**Business/Partnership Tax Problems**

1. **Partnership Tax**

**SOURCES OF PARTNERSHIP TAXATION**

* *Problem 19-1*
  + X and Y form XY partnership
  + A 30-year bond is donated by Z for only charitable uses
  + X and Y do not report any income because they do not have the right to any income from the bond
  + Is the position X and Y are taking correct?
  + If not, what would be the correct analysis?
  + **Taxed.** Partnership does *own* the bond (if title was transferred and if not gift). If equal partners, taxed on half of income via pass-through, but receive separate matching charitable deduction, assuming each partner has matching taxable income and has not exceeded 50% charitable income cap.

**Formation of Partnership**

* *Example*
  + Suppose A and B form a partnership
    - A contributes land worth $5,000 with a basis of $2,000
    - B contributes equipment worth $5,000 with a basis of $6,000
  + The partnership runs a business and earns $4,000 in cash
    - Nothing is distributed
  + Taxed each on $2k of income, and outside basis for each is increased by $2k (outside basis goes in proportional to amount of income allocated to partners).
* *Problem 19-2*
  + XY partnership receives a gift of a bond. Donor’s basis in bond was $800, and FMV is $1k.
  + If not a gift, bond is income to partnership. If gift, get carryover basis (just as person would). **Outside basis** is *increased* by $800 ($400 for X; $400 for Y) for income and tax-exempt income.
    - $800 is exempt from tax (b/c it’s a gift), but defer the $200 taxable appreciation to later.

**Nonliquidating Distributions**

* *Problem 19-3*
  + Ten individuals form partnership by contributing $10,000 each
    - P uses the $100,000 to buy real estate and earns $30,000
    - P distributes $15,000 and retains $15,000
    - One partner sells her interest for $15,000
      * How much gain does she have on sale?
      * What other income did she have, and when?
    - Note that the sale price implies that the partnership is worth $150,000 now
      * What does this tell you about the value of the partnership assets?
      * Does this further information about partnership asset value change anything in your analysis?
  + Each partner recognizes $3k of gain as income (flow through to the partners), and outside basis for each is raised by $3k. Each partner then receives $1.5k, so outside basis lowered by this amount.
  + When partner sells for $15k 🡪 recognize gain of $3.5k (difference between outside basis and sale).
  + Tax only concerned about realization events, not about market increase in partnership value.
* *Problem 19-4*
  + Individual C is a one-quarter partner in CDEF partnership.
    - C receives a distribution of property worth $20,000 with an adjusted basis to the partnership of $14,000
    - What are the tax consequences to C if his outside basis just before the distribution was
      * A) $35,000
      * B) $15,000
      * C) $10,000
    - How would the answers change if the $20,000 had been in cash, rather than in property?
  + A) Reduce outside basis by $14k (inside basis) 🡪 outside basis reduced to $21k. No gain recognized.
  + B) “ “ by $14k 🡪 outside basis dropped to $1k. No gain recognized.
  + C) “ “ 🡪 outside basis to 0. Basis in property is $10k (would like to get to $14k, but $10k is all P had to give).
  + If cash, no change in A, but for B&C, forced to recognize gain (and are taxed) on difference ($5k for B; $10k for C).
    - For taxable gain in distribution 🡪 cash has to be involved, and it must exceed your outside basis.
* *Problem 19-5*
  + H has a $10,000 outside basis in her interest in PQ partnership
    - PQ owns Blackacre with a basis of $12,000 and a fair market value of $18,000
    - PQ distributes Blackacre and cash of $6,000 to P
  + How is this taxed if
    - Cash is distributed first, and then Blackacre
    - Blackacre is distributed first, and then cash
    - Both Blackacre and cash are distributed at the same time
  + If cash is distributed first, outside basis is reduced to $4k, and no gain recognize. Then for property, outside basis is reduced to 0 and basis in Blackacre is $4k.
  + If property first, outside basis to 0, and basis is Blackacre is $10k. Then pay $6k taxes.
  + If distributed simultaneously 🡪 act like ***cash is distributed first***.

**DETERMINING DISTRIBUTIVE SHARES**

**General Test for Economic Effect**

* *Book Example* (p. 604-606)
  + If depreciation schedule is more aggressive than economic reality, then need “chargeback” *if* this is more in line with the party’s intent. E.g. Property worth 10k. 4k worth of depreciation deductions, then sold for 9k. P who took deductions needs to pay 3k to other P.
* *Problem 20-2*
  + P and Q form PQ partnership
    - They agree on bottom-line allocations
      * If there is a loss for the year, it is allocated 60 to P, 40 to Q
      * If there is a net income for the year, it is allocated 50 to P, 50 to Q
    - Are the partners’ capital accounts time dependent?
      * That is, does it matter how gains and losses happen to be broken up across years, or is it only the aggregate amount over time that matters?
  + Potentially. In years where there is no loss, then no difference in allocation. But if loss, then will be difference. So will matter hugely how choppy your income stream is.
    - Suppose the partnership earns $10,000 in its first year and loses the same amount in its second year. In year 1, the gain is allocated 50/50, so that P's capital account is increased by $5,000 as is Q's capital account. In year 2, the loss of $10,000 is allocated 60/40, so P's capital account is decreased by $6,000 and Q's capital account is decreased by $4,000. Thus, over the two years, P's capital account is down $1,000 while Q's capital account is up by the same amount. Yet, had the gains and losses been incurred in a single year, there would be nothing to allocate, and so there would be no change to the capital accounts.
* *Problem 20-3*
  + X and Y form XY
    - They contribute $1,000 each
    - They want to split losses equally, but they want to give 60% of profits to X, with the remaining 40% going to Y
      * Suppose that they want the agreement to work this way over time and not depend upon how profits and losses are broken up across years
  + See taxnerds

**Alternative Test for Economic Effect**

* *Revenue Ruling 97-38*
  + When a partner is treated as having a limited deficit restoration obligation by reason of the partner’s liability to the partnership’s creditors, the amount of that obligation is the amount of money that the partner would be required to contribute to the partnership to satisfy partnership liabilities if all partnership property were sold for the amount of the partnership’s book basis in the property.
  + See slides
  + Partnership LPRS has two partners
    - GP – a general partner
      * Fully liable to third party creditors (under state law), but not to LP
    - LP – a limited partner
      * No obligation to make additional contributions
  + GP and LP initially contribute $100x each and split everything 50/50
    - Except that GP gets all depreciation and all gain from sales of assets up to the amount of depreciation taken
      * The partners have also agreed to have a QIO
  + LPRS purchases an asset
    - Cost is $1,000x
    - Funding is $200x in cash and $800x in recourse debt (recourse to LPRS)
    - Depreciation deductions are $200x per year for five years
  + Assume all other net income is zero for five years
    - What must the allocations of depreciation be?
  + In year 1, GP cannot go below 0 because building is now worth 800, and 800 is what they owe to the bank. To go negative would be to go beyond what is owed to third-party creditors. But in year 2-5, GP can run deficient b/c it matches what he owes to the bank.
  + If sold in year 5 for $800 🡪 needs to be allocated to GP to restore negative capital account under QIO (irrespective of their agreement to allocate income separately).
  + If it sold for $1,100 🡪 first $800 would go to GP, then remaining $300 would be split as true profit.
* *Problem 20-4* 
  + M and N form MN by contributing 10,000 of cash each
    - MN purchases Purpleacre for 100,000
      * It uses its cash and also borrows 80,000
    - M and N agree to restore deficits in capital accounts only to the extent necessary to repay third-party creditors
      * A) How may the partnership allocate the first 10,000 of depreciation?
      * B) How may the partnership allocate the second 10,000 of depreciation?
      * C) How may the partnership allocate the third 10,000 of depreciation?
  + First $10k 🡪 can allocate any way the partners like.
  + Second $10k 🡪 cannot go negative (to the extend they can avoid) b/c not going below $80k mark (what they owe to creditor). E.g. 7 and 3k in first year, then would have to do 3 and 7k in second year.
  + Third $10k 🡪 both have obligation to repay creditors, so can allocate however they would like.
    - TB: there is a restriction, but it may only come into play for a little while.
* *Problem 20-5*
  + G and L form GL limited partnership
    - G is the general partner
    - L is the limited partner
  + Each contributes $60,000 in cash initially
  + GL uses the $120,000 in cash to start an art gallery
  + The agreement provides
    - L does not have to contribute anything further for 3 years, and after that he need never contribute any more than an additional $10,000
    - Income and losses are allocated 20% to G and 80% to L
  + If the partnership loses $30,000 per year for each of its first four years, how much loss is properly allocated to G each year?
    - What are the capital account balances at the end of each year?
  + (See table on taxnerds). At end of Y3 🡪 can only allocate $12k of loss to L b/c he cannot go negative ($10k obligation does not kick in until *after* Y3).
  + In Y4 🡪 can allocate losses to L up to his CA of -10k. L cannot adjust outside basis below zero.

**Contributed Property**

* *Book Example p. 616-21*
  + P and Q form partnership PQ
    - P contributes $10,000 in cash
    - Q contributes depreciable property with value $10,000
      * Depreciation follows the 5-year straight-line method
    - They agree to 50/50 split, subject to the requirements of § 704
  + Consider the following variations
    - Q’s basis in the property was $6,000
      * How does depreciation work?
      * What if PQ sells immediately for $10,000?
      * What about later sales for different amounts?
    - Q’s basis in the property was $20,000
      * How would this change any of the foregoing analysis
  + Use straight-line depreciation for both book and outside.
  + If the property is sold immediately for 10k 🡪 4k gain to Q. No adjustments in capital accounts.
  + If sold for 7k 🡪 3k of loss split evenly, and 1k gain allocated to Q. How to solve this mismatch? 3 methods (below).
* *Problem 20-8*
  + J and K form JK
    - J contributes $24,000 cash
    - K contributes $24,000 worth of property
      * Basis is $8,000; four years of a 10-year depreciable life are left
  + Compute the books of the partnership assuming
    - A) JK has no other income or loss for any year
    - B) JK has other income of $2,000 each year
    - C) JK has no other income or loss for two years, and then $1,000 of other loss thereafter
  + A) Remedial 🡪 real asset = basis: 8. Value: 24. Life: 4. Hypo asset 1 = 8 basis and 8 value and life of 4. Hypo asset 2 = 0 basis and 16 value and life of 10.
    - Total yearly depreciation of $3600 (2k for asset 1 and 1600 for asset 2) 🡪 split evenly between the partners. Limited to 2k because that is the real depreciation. Don’t need a remedy for partner K because remedies are ***only for non-contributing partners***.
    - Splitting property helped with allocating appropriate gain/loss to non-contributing P.
    - In Y5 🡪 can make up 800 in deduction as long as you give contributing partner matching amount.
  + B) Can shift 1k of income from J to K (balances the book for J).
  + C) ?
* *Problem 20-9*
  + A and B are equal partners in the AB general partnership
    - Each has an outside basis and capital account of $40,000
    - AB owns Purpleacre
      * Basis of $80,000
      * FMV of $100,000
  + C joins AB
    - Contributes accounts receivable of $65,000 and accounts payable of $15,000
      * What are the outside bases once C is admitted?
      * How do the capital accounts and outside bases change if the partnership receives payment on the receivables, makes payment on the payables, and sells Purpleacre for $160,000?
  + Once C is admitted, the CAs for A & B are “booked up” to FMV (required by regulations), but A & B are not taxed (yet) on this extra 10k of CA value at the end of the year (non-recognition).
  + C will get allocated all gain/loss in Receivables/Payables b/c he contributed.

