**Business/Partnership Taxation Outline**

1. **Partnership Taxation – Subchapter K**

**THE STRUCTURE OF PARTNERSHIP TAXATION**

**Overview**

* **§ 701 Partners, not partnership, subject to tax**
  + Partnerships as such are NOT subject to tax. ***Persons carrying on business as partners*** ARE liable for tax only in their separate or individual capacity.
    - ***Pass-thru taxation***
* **§ 702 Income and Credits of Partner**
  + In determining income tax, each partner shall take into account separately his **distributive share** of the partnership’s income
    - (a) Items that are stated separately (e.g. gain/losses from capital assets, charitable contributions, 1231 property)
    - (b) Taxed specially b/c tax bill is dependent on attributes of partner’s individual income (e.g. charitable giving, short and long-term losses). NOT enough to aggregate partnership income. Need to pass on to partner to determine how much is deductible.
    - (b) ***Character is preserved***.
    - **“Allocable share”** might have been better, because **“distributive share”** is NOT dependent on what individual partner’s actually get, but only what is *included* on P’s individual return.
      * E.g. Pship agreement may say no distributions for 5 years, but there will be distributive shares each year because, as the Pship earns or losses income, the partners much include or deduct it on their individual returns.
* **§ 703:** Partnership computes tax like an individual. (Once income is computed, allocated among partners).
  + Exceptions in (a) (e.g. no personal exemption for partnership, no charitable deduction)
* **§ 704:** Partnership agreement determines **“distributive share.”** (Code allows you to arrange taxation in a beneficial way).
  + **(b) *But***, NOT entirely 🡪 need substantial economic effect
* [Types]
  + **LLC:** creature of state law. Limited liability of corporations, but taxed like a partnership (flow-through taxation).
  + **General Partnership:** no formal organization. Unlimited liability.
* *United States. v. Basye* (Big healthcare provider—Kaiser—had agreement with doctor partnership—Permanente. As partial compensation, set up retirement trust available to members of P. No member of P [both partners and non-partners] was guaranteed part of trust, but was contingent on a number of factors [e.g. 15 years of service, reach age 65]. Partners of P only reported salary, but not trust donations. Argued that $$ was not theirs yet [no claim of right]. Q: taxable?)
  + **Yes** 🡪 currently taxable. Partnership, as ***entity***, is for sure getting the $$. Definite sum and not subject to diminution/forfeiture. Just unclear how it will be divided up. Allocated to partnership (and taxed), but just not distributed yet. Who has to pay tax? ***Only partners*** 🡪 doesn’t matter if they choose to distribute it later.
    - What happens when the trust is distributed? Employees (non partners) will be taxed (income to them), but partnerships will not be taxed AND can get deduction on employee compensation (unless the trust grew, then pay tax on appreciation).
    - TB: not surprising looking back. Allocation to partnership v. distribution to individual partners.
  + **Problems:** huge tax bill up front, and then deductions when maybe they won’t have income. Also, some partners may leave, so never get the deductions. Timing issue causes real economic harm.
    - *Basye* does NOT apply to qualified plans (e.g. pensions). Need to be really careful with do-it-yourself retirement plans.

**Formation of Partnership**

* **§ 721:** Nonrecognition of gain or loss on contribution to a partnership. Contribution is NOT a taxable event.
* **§ 722:** Carryover basis for partner acquiring an interest in the partnership.
* **§ 723:** Carryover basisfor property donated to the partnership.
  + **Double carry-over basis:** the Pship carries over the contributing P’s basis in the asset, and the P carries over the asset basis into her Pship interest
    - Any appreciation or loss in contributed property will be built into the contributing P’s outside basis
* **§ 705(a)** [General Rule]
  + Basis of partner’s interest is *increased* by his **distributive share** of partnership *income* (including both taxable income and tax exempt interest)
    - This ensures that income taxed to P when earned by the Pship will not be taxed a second time upon disposition of P’s partnership interest
    - E.g. income increases by $100 🡪 increase outside basis by $100.
  + Basis of partner’s interest is *decreased* by his **distributive share** of partnership *losses* (and all other deductions), as well as *nondeductible, noncapitalizabled expenses*
    - Outside basis can NOT go negative (**§ 704(d)**)

