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Book 3 of 3 Books

Examination Number 7761

Subject of Examination
Corporate Tax

Date of Examination
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NORTHWESTERN SCHOOL OF LAW

LEWIS & CLARK COLLEGE

EXAMINATION BOOK

Instructions

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6. If you type your examination, use unruled paper. Put your examination number, subject of examination and date of examination on each page and on a cover sheet to be provided. Assemble in page order, place cover on top and staple (or otherwise secure).
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Question 3

[1] Assuming Newco (N)'s only voting shares are the 10 shares distributed to Rachel (R). Then, R meets the requirements of 351: (1) she contributed property, here cash, to the corporation; (2) solely in exchange for stock; and (3) immediately after the exchange, R control 100% of the corporation. Therefore, R will be eligible to the non-recognition treatment under 351.

Since R contributed only cash, she does not have any realized gain or loss. Her basis in the 10-share voting stock will be cost basis of $20K. Stock is capital asset; if she later sells the stock, the gain or loss will be capital. No holding period issue is implicated because R did not contribute ~~property~~. other capital asset.

N Corp. will have no gain or loss, either, by receiving cash from R. Also no holding period tacking issue is involved here

here because N does not receive any capital asset from R.

[2] With regard to Sandy (S)'s contribution of ~~treasure~~, it also meets the requirements of 351. (1) S contributed land to N Corp; (2) in exchange for stock and notes; here "solely" does not ~~mean~~ means "solely" literally; shareholder may receive ~~include~~ ~~stock~~ notes, or cash other stocks. (3) Assuming S and R's transactions ~~are~~ pursuant to one plan; and it also appears to be so because they are only 2-week apart. Then S and R together meet the 80% control test under 368(c); that is; controlling over 80% of all voting shares (R & S together control 100% here); and over 80% of total ~~st~~ shares of other shares (here S & R together control 100% of the non voting). Thus, R will be eligible for non-recognition treatment under 351.

On the shareholder ~~B's~~ S level, the amount received is \$50K (FMV of stock \$18K + FMV of boots received \$32K); For the purpose of 351 transaction, note will be treated as "boot" received. ~~S~~ S's realized gain is \$35K (amount received \$50K minus basis in property \$15K); The gain will be recognized under 351(b)(1) to the extent of boot (\$32K), but no more than the amount realized (\$35K); thus ~~R~~ S's recognized gain here is \$32K; This is ordinary income.

~~Also~~ Since ~~R~~ S is a dentist, not a dealer; he will be entitled to installment method in treating the above \$32K gain under 453 (because he receives ~~note~~ boots that is payable over 4-year). The ratio of the installment method is determined by: $\frac{\text{all recognized gain (\$32K)}}{\text{FMV of all boots received (\$32K)}}$ ~~here, the notes~~ here, it's the note

resulting in a ratio of 1. This means when N pays off the notes, ~~every~~ the total amount of each ~~the~~ payments will be recognized at that time. Of course, this is ordinary income. Thus, when N pays \$8K on 5-29-03, S will recognize gain \$8K x1 = \$8K; this is ordinary income

the remaining \$24K gain will be recognized over the

next 3 years period when the note is paid off; namely

\$8K each year and ordinary income, too.

However, S's basis in his stock will not take into account of ~~consider~~ the

deferring effects of installment method. Thus, ~~[illegible]~~

under 358(a)(1)(A)(ii) & (B)(ii): his basis in his stock will

2 be \$15K (exchanged basis \$15K − FMV of boots, notes

here, \$32K + gain recognized \$32K).

Stock is capital asset: if S later sells the stock, the

gain or loss will be capital. Since Greenacre is capital

asset under 1231, the holding period will be tacked to

S's stock pursuant to 1223(1).

On the corporate level, there is no gain ~~or~~ to recognized under 1032. However, N's basis in ~~prop~~ Greenacre will step up gradually ~~becau~~ as ~~the~~ N pays off the note. Thus, on 5-29-03, N's basis in the property under 362 will be \$23K (exchanged basis \$15K + first recognized gain of \$8K). As S recognizes gain on the installment payment of the note, N increases its basis in the property from ~~\$32K~~ \$23K to \$47K over the next 3 years.

If N later sells Greenacre, the gain or loss will be capital under 1231. Since Greenacre is capital asset under 1231, the holding period will be tacked onto it while it is held by S. However, N does not really care too much about tacking because there is no ~~favorat~~ favorable rate for LTCG for corporate taxpayers.

With regard to the S election, the tax consequens are as follows.

[3] First, N meets the requirements of being a "small business corp." under 1361(b). N (1) is a domestic corp.; (2) not an ineligible corp; such as insurance ~~corp~~ companies. (3) only have 2 shareholders R & S, far from the 75 limit. (4) both of whom are U.S. citizens and (5) only one class of stock; notice that if 2 classes of common's only difference is voting, then they are considered as one class.

~~Seco~~ Second, ~~N~~ N makes an effective election in the same taxable year. N got ~~all~~ shareholder's ~~consent~~ consent from both R & S, N made the election within 2.5-m of the taxable year on 3-14-04; thus, N will become an S corp. for the taxable year of 2004 under 1362(a).

For 2004, N, as S corp. has income of $15K. Under 1366, this income will pass through to shareholders

R & S proportionately based on their respective ownership
of sticks. Here R and S owns 50% each of N's
2 common stock. Thus, R gets $7500 ~~ga~~ income and S
get $7500 income.

Under 1367, the pass through income will be taxed
to the shareholders R & S as ordinary income. Thus, R
2 & S each reports $7500 gain for 2004. The gain
will increase their respective stock basis under 1367.
Thus, R's stock basis increase from $20K to $27,500 &
S's stock basis will increase from $15K to $25,500.

If N further distributes the gain of $15K to S & R.
Under 1368, there is no further tax consequences to S & R.
But, S's basis will be reduced from $25.50K back to
$15K; and R's stock basis will be reduced from $27,500

back to $20K.