**Substantiality Under § 704(b)**

* *Problem 20-12*
  + L and M form partnership LM
    - Contribute $10,000 in cash each
    - Purchase machinery
      * Cost is $20,000
      * Depreciates over 5 years on straight-line basis
      * Subject to recaptures under § 1245
    - Operating income of $3,000 per year
    - After 2 years, sell machinery for $28,000
    - Income and loss are split equally
      * Except depreciation all goes to L, and there is a gain chargeback for L
  + Questions:
    - A) How do the capital accounts look?
    - B) What if there is no gain chargeback
    - C) If the machinery had entitled the partnership to a credit of $1,000, what would happen?
  + A) Can L allocate ordinary recapture income to M? If don’t ex-ante, probably. If ex-post, no.
  + B) Now only 10k in gain, and Pship agreement assumes 50/50 split, but now M is necessarily going to get ordinary income (and not K-gain income). Ok? Seems like you should be fine unless you have too much of a profit.
  + C) The tax credit must be allocated according to the partners' general interest in the partnership. Presumably this would be 50%/50% because of the general sharing (other than cost recovery); the gain chargeback further supports a general 50%/50% relationship.
* *Rev. Rul. 99-43 / Problem 20-13*
  + A and B form partnership PRS
    - Each contributes $1,000
    - All items shared 50/50
    - Upon a further contribution, there is a book-up under § 1.704-1(b)(2)(iv)(f)
    - They buy property for $10,000
      * Funded by cash and $8,000 in non-recourse debt
    - The building drops in value to $6,000
      * A and B do a workout with the bank
      * $2,000 in debt is forgiven permanently
      * $500 in fees are paid, using a contribution from A
      * The partnership realigns interests: 60% for A, 40% for B
  + Why did bank write down? Non-recourse loan. B has liquidity problems. Gave cancellation of debt income to B, and loss from property drop was allocated 3k to B and 1k to B.
  + Real tax event: cancellation of debt income – 2k (gain under *Tufts*). Total of 2k loss 🡪 gave it all to B b/c he’s insolvent (and won’t be subject to taxes). And then did “book up” upon $500 contribution (1.704-1(b)(2)(iv)(f)—happens normally when new partner joins, but can also agree to do this when a new contribution is made).
  + Fails substantiality b/c they’re doing it *ex-post* to minimize tax gain b/c of B’s low tax bracket. Accelerate gain for B and deferring loss. Not changing economics, just taxes. ***Shifting allocation***.
    - If they realized loss by selling the property, then 4k loss (allocated by new structure), would result in 1k loss for both.

**Prohibitions on Retroactive Allocations**

* *Problem 20-14*
  + Suppose ABC wants to admit D as a ¼ partner 3 months into its
  + taxable year
    - Can they admit D as though he had been a ¼ partner for the entire year?
    - Can they allocate items to D from before D joined
  + Can’t allocate items to D from before D joined, but can give him a little more than the next three quarters to balance it out (e.g. make D 1/3 partner, and other partners share remaining 2/3rds). ***Can’t go back to prior time for allocation***.
* *Problem 20-15*
  + PQRS would like to admit T as a 1/5 partner on December 31st
    - T will contribute $50,000
    - PQRS wants to allocate all $60,000 worth of interest expense for the calendar year to T
      * This is because T’s contribution is funding the payment
    - Can PQRS do this?
    - What else might they be able to do?
  + No. 706 prohibits allocated interest from prior to T joining. Can only allocate the interest corresponding to the amount of the year T was in Pship. $$ is fungible. Didn’t have to pay interest with his 50k.

**A PARTNER’S OUTSIDE BASIS**

**Outside Basis and Recourse Debt**

* *Problem 21-1*
  + E and F form EF
    - Contributions of $20,000 each
    - Recourse borrowing of $60,000
    - Purchase of property for $100,000
  + Is the debt recourse, and how should it be allocated if
    - A) agreement provides losses are divided equally
    - B) agreement provides losses go 90% to E
    - C) agreement provides losses are divided equally, but F is a limited partner and is not required to contribute more than an additional $10,000
    - D) both partners are equal general partners, but E personally guarantees repayment of $60,000
    - E) both partners are equal general partners, E personally guarantees $60,000 repayment, and the debt is nonrecourse to the partnership
  + A) Yes, and each allocated $30k. Hypo liquidation, and each loses $50k. Started with $20k in basis, so end up at -$30k.
  + B) E gets to increase OB by $70k, and no increase to F (b/c doesn’t decrease CA below zero).
  + C) E increases OB by $50k, and $10k to F (all he is liable for).
  + D) Personal guarantee doesn’t mean anything b/c E can go after Pship. Both get $30k.
  + E) Entire $60k falls on E (can increase OB by this amount).
* *Problem 21-2*
  + A and B form AB
    - Each contributes $10,000
    - They allocate losses equally
    - They borrow $80,000 from R
  + Is the debt recourse, and how is it allocated?
    - Questions (see slides)
  + A) Recourse, so allocate to A and B equally 🡪 40k a piece.
  + B) B is related to R (80% is threshold for “related person” [1.752-4; 267(b)], and B owns 100%), so B is economically on the hook. B gets allocated the entirety of basis.
  + C) For nonrecourse, no related parties (75% and 25% no enough) 🡪 so allocate according to nonrecourse, which need to know how partners split profits.

**Nonrecourse Debt**

* *Example p.668*
  + X and Y form XY
    - X contributes $30
    - Y contributes $10
    - XY borrows $60 on nonrecourse basis to buy property for X
    - Property depreciates over 10 years on a straight-line basis
    - Profits and losses are split equally, except X gets 75% of depreciation
    - How do capital accounts and outside basis change?
  + Borrowing does NOT affect CA (don’t take it into account b/c will need to pay it back). Don’t worry about economic loss b/c its nonrecourse. Split according to profits interests (tier 3).
  + At end of Y4, outside basis of X and Y equal 60k = equal to outstanding debt. How to allocate this 60k debt for Y5?
    - Tier 1: 60k debt minus 50k book = 10k (7.5/2.5)
    - Tier 2: none
    - Tier 3: 50 (split 50/50 according to profits)
      * In aggregate 🡪 32.5/27.5
* *Example p.669*
  + A and B form AB
    - A contributes property
      * worth 10
      * basis of 4
      * subject to nonrecourse liability of 6
    - B contributes 4 of cash
    - How is the liability allocated?
      * Assume that A and B are 50/50, except for § 704(c) adjustments
  + Tier 1: none (book value is 10k; debt is 6k)
  + Tier 2: 2k. Need to assume sold for 6k. Under traditional method 🡪 2k OB gain to contributing partner, A (2/0). Under remedial 🡪 2k of tax gain, but 4k of book loss (but capped by ceiling). This is fixed by giving A an extra 2k in gain, and 2k loss to B (total of 4 to A/total of 2 loss to B).
  + Tier 3: 4k left, split 50/50 (2k/2k).
    - Total: (4/2)
  + Reallocation (traditional method): outside partner already had 6k of debt (contributing partner—think of A as having baseline of 6), so need to change to A-4 and B-2 🡪 reduce A by 2, increase B by 2. For remedial: gave 4k to A under tier 2, so split the remaining 2 50/50 = total to A(5), B(1).
    - For reallocation, need to ask: *what is the* ***incremental*** *gain?*
* *Problem 21-3*
  + P and Q form PQ
    - P gets 40% and Q gets 60%, except for depreciation, which is 50%/50%
    - P contributes depreciable property
      * Value = 10,000
      * Basis = 4,000
      * Nonrecourse liability = 6,000
    - Q contributes 6,000 cash
    - A) What are the initial capital accounts and outside bases?
    - B) What happens after 1 year, assuming no other income or loss, and 5 years of depreciation remaining (but 10 years for new property)?
  + Traditional method:
    - Tier 1: none.
    - Tier 2: Traditional method 🡪 allocate 2k gain to P.
    - Tier 3: allocate remaining 4k 60/40.
    - Allocation: assume P had 6, so reduce by 2.4, add to W 2.4.
  + Remedial method:
    - (see slides)
  + (b) How much depreciation is there on this asset under the remedial method? Two assets – (1) basis of 4, deemed value of 4 – life of 5. (2) deemed basis of 0, deemed value of 6 – life of 10.
    - First year – deprecation on (1) of .8, and on (2) of .6 🡪 Total of 1.4 (.8 of real tax depreciation b/c real basis is 4 w/ 5-year life). We want tax to follow book, so we give Q .7, and give remaining .1 to P.
* *Problem 21-4*
  + X and Y are equal partners in XY
    - Capital accounts and outside basis of $3,000 each
  + Z joins
    - Contributes machinery for 25% interest
    - Machinery has
      * Basis of $15,000
      * Value of $20,000
      * Debt of $18,000
    - Assume p’ship has only $6,000 in cash in addition to machinery, and suppose $6,000 in depreciation occurs in first year
    - What are the partners’ outside bases?
  + 6k in tax deprecation is same as 8k in book deprecation (6/15 = 8/20). Give all 6 to XY b/c we ***always want tax to follow book, if possible***. No change in debt reallocation b/c we did not hit the ceiling rule 🡪 never have to re-reallocate debt when do not hit ceiling.