**Nonliquidating Distribution Rules**

* **§ 731**
  + **(a)(1):** *gain* is NOT recognized by a partner upon distributions, except to the extent money distributed exceeds basis
    - “Money” ***includes*** marketable securities (§ 731(c))
  + **(a)(2):** *loss* is NOT recognized by a partner upon distributions, except sometimes in the case of liquidating distributions
  + **(b):** the partnership itself recognizes no gain or loss on distributions
* **§ 732**
  + **(a)(1):** basis of property (other than money) is the partnership’s basis, BUT capped by the individual partner’s outside basis before the distribution, reduced by any money distributed in the transaction
* **§ 733:** In non-liquidating distributions, outside basis is reduced (but ***not below zero***) by the money received and basis of non-money property received
  + - If property and cash are distributed simultaneously 🡪 act like cash is ***distributed first***

**DETERMING DISTRIBUTIVE SHARES**

**General Test for Economic Effect**

* A partnership is not a taxpayer (**§701**). Instead, it computes its taxable income as if it were a T and then passes the tax items to its partners (**§702**). The portion of the entity-level items that a partner includes on his individual return is called his distributive share (**§702**), and bares no necessary relationship to the amounts actually distributed to him.
* Under **§704(a)**, each partner’s DS is determined by reference to the partnership agreement, which is defined under **§761(c)** to include all amendments made by the partners up to the time the tax return is due to be filed. As such, it allows partners to allocate the partnership tax items with hindsight and minimize their aggregate tax liability.
* The partners’ DS as reflected in the partnership agreement will NOT be given affect if they lack ***“substantial economic effect”*** (**§704(b)**). Allocations must be consistent with the *underlying economic arrangements* of the partners. **Reg. §1.704-1** separates the test into two components: an economic effect test and a substantiality test.
  + A **“special allocation”** is one that does not correspond to a partner’s general interest in the partnership. E.g. If 2 partners agree to allocate all tax items equally except for depreciation deductions; the DD’s have been specially allocated.
  + A **“bottom line”** allocation is one that allocates the partnership’s net income or loss (rather than individual items).

[Substantial #Economic Effect]

* **§ 704(b) Default Rule** 
  + A partner’s distributive share is determined in accordance with the ***“partner’s interest in the partnership” (PIP)***
* **§ 704(b) Safe Harbor**
  + Specification of distributive shares in the partnership agreement will be respected if
    - The allocation has *“substantial economic effect”* 🡪 consistent with the underlying economic arrangements of the partners and must affect the $$ amounts received by partners independent of tax consequences
  + To achieve this, **§ 1.704-1(b)(1)** gives you three choices
    - 1) Follow the rules of § 1.704-1(b)(2)
    - 2) Allocate in accord with PIP (see § 1.704-1(b)(3))
    - 3) Follow a special rule in § 1.704-1(b)(3)
  + For now, we focus on the rules of § 1.704-1(b)(2)

[§ 1.704-1(b)(2) Rules]– Two Part Test 🡪 *“economic effect”* AND *“substantial”*

* **§ 1.704-1(b)(2)(ii)** deals with ***“economic effect”*** 
  + There are three requirements (§ 1.704-1(b)(2)(ii)(b))
    - (1) Maintain ***capital accounts*** in accordance with **§ 1.704-1(b)(2)(iv)**
      * Keep accounts so you can liquidate according to accounts later. Goal of the gov is to keep taxes and economics aligned.
      * Capital accounts do NOT have restrictions on negative basis
      * When you initially contribute property, CA takes basis at FMV
      * You do not *have* to have capital accounts, but most Pships do (b/c they follow § 704)
    - (2) Liquidating distributions must be in accord with positive capital account balances
      * Note that this does NOT apply to *non-liquidating distributions*
    - (3) Partners must have an obligation to restore negative capital account balances within 90 days of liquidation
      * This is the really burdensome requirement, and it necessarily entails unlimited liability 🡪 if one partner has a negative cash account balance upon liquidation, then needs to pay partnership to make account whole.
      * We will see an alternative method that avoids this requirement in **§ 1.704-1(b)(2)(ii)(d)**
* **Economic effect** is about the timing of partnership tax items. A proper allocation results in tax consequences being felt as income is earned (and depreciation claimed). So long as the CA’s are properly maintained and liquidation proceeds properly distributed, ANY set of partnership allocations will have economic effect under the general test.
  + Absence of economic effect means that the distribution of liquidation proceeds will result in a gain or loss to the partners. It does not result in phantom income or loss over the life of the partnership; the outside basis rules of **§705** ensure that whatever economic effect is lacking during the life of the partnership will be corrected upon liquidation.
* **§ 1.704-1(b)(2)(iii)** deals with ***“substantial”***

