Corporate Tax
Spring 2019
Exam Issue Outlines

Question 1

Part A

The liquidation of Subb may be covered by IRC §§ 332 and 337, which provide for nonrecognition of gain and loss to a parent corporation and its controlled subsidiary on liquidation of the subsidiary. To be eligible for this treatment, however, the liquidation must meet procedural requirements set out in IRC § 332. One of these is that the liquidation must be completed within a single taxable year (this one is not) or pursuant to a plan that calls for all liquidating distributions to be made within a three-year period. IRC §§ 332(b)(2), (3). It is not clear that the Subb liquidation plan calls for such a timetable.

Additionally, the facts do not clearly establish that all of the distributions are liquidating distributions. The 2019 distributions are made "around the same time" as the adoption of the plan. Distributions made before adoption of the plan would be covered by IRC § 301, rather than by the liquidation rules.

Assuming that the liquidation is covered by IRC §§ 332 and 337, and that all of the distributions are pursuant to the plan of liquidation, the following tax consequences apply:

The distributions of Factory and money by Subb to Parr do not cause gain or loss to be recognized by either corporation. Parr takes Factory with the same basis that Factory had in the hands of Subb, $1,000,000. Parr also takes over Subb's earnings and profits.

Subb's distributions to Iris are not covered by IRC § 332 and 337, which apply only to distributions to the "80-percent distributee." The distributions to Iris are covered by IRC §§ 331 and 336. Iris is governed by IRC § 331. The money and XYZ stock that she receives are treated as being received in exchange for her Subb stock. Courts and the IRS allow gain on the deemed sale to be accounted for using an "open transaction" approach. Thus, when Iris receives her first distribution of $150,000, it is not taxable to her; instead, it reduces her basis in her Subb stock by $150,000. When Iris later receives the XYZ stock, she can use her remaining $50,000 basis against her amount realized on the deemed sale of her Subb stock.

Iris's amount realized upon receipt of the XYZ stock is the "equity" she receives – that is, the $450,000 fair market value of the stock minus the liability of $150,000 that Iris assumes. Thus, her amount realized is $300,000, and subtracting her remaining $50,000 basis in the Subb stock, she recognizes a $250,000 gain in 2021. This is a capital gain, assuming that Iris is not a stock dealer. Her basis in the XYZ stock is its fair market value, $450,000. IRC § 334(a).

Upon the distribution of the XYZ stock, Subb is treated as if it sold the stock to Iris for its fair market value of $450,000. IRC § 336(a). Subtracting Subb's $200,000 basis in the XYZ stock

results in a $250,000 gain recognized by Subb. This is a capital gain, assuming that Subb is not a stock dealer.

The facts make no mention of Subb holding back enough assets to satisfy creditors, including the IRS. If the shareholders are required to pay any of Subb's debts as transferees of Subb's assets, the tax treatment of the payment by them would relate back to the liquidation. In Iris's case, the result would be a capital loss equal to the amount she paid to the creditors.

Part B

Subb cannot be an S corporation, because an S corporation may not have another corporation, even another S corporation, as a shareholder. If Parr were an S corporation, it could elect to treat Subb as a disregarded entity (a qualified subchapter S subsidiary, or "QSub"), but only if Parr owned 100 percent of Subb's stock, which is not the case here.

Question 2

Newco recognizes no gain or loss on the receipt of property in exchange for its stock. IRC § 1032.

If IRC § 351 applies to Luke's and Monique's transactions with Newco, the following tax consequences apply:

> Neither shareholder recognizes any gain or loss on the exchange of their property for Newco stock. In Luke's case, the assumption by Newco of the Blackacre mortgage raises issues under IRC § 357. Under IRC § 357(c), the excess of the assumed liability over the adjusted basis of Blackacre would be treated as recognized gain, except that courts have held that Luke's transfer of the $10,000 promissory note provides additional basis, so that Luke avoids recognition of gain. *Peracchi*.
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> Under IRC § 358, the basis of Luke's Newco stock is a carryover basis from Blackacre ($30,000), minus money received (the Blackacre mortgage, $40,000, *see* IRC § 358(d)), plus the $10,000 promissory note (*Peracchi*), or zero.
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> Monique does not recognize her loss on the transfer of Whiteacre to Newco in exchange for stock in the section 351 transaction. The liability assumed by Newco is ignored for purposes of IRC §§ 351 and 358 because it would have been deductible as a business expense if Monique had paid it herself. IRC § 357(c)(3).
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> Monique's basis in her Newco stock is a carryover basis from Whiteacre, or $90,000.
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> Newco's basis in Blackacre carries over from Luke, or $30,000. Newco's basis in Whiteacre is the lower of carryover basis or fair market value, or $76,000, under IRC § 362(e)(2). If the parties file an election with the IRS, Newco can have a carryover basis in

Whiteacre of $90,000, but under such an election, Monique's basis in the Newco stock would be reduced to $76,000.