**NONLIQUIDATING DISTRIBUTIONS**

**Distributions and Capital Accounts**

* *Problem 22-1*
  + X is a partner of P
    - P distributes
      * Cash of $11,000
      * Capital asset #1 with basis of $6,000 and fmv of $9,000
      * Capital asset #2 with basis of $24,000 and fmv of $18,000
    - X has an outside basis of $31,000 at time of distribution
      * How much gain or loss is there, and how is basis allocated across assets?
  + Would to take full inside basis in two properties, but not enough outside basis after decreases OB by 11k in cash. So need to allocate. First, 6k to CA #2 w/ built-in loss. Allocate the remaining 4k pro rata.
  + No final gain/loss. (Cannot get gain unless cash exceeds outside basis, and cannot get loss unless liquidating distribution, and you’re getting less than your OB).
* *Problem 22-2* 
  + See slide
* *Problem 22-3*
  + See slide
  + You “book up” then deduct CA by new book value (FMV). This affects all partners, kind of like a sale in capital accounts world 🡪 net downward adjustment for A of 36k. Outside adjustment of 22k = disparity of 14k. Potentially, 10k can be cured, the other book up value distributed to other Ps (4k is a permanent book/tax disparity that cannot be eliminated until Pship liquidation). *Can remedy all disparity except that which was permanently lost by outside basis allocation*.

**Distributions of Encumbered Property**

* *Rev. Ruling 79-205*
  + Equal 50/50 Pship, so each has equal liability of debt prior to distribution.
  + A’s outside basis is reduced to 0 ($600 of debt reduction, and $400 worth in new property), and basis in distributed property is $400.
* *Example p.692*
  + K and L are equal partners
    - Each has a capital account of 10,000 and an outside basis of 13,000
    - The partnership has
      * $13,000 in cash
      * Whiteacre
        + Basis, book, and market value of $8,000 (note: text omits “book” here)
        + Subject to debt of 6,000
    - What happens if Whiteacre is distributed to K?
  + Debt consequences
    - Each partner’s share of partnership debt goes down by 3,000
    - K’s share of personal debt goes up by 6,000
    - Thus, outside basis changes as follows:
      * Up 3,000 for K
      * Down 3,000 for L (floored at zero, under § 733)
        + Query: what would happen if net debt relief to L had been greater than L’s outside basis?
  + Basis of asset distributed
    - Carryover, under § 732
  + Capital accounts
    - K’s capital account is reduced by net economic value received
    - Note that no “book up” of asset was necessary because book value = fair market value
* *Problem 22-4*
  + See slide
  + 9k reduction in C’s CA is the actual amount of economic value being distributed (15k FMV – 6 of recourse)

**Character of Distributed Assets**

* *Problem 22-6*
  + Partnership P distributes assets to X in nonliquidating distribution
    - Assets had
      * inside basis of $12,000
      * Fair market value of $15,000 at time of distribution
    - At time of distribution, X had an outside basis of $12,000
  + What are the tax consequences if X sells in 3 years:
    - A) for $20,000, and assets were inventory to partnership and capital to X
    - B) for $20,000, and assets were capital to partnership and inventory to X
    - C) for $10,000, and assets were inventory to partnership and capital to X
    - D) for $20,000, and assets were unrealized receivables to partnership and capital to X
  + A) OI of 8k (all increase is tainted) 🡪 within 5 years.
  + B) OI of 8k 🡪 *ordinary* to X, so doesn’t matter if it is k-gain to Pship (distribution will never turn ordinary income into k-gain).
  + C) OL of 2k (within 5 years)
  + D) OI 🡪 *receivables* are always ordinary.

**A PARTNER’S TRANSACTION WITH THE PARTNERSHIP**

**Disguised Sales**

* *Example p.714*
  + A and B form AB
    - A contributes property with basis 40 and value 100
    - B contributes small amount of cash
    - A and B will divide profits and losses equally
  + After formation,
    - AB borrows and distributes 100 to A
    - What are the taxpayers trying to achieve?
    - What does § 707(a)(2)(B) say
  + Trying to mimic sale, and now it’s not just A on the hook (b/c done through the Pship). If you took Pship away, no problem. Just borrowing. But here, it’s debt owned by a different person (the Pship). Essentially, A sold property.
* *§ 1.707-3(f): Example 1*
  + A transfers property to partnership AB
    - FMV is 4 million
    - Basis is 1.2 million
  + AB immediately transfers 3 million in cash to A
    - Assume that this is treated as a part-sale under § 707(a)(2)(B)
    - What is the appropriate treatment?
      * Specifically
        + What are A’s outside basis and capital account balance?
        + What is the partnership’s basis in the asset?
        + What are the tax consequences to A?
  + Scale down asset/basis/built-in gain by 75% (amount we’re saying P is selling to Pship). Think of asset in two parts:
    - Whole asset
      * Value: 4m
      * Basis: 1.2m
    - Sale Part
      * Value: 3m (divided into CA of partners)
      * Basis: .9
      * Taxable gain: 2.1m
    - Contributed Part
      * Value: 1m (will become CA)
      * Basis: .3m (will become OB)
* *§ 1.707-3(f): Example 2* – same as 1, but happened a year later
  + Same as last example, except that
    - The transfer occurs one year later
    - The transfer is still deemed a part-sale
    - The applicable federal rate is 10%, compounded semiannually
  + Note that the present value of the 3 million payment is now about 2.7 million
    - How does this change things?
    - How do the OID rules and the installment method come into play?
      * Who are the parties that get the interest deductions and inclusions?
  + Basis of sale part is .8m (new sale amount scaled over 4m), and the value becomes 2.7 🡪 taxable gain of 1.8m
  + Contributing partner is taxed on .3m? \*\*\*Need to ask about
  + Contributed Part
    - Value: 1.3 (CA)
    - Basis: .4 (OB)
* *Problem 23-3*
  + Z joins XY general partnership
    - Z contributes property with
      * fmv of $100,000
      * basis of $40,000
  + One day later, the partnership distributes $50,000 to Z
    - A) What are the tax consequences to Z?
      * What are outside basis and capital account for Z?
      * What is partnership’s adjusted basis in the contributed property?
    - B) How would things change in they had waited a year for the distribution?
      * Assume the applicable federal rate compounded semi-annually is 10% and that the present value of the $50,000 payment is thus about $45,00
  + Looks like disguised sale (within 2-year presumption). Under DS rules, selling essentially half of his property 🡪 can put 20k of basis towards sale.
    - Sale Part for P
      * Amount realized: 50k
      * Basis: 20k
      * Gain: 30k
    - Contributed Part
      * OB: 20k
      * CA: 50k
      * Inside basis for Pship: 70k (20k carryover basis from contributed part and 50k they paid for sale part)
  + B) Adjust for interest. What you’re really getting is 45k 🡪 need to properly scale down.
    - Gain and Income to P
      * Gain: $27k
      * Interest Income: 5k
      * Interest Deduction: 5k (if all allocated to P)
    - NO capital account changes or gain/loss for ***other partners*** 🡪 simply an exchange of assets

[Qualified Liabilities]

* *Problem 23-4 (see slides for tables)*
  + P and Q form PQ
    - P contributes $800,000 in cash
    - Q contributes property
      * Fair market value of $1,600,000
      * Adjusted basis of $900,000
      * Subject to debt of $800,000
    - P and Q are equal partners for everything, and neither is liable for the debt
    - What are the initial capital accounts and outside basis?
  + Nonrecourse debt. Reduce 400k from Q’s OB b/c he was relieved of this amount of debt.
  + If assume non-qualified 🡪 treating the debt relieved of as cashed paid out (*Tufts/Crane*), and treating as disguised sale the portion of the debt that CP is getting rid of in relation to the FMV of whole. The debt relief ***is*** the disguised sale.
    - FMV: Entire Property = 1.6k; Sale Part = 400; Contributed Part = 1.2k
    - Basis: EP = 900; SP = 225; CP = 675
    - Debt: EP = 800; SP = 400; CP = 400
    - Recognized Gain: EP = 175; SP = 175 (400 – 225); CP = 0
      * Now, basis for SP will be 400 (just “bought” it), and basis for CP is 675
    - Debt split 50/50 b/c for non-qualified sales, only use tier 3. First, need to nail down the amount of debt the CP is being relieved of 🡪 then you can find fraction of whole and work through the steps.
* *Problem 23-5*
  + X owns unimproved real estate
    - Basis is $400,000
    - FMV is $2,000,000
  + X builds a building on the real estate
    - Cost is $2,500,000
    - New FMV of entire property is $5,000,000
  + X contributes property to partnership
    - What is the maximum reimbursement for construction costs that can be made without triggering a disguised sale?
      * See § 1.707-4(d)(2)(ii)
    - How might X have structured the transaction to permit a greater reimbursement without triggering tax liability?
  + Disguised sale? No if made to reimburse for expenditures ($$ to build building) in 2 years prior, BUT only to the extent that expenditures do not ***exceed 20% of FMV***. BUT this limit does not apply if the FMV of contributed property does not exceed 120% of partner’s adjusted basis in the contributed property at the time of contribution. So, if the property is not appreciated substantially, then no cap. Here, only $1m can be paid out before there is an disguised sale.
    - How to avoid this? Try to pay for expenditures through indebtedness 🡪 exception for “qualified debt.” If you take debt to pay for capital improvements, then disguised sale won’t be triggered. Arbitrary rule (form over substance).
    - If 120% basis is greater than FMV, then you can get unlimited amount out (?)

**Dispositions of Contributed Property**

* *Problem 23-6 (see slides for tables)*
  + P and Q form PQ
    - P contributes property with basis of 6,000 and fmv of 10,000
    - Q contributes 10,000 cash
  + Property depreciates on straight-line basis over 5 years
    - PQ does not use remedial method
  + After 1 year, property is distributed to Q
  + What consequences if value at time of distribution is
    - A) 10,000
    - B) 12,000
    - C) 4,000
  + A) CA: 10k. Basis: 4.8k. Treat as sale to 3rd party.
    - Gain to P: 3.2k 🡪 treating it as triggering the built-in gain. No affect on CA b/c its 704(c) item.
    - Book-up of property (704(c) sale) 🡪 book gain is split 50/50.
    - ***Only*** 704(c) gain is taxed 🡪 the remaining 2k of gain is reflected in the CA and will be taxed upon distribution of the partnership.

**737**

* *Problem 23-7 (see slides)*
  + P and Q form PQ
    - P contributes property
      * Basis of $6,000
      * FMV of $10,000
      * Depreciable over 5 years
    - Q contributes land with
      * Basis of $2,000
      * FMV of $10,000
    - P and Q are equal partners, except as required under § 704(c)
      * Also, no remedial allocation election
    - A) How would Q be taxed under § 737 if PQ distributes the depreciable property to Q after one year when its FMV is $10,000?
    - B) How would the answer change if the land had had a basis of $9,000 at the time it was contributed by Q?