[Basic Rules For Capital Accounts]

* **§ 1.704-1(b)(2)(iv)(b) [Basic Rules]:**
  + Each capital account is *increased* by
    - 1) the amount of money contributed by P to Pship
    - 2) the FMV of property contributed by P to Pship (net of assumed liabilities)
    - 3) allocations to P of Pship income and gain (including tax exempt income)
  + Each capital account is *decreased* by
    - 4) amount of money distributed to P by Pship
    - 5) the FMV of property distributed to P by Pship
    - 6) allocations to P of Pship expenditures described in § 705(a)(2)(B)
    - 7) allocations to P of Pship loss and deduction

[Capital Account v. Outside Basis]

* Outside basis is determined under **§ 705, 722, 733, 742**
* **Key differences** between outside basis and capital accounts are:
  + Capital accounts *can* be negative
    - Outside basis *cannot* be negative (§ 705(a)(2) prevents decreases below 0)
  + Capital accounts use ***Fair Market Value*** for contributed or distributed property
    - **§ 722** increases outside basis by the basis of contributions (plus any gain recognized)
    - **§ 733** decreases outside basis by the basis of distributions (as determined under § 732)
  + Capital account of purchaser of interest is carried over (§ 1.704-1(b)(2)(iv)(m))
    - **§ 742** gives purchaser of interest in the usual manner (generally, basis = purchase price)
  + Capital account balances measure the *economic* (rather than tax) relationship between the partners, BUT reflects the book value 🡪 does not (in general) reflect any unrealized appreciation or loss accruing *after* the property was acquired by Pship
    - The aggregate value of the partner’s CA should always equal the aggregate book vale of the Pship assets (less liabilities)
* Note that there are many other special provisions and additional rules that we will get to in later classes
  + The comparison here is just at a basic level

**#Alternative Test for Economic Effect**

* **§ 1.704-1(b)(2)(ii)(d)** specifies an alternative to the general test
  + You must still satisfy (1) and (2) of § 1.704-1(b)(2)(ii)(b), i.e.:
    - Maintain capital accounts in accord with § 1.704-1(b)(2)(iv)
    - Liquidating distributions must be in accord with positive capital account balances
  + However, you don’t need the unconditional “deficit restoration obligation”
  + Instead, you need a ***“qualified income offset”*** (QIO)
* **QIO rules** include:
  + An allocation may drive the P’s CA negative *only to the extent* that the P can be required to make further capital contributions.
    - If so agree, allocations have economic effect to the extent they do not cause or increase a deficit balance in a capital account (in *excess of any deficit restoration obligation*)
  + Before making allocations, the effect on capital account balances of anticipated adjustments, allocations and distributions *must be taken into account* 🡪 **“look ahead requirement”** (anticipate in your mind upcoming adjustments and consider before allocating)
    - Requires that a P’s CA be adjusted downward immediately once it is known with reasonable certainty that an event in the future will cause a CA reduction. This limits a P’s share of tax losses so that his CA will be sufficient to absorb those future events when they occur.
  + If an unanticipated event causes a negative capital account balance (in excess of any deficit restoration obligation), then *future income must be allocated* to make up for the excess negative balance as quickly as possible
    - The goal of the alternative test is to ensure that T’s cannot deduct more than their maximum possible economic loss
* *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.
* [Failure to Satisfy] An allocation in the partnership agreement lacking substantial economic effect will be disregarded, but *only* as to the invalid component.
* **Gain Chargeback Necessity:** if depreciation deductions are taken in excess of later sale of relevant property or Pship, allocate gain as necessary to the P who received the deductions in order to make the deductions accurate

