

## Question 2:

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The creation and distribution of the non-preferred stock turns Sco from an S corporation into a C corporation on May 28, 2008. For this taxable year, the taxes for the first portion of the year will be calculated as an S corporation and the taxes for May 28<sup>th</sup> and on will be calculated under the double taxation rules as a C corporation. An S corporation can not have two categories of stocks except one group can be voting and one group can be non-voting. But adding preferred to common removes it from the S corporation category.

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Belinda and Art are going to try and say the transfer of property was a coordinated plan so the transfer of the property is a non-recognition event under §351. If they are not successful, since the facts indicate this was not a coordinated plan, the transfer of property fails as a non-recognition event. Each transfer is looked at separately and Belinda does not have control, i.e.

80% of the voting stock AND 80% of the common stock, immediately after the transfer.

Therefore, she will recognize a capital gain of \$120,000 on the transfer of Whiteacre. She receives \$300,000 total consideration of \$50,000 cash and \$250,000 preferred stock. Her basis is \$250,000 in the stock. Sco's basis in Whiteacre is \$300,000 (Belinda's basis + gain recognized).

Art also does not have control immediately after his transfer. Although he has control of 80% of all voting stock, he does not have 80% control of all common stock. Control in preferred stock is not considered. So the transfer of equipment by Art is a recognition of realization of a gain. Art has a recognition of \$35,000 that will be treated as gain on a capital asset. The gain will be ordinary income as there was probably depreciation that must be recovered on the equipment.

Art's basis in his stock will be \$55,000 and Sco's basis in the equipment will be \$55K.

If they are successful in converting these transfers to a coordinated plan for the IRS, the difference in timing is irrelevant and control of the corporation will be viewed as to all the SHs transferring property for stock within the scope of the plan. The requirement of §351 is that property is transferred solely for stock and the SHs involved in the transfer are in control of the corporation immediately after the transfer meaning together in control of 80% of the voting stock and 80% of the common stock. Together they are in 100% control of the voting stock and 100% control of the common stock. In addition, the transfer could be struck down if the transfer by Art

looked to be de minimus, but that is not the situation here. He is not receiving any stock for services and the amount of his transfer is significant.

Under a §351 qualified transfer the boot received by Belinda does not jeopardize the non-recognition event. She will report a \$50,000 capital gain. She can not deduct her basis in Whiteacre against the \$50,000. Her basis in her \$250,000 stock is \$180,000. Sco's basis in Whiteacre would be that of the transferor, \$180,000 and Sco's holding time for Whiteacre is tacked on to that of Belinda. Art would not recognize any gain. His basis in his \$55,000 stock would be \$20,000 and Sco's basis in the equipment would be that of the transferor, \$20,000.

Sco does not have a recognizing event to pay tax in any event since exchanging stock for property is not a taxable event for a corporation. This does not change E&P for the company.