**Capital Avoidance**

* *Problem 23-8*
  + (See slides for facts)
  + In the first case, no taxable income to Y. In the second case, 1m is taxable to Y. X gets taxed the same, but in case 1, it allows Y not be taxed. The difference is from the *payors* point of view 🡪 cannot deduct extra 2m b/c its payment for an asset (would need to be included in the basis of the asset and capitalized). How to make this work? Can make any part of the payment “special allocation” that bears genuine risk (here, the 2m would be ok if it was not certain that this money would materialize).
    - If what *really* is going on is a sale, but value is just being moved to special allocations to avoid taxation on other P.

**ACQUISITIONS OF PARTNERSHIP INTERESTS**

**Contributions of Property**

* *Problem 24-1*
  + A and B form AB
    - A contributes Whiteacre
      * Basis of 60
      * Fmv of 120
      * Recourse debt of 20
    - B contributes Blackacre
      * Basis of 25
      * Fmv of 260
      * Recourse debt of 160
  + A and B will split P&L 25% / 75%
    - What are the partner’s initial capital accounts and outside bases?
  + For contributed debt, need to look at whether it is recourse or nonrecourse (three tiers). Here, recourse 🡪 do hypothetical sale, see what book loss is (in CA; here A has 5, and B has -185), and allocate debt ***in proportion*** to negative CA balances (B gets all $180 of indebtedness; B originally had 160, A had 20, so reallocate 20 from A to B).
  + If allocation of debt reduces outside basis below zero 🡪 ***taxed on this amount***
* *Problem 24-2*
  + X, Y and Z form XYZ
    - X contributes accounts receivable of 150 (basis 0) and accounts payable of 50
    - Y contributes land with basis 120 and fmv 100
    - Z contributes property with basis 40 and fmv 300, and subject to 100 of debt
    - Percentage interests are 25/25/50
    - A) What are the outside bases and capital accounts of the partners if the receivables are collected, the payables are paid, and the property is sold for fmv immediately?
    - B) what is the character of the partnership’s income and loss?
      * See § 724(a)
    - C) Was the partnership entitled to tack the contributing partner’s holding period?
      * See § 1223(2)
    - D) How do the answers change if the interests are 20/20/60?
  + X has CA of 100 🡪 accounts payable is like debt.
  + Total hypo loss of 550. Does payables give you 50 of gain? If so, only loss of 500.
  + A) X receives all 150 of accounts receivables under 704(c) and 50 loss is allocated to X, again 704(c). Same for 20 loss to Y, and 260 gain to Z. What happened to the debt? Problem didn’t say the debt was paid off.
  + B) Character of income/loss?
    - Y property: assuming property was capital asset in hands of Pship, then capital for Y
    - Z property: every reason to think this is capital for both.
    - X property: unrealized receivables are ordinary income/loss (724(a)).
  + C) Tacking permitted for both assets under 1223(2).
  + Because of debt reallocation, you can have *gain* to a P, in this case, Z.
  + D) Z ends up with all of the indebtedness, and since Z started with all the indebtedness, there is no debt reallocation.

[HOLDING PERIOD RULES]

* *Example p.747*
  + X has held a partnership interest for 10 years
    - Basis is $300 and value is $500
    - It is held as a capital asset
  + X contributes an extra $250 in cash
  + 6 months later, X sells the partnership interest for $750
    - What result?
      * Consider what the basis is
      * Then calculate income under § 1001
      * Then determine holding period to see whether it is short-term or long-term
  + Start w/ basis of $300, and contribute cash 🡪 raises OB to $550. When sell for $750 = gain of $200.
  + Holding period for this gain? 1/3 gain is short term from cash. 2/3 of gain is long-term from asset.
  + If you put in more long-term assets, can up the percentage that goes to long-term gain.

[CHARACTER RULES]

* *Example p.748*
  + Property is contributed to a partnership
    - Basis is 120
    - Value at contribution is 100
    - Capital asset to partner
    - Inventory to partnership
  + What happens if the partnership sells the property for
    - 75?
    - 105?
    - 150?
  + 75 🡪 loss of 45, 20 of which is capital.
  + 105 🡪 15 loss is capital. Just 15, not 20.
  + 150 🡪 Just 30 gain. Don’t consider built-in loss. Ordinary gain (inventory to Pship). 724(c)
* *Problem 24-3*
  + (See slide)
  + *If before 5 years*, then treat all gain as ordinary (not just part accrued at contribution).
  + 2) No book gain to allocate, just loss. But no tax gain, so under traditional, allocate nothing to non-contributing, and 1500 gain to contributing P. Under remedial, give 250 loss to NC P, and 1750 gain to CP.
  + 5) 724(c) applies b/c given with capital built-in loss. 2k of capital loss, and 1k of ordinary loss.

**Contribution of Services**

* *Problem 24-4*
  + A and B form a partnership
    - A and B each have outside basis and capital account of $40,000
    - AB owns a racehorse with basis $80,000
  + C joins partnership
    - At the time of joining, racehorse is worth $160,000
    - C gets ¼ interest in future profits in exchange for services
  + Please answer:
    - A) What are the tax consequences when C joins?
    - B) How would the answer change if C gave $15,000 in cash too?
    - C) In either case, should C make a § 83(b) election?
    - D) What if C is given a ¼ interest in profits ***and capital***?
  + CA should be booked up with C joins Pship.
  + D) Taxable to the extent C gets capital interest. AB gets deduction or capitalized into asset and gets deduction later.
* *Problem 24-5*
  + D has a 10% interest in partnership P
    - Outside basis is 25
    - Capital account is -10
    - Interest was bought with 20 of borrowed funds
  + Bank forecloses on D and gets interest
    - What is bank’s basis?
    - What is bank’s capital account?
  + Basis: 20, the value the bank has in the debt instrument. Exchanging debt for new asset (partnership interest), so takes same basis. P gets loss of 5.
  + CA: Stays -10.

**DISPOSITIONS OF PARTNERSHIP INTERESTS**

**Liquidating Distributions**

* *Example 1 (p.764)*
  + Q has an outside basis of 20
  + Q receives liquidating distribution of
    - 10 in cash
    - 8 (fmv and basis) of inventory
  + What is the basis of Q in inventory?
  + Is any gain or loss recognized?
  + Cash reduces basis from 20 to 10.
  + Inventory needs to be set towards carryover basis, which is 8, so must recognize loss of 2. Unlike distributions, where you *cannot get losses*.
* *Example 2 (p.765)*
  + Same situation as before, except
    - Inventory distributed has basis 8 and fmv 15
  + What is the basis of Q in inventory?
  + Is any gain or loss recognized?
  + Still recognize a loss of 2. *Value* of distributed property plays no role in determining the extent to which the distributee partner recognizes gain or loss on liquidating distribution. FMV is irrelevant. Here, recognize loss while realizing gain.
* *Example 3 (p.765)*
  + Q has an outside basis of 20
  + Q receives a liquidating distribution of
    - 11 in cash
    - Inventory with basis 8 and fmv 12
    - Unrealized receivable with basis 4 and fmv 10
  + What is Q’s basis in inventory and unrealized receivable?
    - Note that the necessary reduction will be pro rata according to bases because there is no unrealized depreciation
  + Is any gain/loss recognized?
  + Target 8 for invoice and 4 for receivables, but only have 9 to allocate. No unrealized depreciation, so allocate in accordance with basis.
  + No gain/loss recognized. No excess basis.
* *Example (p.769)*
  + Q is a 1/3 general partner in a service partnership (e.g., a law firm)
  + Partnership has 30 in cash and 60 in receivables
  + Q has a basis of 7 and receives 30 cash in liquidating distribution
    - What result?
      * How much is taxed under § 736(b)?
      * How much is taxed under § 736(a)?
  + What if Q also receives the following:
    - 5% per year for next 3 years of partnership income
    - A fixed cash amount each year for next 3 year
  + Q is getting two things: 736(b) cash part, and 736(a) receivables part. For cash, recognize 3 of capital gains. Ordinary income of 20.
  + If 5% of future profits 🡪 736(a)(1) taxed as a distributive share and the character of payments would flow through (almost certainly will be ordinary, b/c services income, but doesn’t have to be).
  + If fixed amount 🡪 guaranteed payment, taxed as OI under 707(c).
* *Example (p.770)*
  + (See slide)
  + 20k of receivables will be 736(a)(2) taxed as OI guaranteed payments.
  + 4k of goodwill, absent an election, will be treated as 736(a) OI.
  + 1k gain (basis of 3k, 4k FMV) will be 736(b) and taxed as capital asset gain.
* *Example (p.772)*
  + See slides
* *Problem 25-1*
  + See slides
  + First, consider as if timing issue is off the time. A takes 200k in cash. OB of 50k, so 150k of gain, all recognized b/c its cash.
  + Not a services Pship, so don’t worry about goodwill. Look at receivables and inventory. 751. 1/3 of total FMV – 1/3 of total basis = 110 – 110 = 100 of *ordinary income*.
  + Remaining 50 gain is *capital*.
  + \*\*\*check what happens to other partners and remaining book accounts
  + With timing:

**Disposition of Partnership Interest other than in Exchange for a Liquidating Distribution**

* *Problem 25-2*
  + Recall the facts of Problem 25-1
  + How would the answer change if A sold her interest to B and C for 50?
    - § 741 applies to determine taxable gain/loss
    - Total gain is 150
      * Total share of basis in assets is 50 (=1/3 of 150)
      * Total share of value of assets is 200 (=1/3 of 600)
    - Note that § 751(a) instead of § 751(b) applies here
      * The main difference is that there is no inside basis step-up as a result of the tax paid by A (although note that a § 754 election could fix this)
  + Share of
    - Receivables: 80 of OI gain
    - Inv: 20 of OI gain
  + If total gain is less than ordinary gain? There would be a capital loss.
* *Problem 25-3*
  + See slides
  + Basis is allocated 50/50 (because 50/50 agreement if basis goes away), and appreciation is split 75/25.
  + Total gain: 48k
  + 751(a) says look… Do three steps (hypothetical sale for FMV). Step 1: 33k of OI gain.
* *Problem 25-4*
  + See slides
  + Plan A: total gain of 7k. 741 says its all capital. 751(b) does not apply b/c no substantial appreciation of receivables/inventory. No basis increase for Pship.
  + Plan B: 20k of cash distrubited, reduces basis from 45 to 25. Take remaining basis and allocate across remaining assets. 15 basis allocated to receivables/inventory, and remaining 10 is allocated to capital. When sells this back to Pship, OI gain of 2k on inventory, and capital income of 5 on cap asset. Pship increases inside basis by total of 7 (5 to capital asset, and 2 to inventory).
  + Plan C: 2 of ordinary, 5 of capital (\*\*check this). No basis increase for Pship.
    - Pship has complete discretion to do whichever plan it likes.
* *Problem 25-5*
  + See slide
  + Plan A: Now have 751(b) assets 🡪 distribute those assets to partner and have P sell them back. OI of 12 (10 gain in receivables, and 2 of inventory).
    - Total gain of 17k. So capital gain of 5. And basis increase (only ordinary items) for Pship.
  + Plan B: 17k total gain. Sell assets and buy back. 12 of OI (because sufficient outside basis). 5 of capital. Basis increase of Pship (both ordinary and capital).