**#Contributed Property Allocations**

[§ 704(c) Contributions]

* **§ 704(c)(1)(A):** Gain, loss and deductions with respect to contributed property must be allocated so as to take into account built-in gain/loss upon contribution
* **§ 704(c)(1)(B)**
  + If a contribution is followed by a distribution of the same property to a different partner ***within 7 years*** (>7 so it’s not planned), gain or loss is recognized based on fair market value at the time of distribution
  + There is an exception for things that are effectively § 1031 exchanges [like kind]
    - See § **704(c)(2)**
* **§ 704(c)(1)(C):** Any built-in loss in contributed property can be taken into account *only* by the contributing partner and all other partners must be treated as if the CP had basis equal to value at the time of contribution
  + Prevents shifting loss around

[#Traditional Method]

* **§ 1.704-3(b)(1)**
  + Allocations must avoid shifting of built-in gain or loss
  + On sale of contributed property, built-in gain or loss is allocated to the contributing partner, to the *extent possible*
  + Depreciation allocations also take into account built-in gain or loss
  + **Ceiling Rule:** Under the *traditional method*, total income, gain, loss or deduction allocated cannot exceed the total income, gain, loss or deduction for the partnership
    - When ceiling rule is encountered under TM 🡪 *do nothing*
* ***“Tax Follows Book”*** (as much as possible)
  + When applying the **traditional rule**, proceed in the following order:
    - 1) Determine capital account balances
    - 2) Attempt to make the *non-contributing partners* have tax accounts (i.e., outside bases) that follow their capital accounts
      * Do this to the extent possible subject to the ceiling rule
    - 3) Use any additional gain/loss/depreciation for the *contributing partner*
  + The next two methods (curative allocations and remedial allocations) are designed to address the problems created by the ceiling rule
    - These also try to make “tax follow book” for the ***non-contributing partners***

[Traditional Method With #Curative Allocations] – essentially allows you to ***pool different assets/income***

* **§ 1.704-3(c):** Allocations of tax items may differ from book allocations in order to
  + Reduce or eliminate disparities between book and tax items of *non-contributing partners*
  + Must be *“reasonable”*
    - May ***only*** be applied within the same year 🡪 one year’s worth of disparity (§ 1.704-3(c)(3))

[#Remedial Method]

* **§ 1.704-3(d)**
  + Offsetting notional items of gain/loss may be created
    - Doing so must be *reasonable*
    - The purpose must be to remedy problems caused by the ceiling rule
    - Limited application to the same tax year as the problems arose
  + Special rule for determining book items (§ 1.704-3(d)(2))
    - Essentially pretend there are two assets
      * One has a fair market value equal to its *tax basis* (unappreciated)
      * The other has a fair market value equal to the *built-in gain and a tax basis of zero*
    - In any year in which the ceiling limitation cases book/tax disparity 🡪 cure by manufacturing tax allocations
  + You depreciate each asset according to its own schedule, and you allocate deductions from the two separate assets to the partner
    - Zero basis asset is treated as if newly purchased 🡪 depreciation schedule does NOT carry over from CP but instead starts fresh
* **Problem with “reasonableness” and anti-abuse:** hard to know where the line is. As long as it looks like you’re not trying to exploit…?

