#2
On 5/28 – Belinda's transfer of the property to the S-Corp in return for a 3rd class of non-voting preferred stock blew the corp's S-status and its election immediately terminated by violating the 1361c5 eligibility requirement. Now, the corp is going to be facing a rather large accounting bill because it's tax year was bifurcated and it must file 2 "short-year" returns for the 2008 taxable year – one for its S-Corp days prior to 5/28, and one for its new C-Corp days 5/28 and on. Their accountant is going to have to reconstruct what happened and when – I don't envy him, although I might envy his bill.

It should be noted that under 1362f, the IRS has the authority to reinstate the S-corp status if the problem causing the termination (issuance of a truly 2nd class of stock) is shown to the satisfaction of the IRS that it was inadvertent and the problem must be corrected by redeeming the shares and burning them. This is unlikely, however, because of the second issuance of the same stock to Art on 6/2. Art could, I suppose, rely on a defense that the damn corp's tax advisor should be liable and Art & Belinda merely relied on his professional judgment – likely a loser though – especially since 1362f authority is discretionary.

As to B's transfer of property – although we didn't discuss this particular timing issue – I suspect was made to the S-corp form of the corp, rather than its new C-corp form of the corp – because the termination occurred immediately as a result of it. Therefore, when B, as a S-corp shareholder, contributed the appreciated property to the S-corp, she realized $120k, but we must engage in a 351a analysis to see if she qualifies for non-recognition (because the same 351a nonrecognition rules apply to S-corps as they do to C-corps as a result of the 1371a provisions mandate that sub-c rules apply to sub-s corps and shareholders to the extent they are not inconsistent – and here they are not inconsistent. She is a person transferring property solely (although she is getting $50k cash as boot – and if this qualifies – which it won't – B would have to recognize gain on the exchange to the extent of the $50k cash boot received) for stock...but, she won't meet the 368c control test definition. She currently owns nonvoting common shares and Art owns all the voting shares. Furthermore, she is receiving a new class of non-voting preferred → she has no voting stock – thus, she certainly doesn't have 80% of it (nor does she have 80% of both all types of stock). If she and Art were both acting under an integrated plan, this problem would be cured by the inclusion of Art – but there is no mention of an integrated plan in the problem – so I will assume that there isn't one (unless I have time at the end of the problem – because they are only days apart – 5/28 & 6/2**). As a result, B will recognize all $120k of built-in gain in Whiteacre upon contribution and receipt of the $250k of C-class stock and $50k of cash. She will likely be LTCG to her because she doesn't appear to be a dealer in real estate, she held it for investment, and she owned it for more than one year – taxed at 15% LTCG rate → That is $18k she will owe. She will take her stock with a tax cost basis of $250k and the cash as...well, cash. The corp will take a carryover basis increased by the amount of gain B recognized under 362a of $300k.

On 6/2, this is clearly no longer a S-corp and Art contributed an appreciated computer (equipment) in exchange solely for stock. This won't qualify for 351 nonrecognition either because, even though he is a person contributing property to the corp and receiving solely stock, he doesn't meet the 368c control test either. He may own 100% of the voting stock, but he doesn't own the requisite 80% of all outstanding classes – namely class B (he owns none) and

class C (he owns approximately 18%). Also – there is no mention of an integrated plan (which would have cured his problem too – giving him non-recognition) and his transfer is apparently unrelated. So Art will recognize $35k of gain – likely ordinary income – because this doesn't seem to be a capital asset (computers aren't investments). Furthermore, if the difference in the computer's FMV and basis were due to depreciation deduction, rather than from the fact that computers decline in value rapidly – it would definitely be ordinary recapture income. He would then take a $55k tax cost basis in his class C shares and the corp would take a $55k basis in the computer it just acquired under 362a (carryover basis from Art increased by the amount of gain he recognized).

** Assuming that A&B are able to prove that they acted according to an informal integrated plan that defined the rights of the parties and they proceeded in a timely manner – they may get 351a nonrecognition.

Under this scenario – B would realize $120k, but only recognize $50k under 351b, which provides that in a 351a transaction involving boot (here the $50k cash) gain is recognized to the extent of boot – and the amount recognized is limited to the amount realized (not a problem here) That $50k would be LTCG taxed at a 15% rate (which equals $7.5k). The boot is cash, so there is no need to discuss the basis of the boot. 351b action triggers a 358 basis adjustment and B's basis in her newly acquired C-class stock would be = $180k (as calculated below)

- her exchanged basis in the land ($180k)
- minus FMV of any noncash boot ($0)
- minus cash received ($50k)
- minus recognized loss (impossible in 351 exchange – can't recognize loss)
- plus dividend received ($0)
- plus gain recognized ($50k)

B can tack her holding period in the property under 1223(1) because it appears to be a capital asset.
Under 362a the corp would take a carryover basis increased by the gain B recognized of $230k and under 1223(2) it can tack B's holding period.

As far as Art is concerned in this pro-351a scenario – he would realize $35k and recognize nothing. He would take a carryover 358 basis in his newly acquired class-C stock of $20k – but he likely can't tack his holding period under 1223(1) because this isn't likely a capital or 1231 asset.
Under 362a the corp would take a carryover basis of $20k in the computer and it could tack Arts holding period under 1223(2) – although it is likely useless to them.