolated redemption is not subject to IRC § 305 treatment.

RST recognizes no gain or loss on the redemption. If the redemption is treated as a distribution covered by IRC § 301, RST's accumulated earnings and profits going forward are reduced to zero. If the redemption is treated as an exchange under by IRC § 302(a), RST's accumulated earnings and profits are reduced by the percentage of stock redeemed (40 percent) – that is, from $300,000 to $180,000.

Question 3

In the asset sale by Zzz, the overall purchase price must be allocated among the assets sold. IRC § 1060 requires the "residual method" of allocation between tangible and intangible assets. In this case, the amount realized on each asset would be its fair market value. This would result in Zzz recognizing the following gains: $100,000 on the investments (capital gain), $100,000 on the real estate (capital gain), $150,000 on the inventory (ordinary income), and $150,000 on the goodwill and going concern value (capital gain). Zzz could report its gains on the installment method, except for the gain on the inventory, which is ineligible for installment reporting. Zzz could elect out of the installment method. Under the installment method, since two-thirds of the consideration on the sale ($1,000,000 out of $1,500,000) is received at the closing, Zzz would report two thirds of each capital gain at the closing.

When Zzz distributes the Pubcorp note to Jung, Zzz recognizes the remaining capital gain on the assets. The note is property, the distribution of which triggers gain at the corporate level under IRC § 336(a). Similarly, when Zzz distributes the equipment to Rachel, Zzz recognizes $80,000 of gain under IRC § 336(a). The latter gain is probably all ordinary income, on account of depreciation recapture.

Jung treats the liquidating distribution he receives as being received on a sale of his Zzz stock. IRC § 331. The gain Jung recognizes is capital gain. Jung might be able to defer half of his $800,000 gain over five years, because the Pubcorp note Jung receives may qualify for installment reporting under IRC § 453(h). If the sale of the Zzz assets is deemed to have taken place prior to the adoption of the Zzz plan of liquidation, however, IRC § 453(h) does not apply. Here, Jung made a verbal commitment to Pubcorp a week before the plan was adopted. Query whether that might cause the sale to fall outside of IRC § 453(h). If IRC § 453(h) is unavailable, Jung would recognize all of his gain on receipt of the cash and note.

Rachel recognizes a $60,000 capital gain under IRC § 331(a). Her basis in the equipment is its fair market value, $80,000. IRC § 334(a).

It appears that Zzz may not have reserved enough funds to pay its tax debt to the IRS. If the IRS collects from Jung and Rachel as transferees of Zzz, Jung and Rachel will recognize capital losses under the *Arrowsmith* doctrine.

In addition to regular corporate income tax, Zzz may be liable for the accumulated earnings tax, because it has accumulated earnings and profits beyond the reasonable needs of its business. Upon the liquidation, Zzz's earnings and profit accounts disappears with no further tax consequences.