**#Reverse § 704(c) Allocations**

* **Treas. Reg. § 1.704-1(b)(2)(iv)(f):** Assets may be revalued and capital accounts may be restated (**“booked up”**) to reflect the *fair market value*s upon the admission of a new partner to the partnership.
  + **BUT**, no adjustments to outside basis
  + Creates book/tax disparity that for pre-admission Ps that can be eliminated by allocating tax gain/depreciation deductions
  + NOT dealing with **§ 704(c)** problem because book/tax disparity is not cause by the *contribution* of appreciated or loss property, but same analysis. Difference is that **§ 704(c)** is ***mandatory*** and **reverse § 704 (c)** is nominally optional, but failure to do so might be characterized as a gift or otherwise. Unclear if Pship can elect to revalue only some of its assets.
    - **“Securities partnership”** is permitted to aggregate unrealized gains and losses from “qualified financial instruments” in making reverse **§ 704(c)** allocations

**#Substantiality Under § 704(b)**

* **§ 1.704-1(b)(2)(iii)(b)** – *Shifting tax consequences*
  + If there is a ***“strong likelihood”*** that
    - The net effect of allocations on capital accounts is small; and
    - The total tax liability of the partners will be less than it would be but for the allocations
      * TB: about being *fairly certain* that you’re just shifting economics around for tax benefits. Are you failing to improve economics, but just improving taxes?
  + Then, the allocations are NOT “substantial” and will be disallowed
    - Basically, shifting around the tax pieces but keeping the CA the same 🡪 NOT substantial. We want there to be a meaningful change in economics along with the change in tax. Unsubstantial allocations differ from the Pship’s general interests in the Pship *only* in the tax sense 🡪 tax allocations do NOT affect the number of dollars to be received by any partner (just shifting tax liability around).
    - If you do tax allocations ***ex-ante*** when you don’t know what tax allocations will be 🡪 more likely to be substantial
    - ***Ex-post*** tax allocations are more likely to be non-substantial (can’t usually do things ex-post).
* **§ 1.704-1(b)(2)(iii)(c)** – *Transitory allocations*
  + If there is a ***“strong likelihood”*** that
    - The net effect of allocations on capital accounts across years is small; and
    - The total tax liability of the partners over time will be less than it would be but for the allocations
  + Then, the allocations are NOT “substantial” and will be disallowed
    - Basically, if you haven’t really changed the CA over time, and have significantly reduced the Pship’s tax liability 🡪 unsubstantial
* **“Value equals basis” presumption:** In determining whether a set of potentially offsetting allocations lack substantiality as “transitory”, the regs *assume* that the adjusted tax basis of property will be FMV. Presumption that FMV = book value 🡪 enormous opportunity for aggressive Ps who seek to trade allocations across the years.

**Prohibitions on #Retroactive Allocations**

* **§ 706(c)-(d):** Retroactive allocations are prohibited.
  + **“Retroactive Allocations”:** NOT referring to allocations made after the close of the taxable year, but rather allocations of items of Pship income and loss to persons who were NOT partners when ***items accrued***

**A PARTNER’S OUTSIDE BASIS**

* A partner may acquire his partnership interest in at least 4 ways: 1) in exchange for property contributed to the partnership; 2) by purchase; 3) by gift; or 4) through the estate of a decedent. If the interest is acquired by contribution, the partner’s OB is the basis of the adjusted property (**§722**). If the interest is acquired otherwise, **§742** provides that usual rules apply: cost for purchases (**§1012**); carryover for gifts (**§1015**); and FMV for devises and bequests (**§1014**). If multiple interests are acquired, the IRS’s position is that the partner has only a single, undifferentiated OB.
* A partner’s OB is adjusted under **§705(a)** for subsequent contributions, his distributive share of income and loss, and distributions of cash and property. Because inside basis and OB begin equal, as a general rule, they should remain equal throughout the life of the partnership.
  + The language of **§705(a)(1)(A)** makes clear that the basis adjustments wait until income is realized.
  + Under **§705(a)(1)(B)**, a partner is entitled to increase OB for his distributive share of partnership-level exempt income (i.e. gifts) and must decrease it for tax-exempt deductions.
  + Charitable deductions are reported directly by the partners.
  + More generally, any transaction having a permanent downward adjustment on the partnership’s asset basis should have an equivalent effect on the partner’s OB

**Outside Basis and #Recourse Debt**

* When a partnership borrows money, inside basis (of Pship) increases automatically, so such borrowing must also increase aggregate OB. This is done by **§752(a)**, which treats an increase in a partner’s share of debt as a cash contribution by the partner. **§752(b)** provides that a decrease in a partner’s share of the debt is treated as a cash distribution.
* A **§752(a)** increase in OB is useful to partners, as it (i) allows a partner to report a larger share of partnership losses and/or (ii) receive a greater cash distribution without recognizing gain.