The transaction with Cayla could cause Luke's and Monique's transactions to fall outside IRC § section 351. If the Cayla sale is part of an integrated plan with Luke's and Monique's exchanges, the transferors of property to Newco – Luke and Monique – do not have "control" of Newco, because they own less than 80 percent of the corporation's nonvoting stock, immediately after the exchange.

If IRC § 351 does not apply to Luke's and Monique's transactions with Newco, the following tax consequences apply:

Luke recognizes $75,000 of gain on the exchange of Blackacre, and Monique recognizes $14,000 of loss on the exchange of Whiteacre. The character of the gain or loss depends on whether the shareholder is a real estate dealer.

Newco gets a basis in each parcel of real estate equal to its fair market value. Each shareholder would receive a basis in his or her Newco stock equal to its fair market value, or $75,000 each.

Each shareholder's basis (if any) in the Newco stock must be allocated between the common and preferred stock. The relative fair market values of the two classes of stock should be used for this purpose, so that two thirds of the shareholder's basis (if any) is assigned to the common stock, and one third to the preferred stock.

When Luke sells his preferred stock to Cayla, he recognizes gain or loss equal to the difference between the $20,000 basis and Luke's basis in the preferred stock. The gain is a capital gain, unless Luke is a stock dealer.

Question 3

The stock dividend is not taxable to either the shareholders or Corp. IRC § 305. The basis of the common stock is apportioned between the newly issued preferred and the original common under IRC § 307. This allocation is performed based on the relative fair market values of the two classes – 20 percent to the common and 80 percent to the preferred.

The preferred stock is section 306 stock because the shareholders would have had taxable dividends if Corp had distributed money instead of the stock. When Blake sells his preferred stock, the amount realized on the sale is treated as a dividend to the extent of Blake's ratable share of the earnings and profits that would have been a taxable dividend if Corp had distributed money instead of the stock dividend. As 25 percent shareholder, Blake's share of the $120,000 relevant earnings and profits is $30,000. Thus, on the sale of the preferred, Blake has a $30,000 dividend, taxable at capital gain rates. The other $28,000 received from Dave is treated as the sale price of the preferred. Under the basis allocation discussed earlier, Dave's basis in the

preferred is $30,000 (20 percent of $150,000), but no loss deduction is allowable on the sale of section 306 stock. IRC § 306(a)(1)(C).

Abby is treated as owning the stock owned by her son, Stephen. IRC §318(a)(1). When she redeems her common stock, by attribution her share of the voting and common stock of Corp is reduced from 75 percent to 50 percent. This does not qualify as an exchange under IRC § 302(b)(2) or (b)(3) (and no waiver of attribution is possible because she holds on to her preferred stock), but it is likely a meaningful reduction in her interest so as to qualify for exchange treatment under IRC § 302(b)(1). Thus, she can use her basis in her common stock – $240,000, calculated under IRC § 307 – against the $480,000 cash received, for a gain of $240,000. This gain is capital gain unless Abby is a stock dealer.

There are not enough facts stated in the question to determine whether the redemption alternatively qualifies for partial liquidation treatment under IRC § 302(b)(4).

The earnings and profits of Corp are reduced on account of the redemption of Abby's stock. The reduction is the lesser of the $480,000 amount of the distribution or the percentage of Corp stock redeemed. It is not clear under current law whether the earnings and profits are reduced by the deemed dividend taxed to Blake under IRC § 306.

Corp. may not deduct the amount it pays to redeem its stock.

The redemption of Abby's stock raises potential issues for Blake under IRC § 305(c). His share of the earnings and profits of Corp increased while the Corp distributed cash to Abby. This could be treated as a constructive taxable stock dividend to him under IRC § 305(b)(2). However, the regulations under IRC § 305 state that this analysis is inapplicable to an isolated stock redemption, which Abby's appears to be.