

QUESTION 1

When Bao receives Corp stock in exchange for services rendered, Bao recognizes ordinary income under Section 83(a) equal to the difference between the fair market value of the stock \$100,000, and the amount paid for it, \$10,000. Thus, Bao has ordinary wage income of \$90,000 upon receipt of the Corp stock. Assuming that the services to be performed by Bao are not in the nature of a capital expenditure, Corp will be entitled to deduct immediately the \$90,000 that Bao counts as gross income. IRC § 83(h). Bao's basis in the Corp stock Bao receives is \$100,000.

Does Arnie's exchange of real estate for stock qualify for nonrecognition under Section 351(a)? Yes. Although most of the consideration provided by Bao for Bao's stock is not property, Bao is still considered a transferor of property under IRS guidelines, because the cash exceeds 10 percent of the \$90,000 in stock being received for services. Therefore, immediately after the exchange, the transferors of property, Arnie and Bao, own 100 percent of all classes of stock of Corp, and Section 351(a) applies. Arnie recognizes no gain or loss.

Corp has no income on the issuance of stock. See IRC § 1032.

Arnie's basis in his Corp stock is a carryover basis from the assets he transferred to Corp in the exchange. IRC § 358(a). Thus, his stock basis is \$380,000.

Corp's basis in Redacre and Greenacre generally carries over from Arnie under Section 362(a). However, under Section 362(e)(2), because the aggregate of the bases in the assets being transferred by Arnie (\$380,000) exceeds the aggregate value of those assets (\$330,000), that carryover basis is reduced by \$50,000. That basis decrease is allocated to Redacre, because only it has gone down in value from its basis to Arnie. IRC § 362(e)(2)(B). Thus, Corp's basis in Redacre is \$150,000 (\$200,000 minus \$50,000). Corp's basis in Greenacre is \$180,000.

Arnie's holding period for the Corp stock includes the holding period for Redacre and Greenacre, but only if the real estate constituted capital assets or Section 1231 assets in his hands.

If Arnie and Corp agree to do so, they may jointly elect under Section 362(e)(2)(C) to have Redacre take a carryover basis of \$200,000, but reduce Arnie's basis in his Corp stock by \$50,000, from \$380,000 to \$330,000.

QUESTION 2

Hank's sale of his Topco stock to Doughco is covered by Section 304(a)(2). Topco controls Doughco because it owns at least 50 percent of the Doughco stock. The sale is treated as a distribution in redemption of the stock of Topco.

To determine whether the deemed redemption is an exchange or a dividend, the rules of Section 302(b) apply, and the determination is made by reference to the stock of Topco. IRC § 304(b)(1). Here, immediately before the sale, due to family attribution, Hank is treated as owning 100 percent of the Topco stock (his own and Gert's). Immediately after the deemed redemption, Hank actually owns no Topco stock, but he constructively owns the 40 Topco shares owned by Gert, and under Section 318(a)(2), he is treated as owning 75 percent of the 60 Topco shares owned by Doughco, or 45 shares. Thus Hank owns, immediately after the sale, 85 percent of the stock of Topco. He does not qualify for sale treatment under Section 302(b). Therefore, the \$1,500,000 is treated as a distribution covered by Section 301.

A "waiver" of family attribution from Gert is of no avail to Hank because it would not give rise to a complete termination of Hank's interest. IRC § 302(c)(2). Hank would still constructively own his proportionate share of the Topco stock owned by Doughco, under Section 318(a)(2).

The Section 301 distribution to Hank is a dividend to the extent of either Topco's or Doughco's earnings and profits. IRC §§ 304(b)(2), 316. Because the two corporations have only \$1,000,000 of earnings and profits, only that much of the \$1,500,000 constructive Section 301 distribution is a dividend. The other \$500,000 of the distribution is treated as a tax-free return of Hank's basis in the Topco stock. IRC § 301(c)(2). Thus, Hank's basis in the Topco stock is reduced to \$100,000 (\$600,000 minus \$500,000), and that much basis carries over to Gert, increasing her stock basis to \$500,000.

The \$1,000,000 dividend is taxed at favorable long-term capital gain rates under Section 1(h)(11).

The earnings and profits of Doughco are reduced to zero. Doughco's basis in the Topco stock should be a cost basis, \$1,500,000.

QUESTION 3

The liquidation of Subco is covered by Sections 332 and 337. Parco recognizes no gain or loss on the receipt of the cash and Parcel No. 1. Parco's basis in Parcel No. 1 carries over from Subco, \$500,000. IRC § 334(b). Parco also succeeds to 90 percent of the earnings and profits of Subco under Section 381(a). Parco's basis in its Subco stock is of no consequence. Subco recognizes no gain or loss on the distribution of parcel No. 1 to Parco. IRC § 337(a).

The distributions made by Subco to Irene are not covered by Sections 332 and 337. Instead, they are covered by Sections 331 and 336. The distributions Irene receives are governed by Section 331. Irene is treated as if she disposed of her Subco stock to Subco in exchange for the cash and Parcel No. 2. Irene is entitled to use "open transaction" treatment and recover her basis as each distribution is made. Thus, when Irene receives her first, \$50,000 cash distribution, it is not gross income to her; it reduces the basis of her Subco stock from \$200,000 to \$150,000. Similarly, when Irene receives her second, \$100,000 cash distribution, it is not gross income to her; it reduces the basis of her Subco stock from \$150,000 to \$50,000.

When Irene receives Parcel No. 2, she recognizes a \$50,000 gain, because her amount realized is \$100,000 (the fair market value of Parcel No. 2), and her adjusted basis in her Subco stock is only \$50,000. Irene takes Parcel No. 2 with a basis equal to its fair market value of \$100,000. IRC § 334(a).

Subco's distribution of Parcel No. 2 to Irene is governed by Section 336. Under Section 336(d)(3), no loss is recognized by a liquidating corporation on any distribution in a liquidation to which Section 332 applies. Therefore, Subco may not deduct the loss on Parcel No. 2.