[General Rules]

* **#Recourse Debt**
  + Defined in **§ 1.752-1(a)(1)**
    - Recourse to the extent partner or related party has ***risk of economic loss***
      * **Related person:** family members (not brothers/sisters), controlled/commonly controlled entities (at least 80% o’ship) (Reg. § 1.752-4(b)(1))
  + Determine who bears risk of economic loss
    - Perform hypothetical zero-value liquidation (§ 1.752-2(b)) 🡪 adjust the Ps CA by the ***book*** (not tax) loss realized on the hypothetical zero-value sale (hypo sale for FMV, then reduce CAs)
      * This means that recourse debt allocations are influenced by existing capital accounts
    - A partner bears loss to the extent the she becomes liable after zero-value liquidation
  + Partner’s share of recourse debt (includible in outside basis)
    - Is equal to the ***portion*** of for which the partner *bears the economic risk of loss*
      * All partners are *presumed to be solvent* (able to satisfy obligations in full); can be rebutted in abusive situations. *Canal Corp. v. Commissioner*
* [Recourse Debt Increasing Outside Basis] *Abramson v. Commissioner* (Pship bought movie rights. Paid $224k in cash, paid $1,525k with a note, payable from one-half of movie returns. Partners guaranteed pro rata portions of the note in their individual capacities [Ps concerned about joint/several liability—limiting exposure]. Issue: can limited Ps increase outside basis by the amount of their guarantees?)
  + **Yes, to the extent of their pro rata guarantees**. General partners, if on the hook, can increase their basis by guarantees. No difference between to the two 🡪 limited Ps will bear ***ultimate economic liability*** for their pro rata share.
    - AB: Why do they care? Bigger basis allows them to take more losses (if losses exceed outside basis 🡪 *sits in suspension*).
* No change in capital account when you borrow money, but there *is* a change to ***tax basis*** 🡪 allocation of debt just a tax notion under *Tufts*
* **Recourse indebtedness**, in general, is allocated according to loss interest. **Nonrecourse indebtedness** is (generally) allocated according to profit interest.
* *Only* in the case of **nonrecourse debt** does a guarantee place ultimate risk of loss on the guarantor partner. When the loan is **recourse** as to the Pship, the guarantor partner’s potential rights of subrogation leave ultimate risk of nonpayment on the Pship’s general partners, and so the debt in this case should be allocated among those partners. *Brand v. Commissioner*

**#Nonrecourse Debt**

[Basic Nonrecourse Rules]

* Nonrecourse Allocated in Three Tiers (see slides for schematics)
  + **Tier 1:** Allocate in accord with minimum gain
    - Minimum gain is excess of debt over book value of property (the amount that debt balance ***exceeds*** book value)
    - This gain is split in proportion to prior nonrecourse depreciation deductions (or whatever you did to get the discrepancy). This helps ensure that a partner properly allocated nonrecourse deductions will have sufficient outside basis to exploit them.
  + **Tier 2:** Allocated in accord with built-in gain rules – **§ 704(c)** income rules (debt over basis, capped at §704(c) gain)
    - Assume property is sold for exact amount of debt outstanding
    - Consider under traditional method AND remedial method (traditional w/ curative method is prohibited by regs for nonrecourse allocations under tier 2)
  + **Tier 3:** Allocated in accord with profits interests
    - Only tier that allows Pship discretion

**#NONLIQUIDATING DISTRIBUTIONS**

**Basic Taxation Rules**

* The basic principle underlying the tax treatment of partnership distributions is the that the distribution should be ***tax free*** to the Pship AND to the distributee partner *if possible*.