**INSIDE BASIS ADJUSTMENTS**

**Section 734**

* *Problem 27-1*
  + See slides
  + A) C takes basis in inventory of 27k (no recognition of gain/loss). But inside basis reduced by 33. How to allocate 6k of disparity? In proportion to unrealized appreciation 🡪 1.5k to R#1 and 4.5k to R#2.
  + B) 3k of positive disparity. Allocate to building (only capital asset with built-in gain).
  + C) 27k loss for departing partner. But b/c there is actual gain/loss 🡪 weird rule that overrides and states loss allocated to capital assets first according to their built-in losses.
    - Look at what happens to partner first, then look at effect on remaining partnership.
* *Problem 27-2*
  + Reconsider problem 27-1(b)
    - What happens if the partnership sells the building after the distribution?
    - How much income does each partner report?
* *Example (p.815)*
  + See slides
  + Allocated to basis, which partners share, results in a disparity 🡪 triggering early gain for one partner, and delaying full gain for the other until liquidation.
* *Problem 27-3*
  + A and B each contribute 100 to AB
    - Equal 50% partners
  + AB purchases two assets
    - Blackacre for 60
    - Whiteacre for 140
  + Properties increase in value so that their new fmvs are
    - Blackacre = 300
    - Whiteacre = 200
  + What happens if
    - Whiteacre is distributed to A in a non-liquidating distribution?
      * Assume the partnership elects to restate its undistributed assets upon distribution
  + What would a better (counterfactual) treatment be?
    - Specify the method you think would fix the flaw in § 734

**Section 743**

* *Problem 27-4* (cf. Problem 27-1)
  + See slides
  + D will take OB of 45k. Increase basis (adjustment) of 18k (45 – 27). “Share of previously taxed capital” = 27 + (18 [unrealized book gain] – 18 [unrealized tax gain]) – (9 [unrealized book loss] – 9 [unrealized tax lost) = 27.
  + Net 27. What is ordinary? What is capital? Hypothetical liquidation of all ordinary items = 72 of built in gain, divided by 3 = 24. Capital basis adjustment = - 6 (what number will get you to 18 from 24). ***Always do ordinary first***.
    - Ordinary Asset Adjustments: Inv: +4. Rec #1: +5. Rec #2: +15 (check this to understand).
    - Capital Asset Adjustments: Land: -1. Build: +3. Securities: -8.
    - D’s adjusted basis in assets and FMV of the assets would now be the same. Eliminates built-in gain/loss at moment of acquisition.
  + ***Go through each step*** 🡪 will cause problems if not when tax does not equal book.
* *Don’t worry much about 27-5*

**PARTNERSHIP LEVEL ISSUES**

**Classification Issues**

* *Problem 28-1*
  + See slide
  + Disregarded truly means disregarded. Ignore three LLC’s and understand the structure to be X-corp owning the partnership = only one person, so no partnership.
  + If LLC-3 is corporation *then* you can have a Pship.
* *Problem 28-2*
  + See slide
  + Regardless of what X is getting in exchange for it, X is treated like X is selling the assets b/c LLC-B is a disregarded entity.
  + Under 99-6 Situation 2, we deem liquidation for Y and Z to happen *first*, so can be like kind exchange.
* *Problem 28-3*
  + See slide

1. **Taxation of Corporations**

**CORPORATE FORMATION**

**Qualification under § 351**

* *Example*
  + Assume:
    - B forms corp. X by contributing Blueacre in exchange for all X stock
    - Blueacre had a value and basis of 100 and 60 before contribution
      * Also, Blueacre had been held by B for over one year
  + How much gain is realized, and how much is recognized?
    - 40 gain is realized, and none is recognized under § 351
  + For the new X stock in B’s hands
    - What is the basis? 60
    - What is the holding period? Over one year (get carryover)
  + For Blueacre in X’s hands
    - What is the basis? 60
    - What is the holding period? Over one year
  + Have built-in gains just doubled?!? **Yes.** Generally do NOT want to contribute appreciated assets. How to make only one level of taxes? Trigger § 351.
    - Why would ppl then use § 351? The value of deferral and/or different rates must be great then doubling of appreciated basis. Often, people will try to keep deferred taxes in corporations in perpetuity, and then just pass on appreciated stock at death, taking advantage of step-up basis.
* *Problem 2-1*
  + See slides

|  |  |  |  |
| --- | --- | --- | --- |
|  | 2-1(a) | 2-1(a) Using Intermountain | 2-1(b) |
| A’s basis in stock | 150 | 500 | 150 |
| B’s basis in stock | 500 | 500 | 500 |
| C’s basis in land | 300 | 1,000 | 650 |
| A’s gain recognized | 350 | 700 | 350 |

* + (a) Basis for X is 300. § 351 transaction. However, if under *Intermountain* (had obligation to transfer stock back to B), then taxed on full 700.
  + (b) Step 2 respected as § 351 transaction. In step 1, Alex will recognize 300 of gain. And now. X’s basis in the land will be 650 (added two bases together). Holding period: 50% will tack onto A’s period, and 50% will be B’s.
  + This problem shows that the order in which you do things can lead to different results

**Tax Consequences of a § 351 Exchange**

* *Problem 2-2*
  + John operates a retail store
  + On January 15, Year 1, he purchases
    - Land for 80
    - Building for 420
  + John took 20 of depreciation deductions on the building in Year 1
  + On January 1, Year 2, John contributes to a new corporation C
    - Land (value 80, basis 80)
    - Building (value 420, basis 400)
  + The land and building are used in the trades or businesses of John and C
  + a) does the transaction qualify under § 351?
    - What are the bases and holding periods resulting from the transaction?
    - Recall that § 1223(1) only applies to capital assets and § 1231 assets
  + b) John sells the C stock on December 1, Year 2, for 550
    - What are the consequences?
      * Is gain ordinary?
      * If capital, is it long or short term?
  + c) C sells the land and building on January 14, Year 2
    - Sale price is 550
    - What are the tax consequences to John and C?
    - Would the answer be any different if the sale were on January 16?
    - Note:
      * For this problem, recall that § 1231(b) only deals with property held for at least one year
      * Also, note that § 1250 and § 291(a) may be applicable here
  + d) Suppose that John transferred inventory instead of land/building
    - Basis was 120
    - Value was 500
    - How would this change answers for (a) and (b)?
    - Can John convert ordinary income to capital gain income to some degree
  + e) would it make a difference in the foregoing problems if:
    - C had been an existing corporation wholly owned by John?
    - C issued no stock to John in exchange for the property?
    - What if John were a corporation instead of a human?
      * Q: what is a “person” under § 7701(a)(1)?
  + (a) Basis: carryover basis (stock = 480; land = 80, building = 400). Holding period? Not § 1231 capital assets unless held for a year, and not regular capital asset b/c it is property to be used in trade/business (§ 1221(a)(2)). § 1223 (2) tells us the corporation’s holding period, and § 1223 (1) tells us John’s holding period. Holding period resets for John’s stock, and the corporation get’s tacking.
    - For John, it matters if property is capital asset or not, but NOT for corporation. This will *only* come up for property that is held for less than the year.
  + (b) Recognizes gain of 70 (550 – 480). It’s capital (stock, but *short-term* b/c of discussion above.
  + (c) C will recognize 70 in gain (basis is 480 for both). Gain is short-term (NOT yet 1 year, even though did get tacking), but NOT capital assets under § 1221 b/c used in trade/business and depreciable, and not yet held for a year under § 1231 so not capital assets 🡪 *ordinary assets*.
    - § 1250 is depreciation recapture – don’t worry about this note
  + (d) Still “property” so § 351 exchange, no gain triggered. Nothing changes, but inventory is always ordinary assets. John sells stock? *Capital asset* 🡪 capital gains rates. Looks like he transformed ordinary income to capital gains, but the ordinary is still in corporation. *Respecting corporation as an entity*. For partnership, we wouldn’t allow this.
  + (e) Doesn’t make a difference if it is a mid-stream or initial contribution. If not stock is issued, and already 100% owner, rules will *deem him* as recipient of stock (not require the formality). And would be the same if a corporation 🡪 corporations *are* a “person” under § 7701(a)(1) 🡪 “individual, a trust, estate, partnership, association, company or corporation.”
* *Problem 2-3*
  + Same facts as problem 2-2, with some additions
    - A) later in the day on January 1, Year 2, Mary contributes property to C and receives 30% of C stock
      * Are John and Mary part of transferor group?
      * How could we make sure they are part of a transferor group?
    - B) What would change if M contributed on January 20, rather than January 1
  + Need to know if rights defined in advanced. Actual timing itself is not so important, but the *agreement* and rights are defined in advanced—written or oral. Closer time looks better than further time apart, and written is preferred. Harder to prove they were not part of the same group b/c have to prove there was no understanding.
* *Problem 2-4*
  + Sally and George form W corporation
    - Sally transfers 100 worth of land in exchange for 100 shares of stock
      * Land was held for several years as investment
    - George transfers 140 worth of equipment for 100 shares and 40 of cash
      * Equipment is used in trade or business and was bought five years ago
  + What are the consequences for Sally, George, and W if:
    - Sally’s basis in the land is 60
    - George’s basis in the equipment is
      * A) 20
      * B) 130
  + § 351 transaction? “Property” yes, and can deal with boot, so need to make sure that they’re a transferor group.
  + Sally’s basis will be 60 in stock, and W’s basis in land is 60. W’s basis in equipment would be 20.
  + A) G’s will have to recognize gain of 40 (value of boot) and basis in stock will be 20 (began at 20, recognized gain of 40, but then allocated it away to the cash). § 358(a)(1). G realizes 120 in gain. W has no gain or loss (dealing w/ own stock, and issuing stock). W’s basis in transferred property is 60 (20 carryover and increased by gain recognized by *transferor*).
    - Here, G’s basis works out nicely because there was built in gain enough for value of boot.
    - Spreadsheet is just about George and the Corp
  + B) Gain realized = 10. Gain recognized = 10. Basis in stock is 100. Why? 130 + 10 (gain recognized) – 40 (amount of money/FMV property received). Need to subtract 40 b/c you want to allocate that basis to cash. For W, basis in transferred property will be 140 (130 + 10 gain realized). § 362(a).
* *Problem 2-5*
  + Same facts as last problem, except instead of 40 in cash, George receives an asset worth 40 in addition to 100 in stock of W
  + What if the asset has basis
    - 35?
    - 55?
  + W will realize some gain/loss.
  + 35 basis? **General rule:** no realization on distribution, EXCEPT if gain is realized. Here, realized gain of 5. § 311. Calculation for G is the same.
  + 55? No loss recognized 🡪 ***loss is really gone***. TB: no good reason to do this transaction.
* *Problem 2-6*
  + See slides
  + A and B form X corp
    - A starts with land worth 1,000 with basis 300
    - B starts with 500 cash
  + A) What happens if:
    - A transfers land for 50% of stock and 500 in cash (borrowed by X) – cash is honest to goodness boot. Realizes 700, and recognizes 500. Basis in stock is 300.
      * X corp takes basis of 800 (300 plus gain recognized)
    - B transfers 500 in cash for 50% of stock – Basis in stock is 500.
      * All of this assumes this is valid § 351 transaction
  + B) What happens if:
    - A borrows 500, secured by land, and transfers encumbered land for 50% stock – recognizes gain of 200 under § 357 (c). A’s basis in stock is zero. When we want to *figure out basis* 🡪 look at § 358(d)(1) (liability ***is***treated as money for purposes of calculating basis, but NOT for calculating gain/loss under § 357(a)).
      * See slide
      * If § 357(b) applies (tax avoidance), then A would recognize gain of 500. Basis in stock would be 300.
    - B transfers 500 in cash for 50% of stock – same.
* *Problem 2-7*
  + See slide
  + What happens when contributed land is split into two parcels? Rules *aren’t clear* – you could say the two assets are aggregated, and thus not gain realized/recognized. If, however, they’re treated separately (might be how IRS approaches), then you’d have to figure out how to allocate basis across assets. Not clear how to do this. And 362(e) says you can’t import losses.
    - Problem goes to problem of what is an “asset”? Two assets here or one asset?
    - See excel for separate treatment—if one asset 🡪 no gain/loss realized or recognized. Doesn’t matter if you’re getting cash out (boot), b/c only to the extent of boot is recognized.
  + If two assets 🡪 don’t get to recognize loss, but must realize gain to the extent of boot (here, 350). How to figure out basis for corporation? You’d like to take carryover basis plus gain recognized, but this would exceed value of the property (1350) 🡪 362(e)(2) says you must ***reduce*** by excess basis, allocated all here to the one loss property (property that has *excess over value*; if two or more of these properties, then allocate excess proportionately). Basically, too much basis, so need to drop basis of one of the assets. 350 of loss is *just gone* (double up on the gains no matter what, but can only take loss once 🡪 can *elect* to take it inside or outside corporation 362(e)(2)(C)).
* *Problem 2-8*
  + Suppose in 2-6(a) that X also issues 100 of nonvoting preferred stock to Charles, X corp’s lawyer, for organizing the corporation.
  + What are the tax consequences?
    - Note the control requirement of § 368(c)
  + Look to § 368(c) 🡪 “control” means ***80% of combined voting power***, AND at least 80% of ***non-voting stock***. By giving 100 shares to C, kills § 351 transaction and makes everyone taxable. Can’t be part of the control group b/c performing services.

