

## Question Two

First off, Sco, even though it has voting and nonvoting common stock, is still a valid S corporation because the regulation under §1.1361 state that differences in voting rights are disregarded in determining the “one class of stock” rule. But this is all destroyed when the first transaction between Belinda and Sco takes place because at that

point Sco has already created a second class of stock, nonvoting preferred. Therefore, from this point forward all transactions will be analyzed assuming Sco is a C corporation.

For the transaction on May 28, 2008, since Belinda transferred appreciated property to Sco, she wants to receive nonrecognition under §351 to the extent possible. Section 351(a) provides nonrecognition for transactions between a shareholder and a corporation when, “property is transferred solely in exchange for stock, and the transferors as a group are in control of the corporation immediately after the transaction.” In this case, Belinda transferred property, the real estate. The transfer was not solely in exchange for stock though, since she received cash. The cash (\$50,000) will be treated as “boot” and she will be required to recognize capital gain in the amount of the boot. She recognizes capital gain because the asset she transferred was a capital asset (because it was property that he had held for at least one year). The portion of the transfer attributable to the stock she received (\$250,000), can still qualify for nonrecognition if Belinda has control of the corporation immediately after the transfer. Control is defined to be owing at least 80% of the total combined stock of the corporation (80% of the total voting stock and at least 80% of the nonvoting stock). In this case Belinda does not have 80% control over the combined classes of stock because even though she owns over 80% of the voting stock, she doesn't own 80% of the nonvoting stock,. She only owns 45% of the nonvoting stock. That means under this facts, Belinda would have to recognize capital gain on the difference in the value of the stock over the adjusted basis in the property she transferred at the time of the transfer, which would be \$70,000 (250 K- 180K). Her basis in the stock received would be her basis in exchanged property (\$180,000) – cash received (\$50,000) + any gain recognized (\$120,000) = \$250,000. So

Belinda would own \$250,000 worth of Class C nonvoting preferred stock with a basis of \$250,000. Sco would take a basis in the transferred property equal to Belinda's basis in the transferred property (\$180,000) + gain recognized by Belinda (\$120,000) = \$300,000. So Sco would own a \$300,000 piece of property with a basis of \$300,000. There is still hope that Belinda and Art's transfers could be treated as made simultaneously for purposes of "control" thereby getting Belinda some nonrecognition treatment and I will discuss that possibility after discussing Art's transaction.

Art transferred "property", the computer system, "solely in exchange for stock," because all he received in return was Class C nonvoting stock. So if Art can satisfy the "control" requirement of §351(a), he can get complete nonrecognition on this transaction. Unfortunately, Art does not have at least 80% control of each class of stock after the transfer of this computer system in exchange for stock and therefore he suffers the same fate as Belinda. He will have to recognize the \$35,000 of realized gain on his appreciated computer system. Assuming the computer system is a capital asset in Art's hands, he will recognize \$35,000 of capital gain on the transfer, and his basis in the stock received in the transfer will be \$55,000. Sco, will have a basis in the computer system of \$55,000 and will recognize no gain or loss on the transaction.

The last chance Belinda and Art to receive nonrecognition treatment is if their transfers are treated as simultaneous, for the purposes of "control." This is their only hope because they are unrelated shareholders and therefore cannot use any of the attribution theories in determining control. If they are treated as simultaneous, then Art and Belinda will collectively have control over the corporation after the transfer of the two separate assets because they are the only two shareholders of Sco. Therefore they

will have satisfied the §351(a) nonrecognition requirements and will receive nonrecognition treatment to the extent it is applicable to their transfer.

In Belinda's case this means that she will get nonrecognition to the extent of the transfer not related to the cash "boot" she received. So she will still be taxed same as before on the \$50,000 in cash boot. But the remaining realized gain she has in the transaction of \$70,000 (\$250,000 FMV of property less her basis of \$180,000) will not be currently recognized. Instead she will receive \$250,000 of stock with a basis of \$180,000 (Basis of her exchanged property – cash received + gain recognized). Thus her realized \$70,000 of capital gain is preserved in the stock that she received and she will recognize that gain when she eventually sells the stock. Sco, receives a basis of \$230,000 in the property and will not recognize any gain or loss on this transaction.

In Art's case, he will not recognize any gain on the transaction because he received no boot in the transfer. Therefore, he will receive a transferred basis in the stock of \$20,000 which is equal to the adjusted basis of the property he transferred, preserving the gain for when Art eventually sells the stock. Distco recognizes no gain or loss on this transaction and takes a transferred basis in the computer system equal to Art's basis which is \$20,000.