Exam # 7290 Corp Tax--Bogdanski 19 Spring, 2002 7 pages total (no staple)

QUESTION ONE

Tarco

In this asset sale, T will recognize gain on the assets. T realizes a total gain of (280k – 125k) + 20k (liability assumed) = $175k. This must be treated as a sale of each individual asset. Since there was no allocation of purchase price for each of these assets, allocation of the $155k gain realized must happen per § 338(b)(5) regs under the residual method of allocation. (§ 1060). Consideration will first be given to Class I assets (cash and cash equivalents). Thus, 50k of the 280k will be allocated to cash. T will recognize no gain on the "sale of cash." (I'm assuming the cash listed as an asset went along with the assets). Next, the accounts receiveable must be valued and allocated a percentage of the sale. Likely there will be no gain on the accounts receivable. Next the inventory will be valued. Any gain or loss above or below the adjusted basis of $12k on this inventory will be recognized by T as ordinary income. Finally, the land will be valued. Any gain or loss on the land over and above the adjusted basis of 34.5k will be recognized by T as capital gain or loss. On the liquidation to its SHs, no gain or loss will be recognized as cash is being allocated. T will hope that as much as possible is allocated to the land as it will be capital gain.

Jen (Wife)

Assuming that the amount of cash being liquidated is 280k, Jen will receive 140k on the liquidation. Under § 331, Jen can treat the liquidation as a sale of her stock. Thus Jen recognizes a capital gain of 140k – 50k = 90k on the liquidation. She will also have 20k of ordinary income on the sale of the covenant not to compete. Since she is 68 years old, there is some risk that the covenant not to compete may raise an eyebrow at the IRS. As she probably has 20 years left in her, the covenant will probably work and will not be reallocated by the IRS.

Justin (Husband)

Justin will also receive $140k on the liquidation. Under 331, this is a sale of stock. He recognizes the same capital gain as does Jen: 140 – 50 = 90k on the liquidation. He will also have 20k of ordinary income on the covenant not to compete. However, his covenant is much more suspect for allocation purposes. He is 72 years old and was not an active member of the biz. Depending on how much knowledge he has of this particular biz, his covenant likely is not worth the same amount as his wifes. There is a danger, then, that some of the covenant's price may be allocated by the IRS to the asset sale. Also, the fact that they are moving to Hawaii suggests that they have no plans whatsoever of competeing with Parco.

Parco

As describe above in the Tarco section, this transaction must be treated as a sale of each individual asset. All the items must be appraised and valued and then allocated according to the 338 regs. P will take an overall basis (§ 1012) of 280k + 20k (liability assumed) = 300k in the assets. This basis will be allocated to each individual item according to the allocation under the residual method (described above). P will want as much to be allocated as possible to the inventory, since this will have the quickest turn-around after the sale. P will get no depreciation in the land and will only be able to use that basis when P sells the land eventually. P also will take a cost basis in the covenants of $40k (§ 1012). This assumes that the IRS won't reallocate the amount put on the covenants. Under § 197, P must amortize its basis in the covenants over 15 years.

QUESTION TWO

Part A

The first issue is whether this redemption of Andrea's (A) stock is a possible dividend or whether it will qualify as an exchange under § 302. To qualify, it must meet one of the categories listed in 302 (b)(1) – (4). First, A's actual and constructive ownership before and after the redemption must be determine (off the bat, this does not qualify for a 302(b)(3) or, apparently, as the biz isn't changing, a (b)(4)). Before the redemption, A owns her own shares (50) and constructively own's her son, B's shares (50), per § 318(a)(1). Thus A constructively owns 100 of the 150 shares outstanding before the redemption (66.6%). After the redemption, A constructively owns 75 of the now outstanding 125 shares (60%). Thus, A's change in ownership constructively goes from 66.6% to 60%. She will not qualify for a (b)(2) (substantially disproportionate distribution) as her ownership is not below 50%. Thus, A's only chance to not have this be a dividend is § 302(b)(1) ("not essentially equivalent to a dividend"). Under *Davis*, the attribution rules apply to this determination and we're looking for a "meaningful reduction of the shareholder's proportionate interest." Rev Ruling 75-502 says that a substantial change in the voting structure of a corporation can be a meaningful reduction. However, applying the attribution rules, A's voting power only goes from 66% to 60%, still a majority interest. Additionally, under Rev Ruling 85-106's reasoning even if attribution rules didn't apply, one would speculate that A and B would team up and vote together. Thus, this is not a qualified redemption under § 302, it is possibly a dividend.

The next issue is whether this distribution to A is a dividend under § 302. A dividend is a distribution out of the current year's E&P or out of the accumulated E&P. On Jan 1, 2002, there is $200k E&P. However, there is a loss for the year of $360k, this number must be determined

at the end of the year, per § 316(a)(2). If the amount of losses mid-year could *actually* be calculated, then A might be able to get away with no dividend as E&P might be negative. However, there is no indication that this number is known. At the end of 2002, E&P is a negative 160k, however, we must use the IRS's method as set forth in 74-164 for purposes of determining the amount of E&P on July 1. The E&P for purposes of determining the distribution on July 1 is: 200k (accum E&P) – (360k/2) = 20k. Thus, 20k of the E&P will create a dividend of 20k to A. This 20k will be ordinary income to A. The remaining 30k of the distribution will be applied against the basis of A's stock. Thus A's basis in her stock is reduced from 35k to 5k. The corporation should check with state law first to make sure it can distribute $ when there is not enough E&P. The corp's E&P at the end of 2002 is: 200 (accumulated) – 360 (NOL) – 20k (dividend) = - 180k.