**Additional Basis Rules**

* *§ 358(h) Example p. 54*
  + T is a cash method taxpayer
    - In a § 351 transaction,
      * T transfers property with a basis and fair market value of 1000
      * T receives 100 worth of stock and 900 worth of liability assumption
      * The payment of the liability will be deductible
  + 357(b)? Not likely, doesn’t seem like principle purpose for avoiding taxation
  + 357(c)? Because the liability give rise to a deduction, then no, (c) does not apply
  + 358(h)? Stock should only have a basis of 100 🡪 reduction of 900
    - Trying to prevent the doubling up of deduction. Both corporation getting 900 deduction and TP taking loss deduction once stock is sold. Preventing double loss.
* § 362(d) *Example p. 55*
  + T transfers property with basis of 50, value of 100, nonrecourse liability of 120
  + T receives stock in return
    - Gain recognition to T is 70 (under § 357(c)(1))
    - Basis in stock received is 0 (under § 358(a)(1),(d)(1))
    - Basis in property held by corporation is 100, and not 120 (under § 362(a),(d)(1))
      * The remaining 20 will likely be allowed as a basis increase to the extent the full 120 liability is ever repaid
* *Problem 2-10(a)*
  + See slide and spreadsheet
  + Tax consequences?
    - For C, allocate value of stock pro rata to each parcel (60% to the one, and 40% to the other). Thus, realized 4k of loss to parcel 1, and realized gain of 1k to parcel 2. No boot, so 351(a) transaction 🡪 *no recognition* of gain/loss. BUT 362(e)(2) says we need to reduce inside basis by 3k (excess over value). Here, parcel 1 takes basis reduction.
    - If C had give all there properties, then there would have been no excess reduction. But K and C can’t aggregate their contributions (“*a* transferor”). Aggregate basis of all assets of *each* person, but not aggregation across the group.
* *Problem 2-10(b)*
  + No idea..? I think this is similar as above. Check spreadsheet.

**Securities; Boot and the Installment Method**

* *Example p. 60*
  + Have to recognize the entire 80 of gain, but only when the payments are made (?). 100 of basis should go to stock received. When interest payments are made, ordinary income. 20 basis goes to the debt.
    - If you structure payments over time, you can delay gain
  + \*\*Check this. No idea what’s going on here.

**CORPORATE OPERATION**

**Corporate Tax Rates and Base**

* *Problem 3-1*
  + How might a profitable U.S. corporation pay no U.S. taxes?
  + There is no one right answer to this question:
    - Perhaps there are NOLs, either created by the corporation itself in the past or gotten through an acquisition
    - Perhaps all net earnings are in a foreign jurisdiction, and foreign tax credits reduce U.S. income tax to zero (or perhaps U.S. income tax is deferred because foreign earnings are kept in controlled foreign corporations)
    - Accelerated depreciation may reduce taxable income to zero even though a firm is economically profitable
* *Problem 3-2 – Is it possible for a corporation to pay income on the same income twice?* 
  + Yes, it could happen, but **§** **53** gives you a credit for past AMT. BUT still creates a timing problem.

**Capital Structure**

* *Problem 3-3*
  + Debt or equity? Sum certain; regular interest payments; possibility to convert, but not certainty to convert. Aspects of debt and equity. Two pieces that look equity—conversion and something that looks like dividend. Others make it look like debt. Conversion is key b/c the dividend is limited. How high is the probability of conversion? Maybe high, b/c the corporation can redeem for only $600 🡪 convert as long as 50 shares of stock be worth $600, and started at value of $1k = “deeply in the money” call option. Conversion feature seems likely to be exercised, so tilts us towards considering this as equity.
    - Why issue hybrid features? If you can get on debt side of the line, but has equity features, you get tax-deductible equity.
* *Problem 3-4*
  + Depends if the debt/equity ratio exceeds 1.5 to 1. If they $6.66m in equity, then they’d be OK. Why do we have this provision about the debt/equity ration? We don’t want companies to take out a bunch of debt from their parent that doesn’t pay taxes on its interest income. Allows you to do an inter-company loan as long as you’re not thinly capitalized.

**DISTRIBUTION OF CASH AND PROPERTY**

**Cash Distributions**

* *Problem 4-1*
  + Half-way through Year 2, X corp distributed $20,000 to A, its sole shareholder, whose stock had a basis of $5,000
  + As of the end of Year 1, X corp had no E&P
  + In Year 2, X corp had $15,000 of E&P at the half-way point, but only $5,000 for the whole year
  + What are the tax consequences?
    - How much is taxable to A as a dividend? 5k
    - How much is capital gains to A? 10k
    - What is A’s basis after the distribution? 0
    - What is X corp’s E&P at the start of Year 3? It should go down. Should we make it go negative (distributed 15k)? Look at § 312 🡪 “to the extent thereof” = *cannot* reduce below zero. ***Distribution cannot make E&P go negative***.
  + (b) See slide for rest. Div: 5. Basis: 0. KG: 10. Same result even though there is a big deficit leading into year two. New E&P: remains -15K (had zeroed out the 5k).
    - Have to pay dividends out of current E&P *first*.
    - If you waited a few days until year 3, would have negative current E&P, so no taxation on dividends.
  + (c) Div: 20 (first from current, then from accum.). KG: 0. Basis: 5. E&P: 0.
    - 15 loss ½ way through is red herring
  + (d) Div: 5 (20 loss at end of current year, per rev. ruling, is pro-rated in time; thus, ½ way through is -10, combined with accum. E&P results in E&P of 5). KG: 10. Basis: 0. E&P: -10 (dividend of 5 comes from accum, reducing it to 10, and had current E&P of -20).
* *Problem 4-2*
  + Don’t worry about this too much. What’s taxable in a given year is different than what is included/excluded in E&P.

**Property Distributions**

* *Problem 4-3(a)*
  + FMV of 5K: 2k of built-in gain, so taxed on this. And increase E&P by 2k. 2k will come out of E&P as dividend, then come out of shareholders basis in the stock. Remaining basis of stock is 2k.
    - Dividend: 2k
    - KG: 0
    - Prop Basis: 5k (FMV 🡪 2k from dividend, 3k from stock basis)
    - Stock Basis: 2k
    - Corp KG: 2k
    - Corp E&P: 0 (started at 0, increased by 2k through deemed sale, then reduced by 2k through distrubition, ends at 0)
  + FMV of 3K: No KG for corp, so no E&P, so all will need to come out of TP basis
    - Div: 0
    - KG:
    - Prop Basis: 3k (must be FMV)
    - Stock Basis: 2k
  + FMV of 7k: Corp will have to recognize 4k of KG. Starting E&P is 0, increased by 4k, then reduced to 0 via distribution.
    - Div: 4
    - KG: 0
    - Prop Basis: 7k
    - Stock basis: 2 (3k that is left from 7 FMV, reduced by 4k in dividend)
* *Rest of 4-3 problems (see slides)*
  + (b) Corp recognizes gain of excess of liability. So $5k. 336(b) 🡪 codification of *Crane*/*Tufts*. Take the greater of FMV and liability. For shareholder, look to 301(b)(2) 🡪 won’t reduce past zero. Deem the shareholder receives nothing. E&P for corporation *won’t* decrease here b/c of 312. No dividend getting paid out (7k of value w/ 8k of liability), so don’t reduce E&P. Shareholder basis in property under 301(d) is 7k (not liability of 8k), but probably could challenge and get away with 8k basis under Crane/Tufts.
  + (c) Section says you get full amount for E&P purposes, but not for tax purposes. This is a sale. For every payment received, x/7 is recognized as basis.

**Disguised or Constructive Dividends**

* *Problem 4-4*
  + T is sole shareholder in X, a start-up company
  + In its early years, X has many R&D expenses
  + X makes an interest-free loan of $100,000 to T, payable on demand
  + What are the tax consequences?
    - If bona fide loan: less likely to be a dividend. No triggering of any sort of dividend for shareholder. Just borrowing. What to do about the interest? Imputed interest under applicable federal rate. If corp to shareholder, then need to look at E&P. If not E&P, then no constructive dividend.
    - If no boa fide loan: dividend, but since no E&P, basis reduction and KG.
      * Expectation of repayment? Usual characteristics of indebtedness?
* *Problem 4-5*
  + X has $5,000 in E&P in year 1
  + X gives shareholder B an option to buy real estate at a price of $1,000
    - The fmv and basis of the property are $1,000 at the time of option grant
  + After 3 years, B exercises the option
    - Fmv of property is $3,000 at that time
  + X has no accumulated E&P at the start of year 3, and no current E&P in year 3, other than possible effects from the option exercise
  + What are the tax consequences to X and B?
    - B/c of E&P, would not create dividend even if IRS was correct (option value of 2k at time of distribution), but basis in property would be 2k. B may argue for open transaction doctrine, so wouldn’t have to recognize gain until year 3.
* *Problem 4-6* 
  + A is the sole shareholder of each of X corp and Y corp
    - X and Y corp each run a restaurant
    - X makes a loan of $100,000 to Y corp.
  + What are the tax consequences?
  + Two stages to investigation: 1) is this a bona fide loan? Worry about formalities, business purpose for the loan, etc. If not, dividend consequences. Deemed contribution from x-corp to A, and then contribution from A to y-corp.
* *Problem 4-7*
  + X corp rents land from A, its sole shareholder
    - Lease is $2,400 per year for 10 years (fair rental value)
    - In Year 5, X builds building on land at cost of $50,000
      * Building has 20 year useful life
    - At end of lease, X signs new lease for $3,600 per year (fair rental value)
  + What are the tax consequences?
    - Specifically, is there any dividend to A, and if so, when and how much?
    - Note: Recall § 109 and § 1019, which would control if A and X were unrelated
  + Gross income does NOT include the value of improvements. 109 & 1019. And won’t get basis improvements. For 50k building 🡪 is this a disguised dividend? Need to look at whether there is legitimate business purpose for x-corp. If disguised dividend,
  + Need to understand that in these situations, a corp. may be implicitly giving value to its shareholders 🡪 disguised dividend?

**Intercorporate Dividends**

* *Problem 4-8*
  + X corp has owned all stock in Y corp since its formation
    - Basis is $2 million
    - Fmv is $5 million
  + P wants to buy Y
    - Before P buys, Y issues a $3 million note to X
    - P then purchases Y for $2 million
    - Within a year, Y pays X $3 million on the note
  + What are the tax consequences?
  + If dividend (like *Litton*): can deduct 100% of amount to the extent there is E&P. Gain on the sale will be 0 (2-2).
  + If one transaction: $3m note part of sale consideration. So no tax upon distribution, but tax of $3m of gain on sale.
* *Problem 4-9*
  + Reconsider problem 4-8, but assume
    - Y borrows $3 million from unrelated party
    - Y then makes $3 million cash payment to X before sale
  + Increases the probability that $3m treated as dividend. No gain recognition.
    - Shows that if you involved third party, increases likelihood that 2 steps will be respected. But not necessary under *Litton*.

**REDEMPTIONS AND PARTIAL LIQUIDATIONS**

**Treatment of Shareholders: Complete Termination under § 302(b)**

* *Problem 5-1*
  + X has a net value of $1,000,000
    - E&P is $800,000
    - 1,000 shares are outstanding
      * 500 owned by father with basis of $600/share
      * 500 owned by son with basis of $700/share
  + Father wants to transfer his interest to his son
  + What is the treatment in the following possible situations:
    - A) X redeems father’s stock, and father gives proceeds to son
    - B) X redeems from estate after father’s death, and proceeds are devised to son
    - C) father gives stock to son, and X then redeems
    - D) devise the stock to the son and have X redeem after death

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | OI | KG | Son’s Basis | Retained E&P |
| A | 0 | 200 | 350k (no change) | 800k |
| B | 500k | 0 | 850k | 300k |
| C | 500k | 0 | 650k | 300k |
| D | 500k | 0 | 850k | 300k |

* B) 318(a)(1) *only* applies to family. Can’t get rid of estate attribution, only intra-family attribution. Can’t avoid attribution to the estate. Normally think of step-up in basis at death as a very favorable thing, but here, puts you into 301 treatment.
* *Problem 5-2*
  + How would the answers for problem 5-1 change if father were passing the value to mother, his wife, rather than to son?
    - Assume son still owns the other half of X
  + If it’s the mother, the son’s interest is no longer attributable to the estate. Won’t get attributed to the Son. Mother introduces an extra link into the chain, where before, link was directly between estate and son.
  + Estate AND mother need to file for election

**Treatment of Shareholders: Substantially Disproportionate Redemptions under § 302(b)(2)**

* *Problem 5-3(a-d)*
  + X corp is owned by P and Q, unrelated
    - P owns 60 shares with basis $60/share
    - Q owns 40 shares with basis $70/share
    - E&P is $2,000
    - Fmv of each share is $100
  + What happens if:
    - A) P sells 10 shares to Q
    - B) P sells 10 shares to X for $1,000
    - C) P sells 21 shares to X for $2,100
    - D) P sells 50 shares to X for $5,000
  + [see the accompanying spreadsheet for calculations]
  + a) Taxable cap gains of 400. Regular sale.
  + (b) No exchange treatment because owns 56% of company after sale, and has not gone below 80% of his pre-redemption ownership. Taxed as a dividend. E&P reduced by 1k.
  + (c) Just less than 50%, but 80% prong is not satisfied. Could still get exchange treatment, but would have to be a court under (b)(1) instead of (b)(2). *Patterson*. Take E&P, then reduce basis by 100
    - We don’t HAVE to fit under (b)(2)
  + (d) Satisfies both prongs. Taxed as capital gain of 2k (had 3k of basis) as though he sold to someone else (like (a))
* *Problem 5-3(e)*
  + Reconsider (d), but suppose that
  + i) P is Q’s sister
  + ii) P is Q’s mother
  + iii) P and Q are each 50% partners in the PQ partnership
  + iv) Q is a corp and P owns 50% of stock of Q
  + v) Q is a corp and P’s father owns 50% of stock of Q
  + See slides
* *Problem 5-4* (see slide)
  + X corp and Y corp each own 50% of Z corp stock
    - X has a basis of $10,000
    - Y has a basis of $15,000
  + X and Y are each wholly owned by individual O
  + Z has
    - Cash of $50,000
    - Business assets of $50,000
    - E&P of $90,000
  + The price of all the Z stock is $100,000
  + What happens if
    - Z redeems all of X’s shares for $50,000
    - Then Y sells its Z shares to an unrelated party for $50,000
  + How does this compare with a sale by X and Y of their shares to an unrelated party?
  + Because X is owned 50% by O, X will be deemed to own *all* of what O owns 🡪 all of y, and proportional share of what y owns = X is attributed 50% of z on top of X’s own 50%. Thus, X owned 100% before, and 50% after.
  + And 318 only applies when it *specifically says* it applies. Thus, dividend received deduction does NOT depend on 318 attribution rules.
  + Taxed as dividend. Tax due by X: 3.5k
  + Y’s basis? Y is given X’s 10k basis (moves over), so 25k basis. 35% rate say x (50k-25k basis) = $8.75k
    - Total between X and Y: $12.25k
  + Alternate Scenario: 35% x (100k – 25k bas) = $26,250. What is going on here? Like *Litton*, get 80% dividend reduction via attribution rules.
* *Problem 5-5*
  + P and Q own X
    - P owns 60 shares
    - Q owns 40 shares
  + X carries out a redemption
    - 45 shares from P
    - 35 shares from Q
  + What result?
  + For P, no reduction under 80% or 50% level at end. But if you split up steps, and do P *first* 🡪 then can qualify separately for both steps. Can you do this? Need to see if *integrated plan* (302(b)(2)(D))

**Treatment of Shareholders: Redemptions Not Essentially Equivalent to a Dividend**

* *Problem 5-6*
  + X corp has E&P of $25,000
  + X redeems some of B’s X stock with basis of $10,000 and value of $25,000
  + What are the consequences if
    - A) B owns 54% of X before and 50% after, and
      * i) an unrelated shareholder owns all the rest of X
      * ii) 50 unrelated shareholders each own 1% of X afterward
    - B) B owns 12% of X before and 10% after, and
      * i) an unrelated shareholder owns over 50% of X
      * ii) X is publicly traded and no one else owns more than 0.05%
  + Are you reducing control in a meaningful way? Arguably so if voting power is reduced to a tie.
  + B)
    - i) Likely exchange treatment. Not in control 🡪 not in control.
    - ii) Likely get dividend treatment. Still in control.
* *Problem 5-7*
  + Estate Taxes
  + Reconsider problem 5-2(b)
    - Father owns half of stock of X corp
    - Father dies, estate holds stock, and mother is sole beneficiary
    - Son owns other half of stock
    - Plan is for X corp to redeem stock from estate for 500k
  + Now suppose that estate owes 400k in estate taxes and also has either
    - 800k in cash
      * >35% so good to go
      * But only for redemption up to amount of estate taxes and other expenses related to death
        + Any amount of redemption greater ⇒ kicked back to 302
    - 2mm in various other stocks
  + What is treatment of redemption?
    - §303 – distribution to SH by corp in redemption of all or part of stock is included in gross estate of decedent – gets exchange treatment
    - 303b2 – not only must estate own the stock, but also the stock must be more than 35% of the value of the estate
    - however, stock in different corporations can be aggregated together to get to the 35% number, but only for corps to which the estate holds at least 20% of all outstanding shares
    - Amount necessary to pay estate taxes and funeral/admin expenses are what are covered under 303a
  + So even if no 302 treatment available for estate, 303 will preserve
  + Blunt instrument – even if party doesn’t “need” it, then can still use
  + Do not do 318 attribution

**Partial Liquidations under § 302(b)(4)**

* *Problem 5-8*
  + X corp operates a steel mill
  + Business has declined, and so X
    - Shuts down a furnace
    - Lays off 25 of employees
    - Reduces to 60% production
    - Sells 40% of inventory
    - Distributes sales proceeds and 40% of working capital to shareholders and pro rata
  + What result 302(b)(4)?
    - Really needs to be a contraction of business, need more facts to determine if the business is REALLY CONTRACTING
      * Shutting down furnace – is this a big deal in industry or is it on off switch
      * Lay off – is this common, is this a big number for company
      * The reduction of production – is this a hard to reverse
      * Does it matter that comes from working capital?
  + Safe Harbor???
  + If sell off line of business then probably a good example for winning