Part B

There's a remote chance that Ed could have some tax consequences from A's distribution. Under § 305(c), the IRS can treat this as a dividend to Ed. The IRS could be really nasty and say that the same result could have been reached by giving each SH an option to take $50k or to take a certain amount of shares. If this were to happen, B would be taxed on the FMS of the "shares" he took out. However, under Reg § 1.305-3(b)(3), an isolated redemption will not be treated as a § 305(b)(2). This is an isolated redemption and without a series of redemptions, Ed will be alright.

24

QUESTION THREE

The first issue is whether and what transactions qualify for a § 351 transaction. Under § 351, one or more persons must transfer property to a corp "solely" in exchange for stock in such corp and immediately after the exchange such persons must be in "control" of the corp. Control is defined in § 368(c) to be the ownership of at least 80% of the total combined voting power of all classes of stock that can vote and at least 80% of the total number of shares of all other classes of stock of the corp. Thus, Rachel's (R) initial transfer will definitely qualify for § 351 treatment because she owns 100% of all stock of N at the time of her transfer and because money counts as "property." Actually, R doesn't even need § 351 b/c she is just putting money into the corporation—this is just a stock for cash transfer. The real issue is whether Sandy's (S) exchange will qualify for § 351. In order to do so, R and S need to combine their transactions so that the control group includes R and S. The facts say that on May 15, Rachel *and* Sandy form a new corporation. Thus, it is very likely that these exchanges were part of a common. Reg. § 1.351-1. It would be even better for R and S if the plan was written in the incorporation documents somewhere. For purposes of the following analysis, the 2 transactions will be treated as part of a common plan. Thus, R and S have control of the corp and the entire step-transaction qualifies for § 351 treatment.

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On R's transfer, R does not need § 351 and she does not realize any gain on the transfer of § 20k cash to N. R takes a 20k cost basis (1012) in her N stock. Under § 1032, N recognizes no gain or loss on this transfer on any of the transactions.

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On S's transfer, the story is a bit more complicated. First, it should be noted that there is $32k of boot going to S in this transaction (the note). S realizes a gain on the transaction of (32k

+ 18k) – 15k (basis in property) = $35k. Under § 351(b), 32k (the boot) is recognized. S's basis in the stock is: 15 (basis in property) – 32k (noncash boot) – 0 (cash received) – 0 (loss) + 0 (dividend) + 32k (recognized gain) = 15k. It should be noted that Reg § 1.453(f)(3)(ii) says that S can have all the recognized gain from the note for purposes of determining basis. The next issue is *when* will S have the 32k of gain. Under § 453 (and regs), this can be treated as an installment sale. Thus the gain will be recognized according to the Gross Profit Ratio = payment X ((gross profit)/(total K price)). The gross profit is the total amount of recognized gain, $32k. The total contract price is 32k. Thus, no gain is recognized immediatedly to S and the rest of the gain will be recognized to S as each payment is made. Each payment will be recognized to the tune of 8k (8k X (1/1)). Thus on May 29, 2003, S has 8k of capital gain. The corp basis in the land is 15k (SH's basis in property) + SH's recognized gain. Thus the corp's immediate basis is 15k and the corp will get to add more basis as it is reported by SH. Thus, on May 29, 2003, N's basis in the land increases to 23k.

On the S-corp election issue, the first issue is whether the election indeed qualifies. It must be a small biz corp and all SHs must consent for the election to be good. S and R both consented to the election, thus that factor is taken care of. N should qualify as a small biz corp. I'm assuming it's a domestic corporation. The 75 SHs requirement is easily met as there's only 2 SHs. Neither R nor S can be non-resident alien. I'm assuming they are not. There's a possible issue with the one class of stock requirement. R has voting common and S has nonvoting common. This requirement will be met however, as long as the *only difference* (no difference in dividend/liquidation preference, etc) between the 2 classes of stock is voting rights, which apparently it is. Both S and R are obviously "individuals." Thus the S corp election is good.

The next issue is *when* is the S corp election effective. It is good for the current year (2004) in this case if it is filed within 2.5 mos of the beginning of the current year. Mar 14, 2004 just barely makes it. Thus the S corp election is good for 2004.

The next issue is how the taxable income of 15k for 2004 is treated. Under § 1366, the income and losses from the S corp "pass thru" to the SHs based on their pro rata . Thus, in 2004, $15k of income "passes thru" to R and S. The character of this income is determined at the corporate level. There's no indication of what type of biz N is running, but suffice it to say, that if this gain is ordinary, then R and S will report ordinary income and if the gain is capital, they will report capital gain. Under § 1367, when the income passes through to R and S, their basis in the stock of the corp will increase by that amount. Thus, R and S's basis increases by the amount of the $15k income that is allocated to each of them, respectively. Finally, it should be noted that this $15k of income will create an "AAA" account (with $15k in it) for purposes of determining whether future distributions are dividends. There are no tax consequences to N on the switch from an S corp to a C corp. As N isn't paying out any distributions, it should be advised of the lurking accumulated earnings tax.