**Treatment of the corporation**

* *Example*
  + X has 100 shares outstanding; E&P is 30; X redeems 20 shares
    - E&P should be reduced by 6
  + X has two classes of stock, A and B, and 1000 shares of each are outstanding
  + A has a 2-to-1 preference as to dividends on liquidation
  + Suppose X distributes $140,000 cash when E&P is $120,000
  + What result?
    - E&P is reduced by 2/3 of $120,000, or $80,00

**Redemptions Related in Lieu of Buy-Sell Agreements**

* *Problem 5-9*
  + X had 120 shares outstanding
    - 40 owned by each of B, C, and D
    - Basis of 40 in all shares for everyone
  + B agrees to buy C’s shares on C’s death
    - During negotiations, and unbeknownst to B, C buys D’s shares for 100/share
  + C dies and C’s estate tenders 80 shares to B
    - Price at time is 125
  + B buys just 40 shares (@125/share)
    - X agrees to redeem remaining 40 shares from C’s estates (@125/share)
  + What are tax consequences for B,C, and D?
    - D – 40 shares X (100 FMV – 40 basis) = 2400
    - C
      * Basis in 40 shares = 2400 or 60/share
      * Basis in 40 shares = 1600 or 40/share
      * Then at death SUB
        + Basis in all = 125/share
    - C’s estate
      * Never recognizes gain, due to SUB
    - B
      * Takes 125/share basis in 40 shares purchased
      * If non-obligation
        + Then a redemption (302(b))
        + C still doesn’t recognize gain (as long as not treated as a dividend, given §303, probably a redemption)
      * If obligation
        + Then still for C nothing
        + But for B treated as distribution

Dividend prob? Unless somehow 302 applies

Of 5k

**Redemptions as Part of Bootstrap Acquisitions**

* Example:
  + A owns X, and B wishes to acquire X
  + B does not have enough money, but X has cash/property inside that it doesn’t need for the business B wants to run through X
  + So
    - A sells some stock to B
    - X redeems the rest of A’s stock
  + If these are two separate steps, then A gets exchange treatment
  + Under the *Zenz* doctrine, the order doesn’t matter, get exchange treatment
* Problem 5-10
  + A owns all of X
    - 100 shares; aggregate basis of 40k
    - FMV of shares is 100k
  + P wants to purchase but only has 50k
  + X has lots of E&P
  + What happens if
    - X distributes 50k to A and then A sells stock to P for 50k
      * Dividend to A
      * Followed by sale for CG on 50k – 40k (basis)
      * E&P reduction by 50k
      * If this was part of a plan, then this would be exchange treatment for A, rather than dividend
    - A sells to P for 100k (half cash, half note), then P gets distribution of 50k from X to pay off note
      * Note still affects E&P normally, but for tax purposes it does delay under installment method – remember that for calculating E&P
      * P gets dividend treatment
        + But now has basis of 100k
        + P is taking OI NOW, in order to get higher basis to be used later – not good under TVM

But may be useful if have expiring losses

* + - A sells 50 shares to P for 50k and then X redeems A’s remaining shares for 50k
      * 30 CG on sale to P
      * 30 CG on redemption to A by X
      * P gets 50k basis
      * E&P reduced by half but capped at 50
      * If switch the order, doesn’t matter 🡪 *Zenz* says doesn’t matter
    - If you (A) are the corporation which of these do you prefer?
      * Option 1 because then you get the dividend received deduction
      * Corporate parent wants to extract as much E&P as possible before selling stock
        + BECAUSE get the dividend deduction, and the stock is worth FAR less and therefore no gain really realized
        + And purchaser gets co with low E&P and therefore any distributions will be basis recovery so don’t have to delay that recovery
* This is a great example of the following
  + LOOK at each section and determine the alternative ways you can structure the transaction to either fit in the section’s requirements or to avoid them – depending on whether you want that section’s treatment or want to avoid it

**DISTRIBUTIONS OF STOCK**

**Distributions of Stock and Stock Rights under § 305**

* *Example*
  + X corp has 200 shares of stock outstanding
    - 100 owned by A
    - 100 owned by B
  + X is worth 600x; each share is worth 3x
  + What are the tax consequences of each of the following alternatives?
    - 1) Distribute 150x to A, and distribute 100 shares to B – A will be taxed as cash dividend. B will also be taxed b/c of disproportionate distribution under § 305(b)(2) 🡪 B is now 2/3 owner, and A is 1/3 owner
      * Fmv of 150x to each of A and B
    - 2) Redeem 50 shares owned by A for 150x – may implicate **§ 305(c)**. B is not getting shares, but de facto increasing his stake in the corporation. 302 analysis: 50/150 = .33 < .5; 33% > 80% (50%) (works!). Tax A on capital gains exchange treatment.
      * If it is a ***real redemption*** (302) 🡪 then 305 does not apply at all.
    - 3) Have A sell 50 shares to B for 150x – Tax A on capital gains
* *Problem 6-1(a)*
  + X has two classes of stock outstanding
    - M has 100 shares of common
    - N has 100 shares of nonconvertible preferred
  + What are the consequences if:
    - X distributes common on common, and shareholders can elect to receive cash instead of stock? Captured by **§ 305(b)(1)**
      * Does it matter if all shareholders elect stock? No
    - X distributes preferred on common and cash on preferred? Cash is taxable, and common fall under **§ 305(b)(2)** 🡪 receipt of property by *some* shareholders, AND increase of proportional interest of *other* shareholders
      * TB: one way to get an increase in interest is to get *more* of your class of stock, OR you can get a class of stock that has a *higher interest* (e.g. preferred)
      * Does it matter if the cash is distributed 18 months before or after the stock?
    - Common on preferred and preferred on common? Any time preferred getting distribution other than on conversion ratio 🡪 get taxed as divided **§ 305(b)(4)**. Preferred on common taxed as distribution under **§ 305(b)(2)** 🡪 preferred get property, and common get greater proportional interest. BOTH get taxed.
* *Problem 6-1(b)*
  + X corp has two classes of stock outstanding
    - M owns 100 shares of class A common
    - N owns 100 shares of class B common
    - The class shares participate ratably in current and liquidating distributions
  + What happens if
    - X distributes cash on A common and distributes class B common on the class B common? A common get taxed on cash (obviously). B is increasing proportionate share, so taxed via 305(b)(2)
      * Would the answer change if each class were entitled to 50% of current and liquidating distributions? Yes. B would NOT be getting a proportional increase. NOT taxed b/c doesn’t satisfy second prong.
    - X redeems ¼ of class B shares? Depends on the relationship between class A and B. Fails to satisfy 302 requirements (not getting under 80%) 🡪 fails to satisfy 305(b)(2). But maybe satisfy 302(b)(1) 🡪 get redemption treatment. Thus, satisfy 305(b)(2) and BOTH M and N get taxed. \*\*See professor’s email
    - X distributes class A common on the class A common and preferred stock on the class B common? Taxable under 305(b)(3)
  + *Is common stock “property”?* No. What if you receive common on preferred? Look through 305(b)(4), where common *is* treated as “property”, then *apply*  to 305(b)(2). ***For purposes of exam, common = “property”***
* *Problem 6-1(c)*
  + X corp has two classes of stock
    - M owns 100 shares of common
    - N owns 100 shares of nonconvertible preferred
  + What happens if
    - X distributes cash on the preferred and common on the common? Cash taxed. And second prong of 305(b)(2) not satisfied (two separate blocks). Common NOT taxed.
      * Would the answer change if the preferred stock were convertible into common? Perhaps—depends on convertible terms and whether it adjusts. Reg. says convertible preferred will be treated as converted to determine whether 305(b)(2) has been triggered.

**LIQUIDATIONS**

* *Problem 7-1(a)*
  + (See slides) What happens if X liquidates and distributes each asset pro rata (according to ownership percent) to the two shareholders?
  + Under § 336, there is a deemed sale of assets by X to each of A and B
    - For each, consider the applicability of loss limitations in
      * § 267(a)(1),(b)(2)
      * § 336(d)(1),(2)
  + Under § 331, there is a deemed sale of stock by each of A and B to X
  + For shareholders: capital gain (assuming shares are held as capital asset). From shareholders view (at this point), ignore everything that is going on in corporation. A gets 500 k gain. B gets 400 loss. Like redemption, so E&P is NOT relevant.
  + For corporation: generally, would recognize 300 gain on Asset 1, and 300 loss on asset 2 🡪 combine for no tax. BUT many limitations on corp taking loss.
    - **§ 336 (d)(1)(A):** no loss shall be recognized by corp if (i) related person or (ii) “disqualified property”. Here asset B could potentially be disqualified property b/c acquired within 5 years. And here, A is related (b/c it owns 80%), but B is not. So 80% of loss in Asset 2 is disallowed 🡪 only 60 of loss allowed (240 of loss is gone forever).
* *Problem 7-1(b)*
  + (b) what would change if asset 2 had a basis of 800 and a value of 700 at the time of the § 351 transfer?
    - i.e., asset 2 had a built-in loss of 100 at the time of contribution
    - Recall the role of § 362(e)(2):
      * By default, under § 362(a),(e)(2), contribution of built-in loss property to the corporation under § 351 results in property with basis equal to fmv in the hands of the corporation and stock with built-in loss in the hands of the shareholder
      * However, § 362(e)(2)(C) allows the built-in loss to be present in the property in the hands of the corporation instead, and not in the stock of the shareholder
      * (That is, there is always only one built-in loss, but you have a choice of where to put it)
    - Consider how the tax consequences depend upon whether an election under § 362(e)(2)(C) is made.
  + For shareholders: We don’t know who contributed Asset 1, but assumedly A and B recognized same amount.
  + For corporation: 336 says built in loss at time of sale needs to be reduced by amount of loss given at time of contribution 🡪 40 loss (80% of 200 = 160 loss disallowed).
    - This loss is not allowed on if the loss contribution was part of plan to exploit loss, and if contributed less than two years ago 🡪 assumed that you have a plan
* *Problem 7-1(c)*
  + 5 year window does not apply, so not “disqualified property”, and not under 2-year presumption for loss plan.
    - Asset 1: still taxed at 300 gain
    - Asset 2: still have question of whether 362 election was made. If not made 🡪 200 loss. If made 🡪 300 loss.
    - Shareholders taxed the same