[Nonliquidating Distributions § 731]

* **§ 731(a)(1)**
  + No gain recognized on distribution
  + *Except*to the extent money (including marketable securities) distributed exceeds basis
* **§ 731(a)(2)**
  + No loss recognized in case of nonliquidating distributions
* However, the relative simplicity of **§ 731(a)** can be overruled by application of **§ 751(b)**

[Basis Allocation § 732]

* **§ 732(a)(1)**
  + Carryover basis, generally
* **§ 732(a)(2)**
  + Aggregate is capped at outside basis *before distribution*, reduced by money distributed
  + Basis shortfall is allocated among the distributed assets in accordance with the rules of **§ 732(c)** (written so that OI assets will be given carryover basis *before* capital assets, reducing chance of OI recognition)
* **§ 732(c)**
  + Allocation of basis across non-money assets:
    - **§ 732(c)(1)(A)**
      * First to unrealized receivables and inventory to make these have carryover bases
      * If not enough to reach goal, make a tentative allocation of basis, then make negative adjustment
        + First to assets with built-in loss, to the extent of built-in loss
        + Then to in proportion to respective adjusted bases (after adjustment for built-in losses)
    - **§ 732(c)(1)(B)**
      * Next, anything remaining to other properties to make these have carryover bases
      * If not enough to reach goal, make a *tentative allocation* of basis, then make negative adjustment
        + First to assets with built-in loss, to the extent of built-in loss
        + Then to in proportion to respective adjusted bases (after adjustment for built-in losses)
* **§ 733(1):** When a transaction includes cash AND property 🡪 the P’s outside basis is reduced by cash first, *then* by the property
* A **loan** from the Pship is NOT a distribution under **§ 731-733** *unless and until* the loan is forgiven by the Pship.

**Distributions and Capital Accounts**

* ***How are the CAs affected?***
  + First, the CA must be adjusted to reflect income, gain, loss inherent in the property 🡪 ***“book up” to FMV***
    - “Book up” is according to unrealized *book* gain/loss and NOT unrealized *tax* gain/loss.
  + This is then split between the Ps according to the partnership agreement.
  + Next, the FMV of the distributed property is deducted from the receiving partner’s CA.

**Distributions of Encumbered Property**

* When encumbered property is distributed by a Pship, the debt allocation rules of **§ 752** are triggered. As to the non-distributee partners, the effect is a constructive distribution equal to the share of debt eliminated. As to the *distributee partner*, though, the effect of the debt is ***twofold***: The distributee loses her share of the debt *qua* partner but acquires the entire debt as an individual. These two effects are netted to produce a single net increase in the share of debt.
  + **§ 752(a):** Increase in liabilities is considered a contribution of money 🡪 dollar for dollar increase in OB
  + **§ 752(b):** Decrease in liabilities is considered a distribution of money
    - *Rev. Ruling 79-205* tells us that liabilities in the transactions considered should be *netted together*

**Character of Distributed Assets**

* Generally,
  + Character of gain on disposition of distribution is tied to use of property by distributee
* However,
  + **§ 735(a)(1):** ***unrealized receivables*** always give rise to *ordinary income*
  + **§ 735(a)(2):** ***inventory*** gives rise to *ordinary income* for 5 years
* Also note:
  + **§ 735(b):** tacking of holding period for distributed asset

**Distributions Subject to § 751(b)**

* Under **§ 751(b)**, distributions that rearrange the partners’ interests in ordinary income assets may be taxed as a sale or exchange between the distributee partner and the partnership (and thus recognize gain on the recharacterized transaction).

[Notice 2006-14]

* **§ 751(b)**regulations
  + Require identification of two types of assets
    - **“Hot” assets**
      * Unrealized receivables (defined by § 751(c))
      * Substantially appreciated inventory (defined by § 751(d),(b)(3)) – inventory’s aggregate FMV exceeds 120% of its aggregate adjusted value.
        + Either *all* or *none* of the inventory items will be treated as “substantially appreciated”
    - **“Cold” assets**
      * Everything else
  + A distributee must compare shares of gross values of hot and cold assets before and after the distribution
  + If relative shares have changed so that one category is relinquished when the other category is acquired, then there is a deemed exchange and possible taxation
* The existing regulations are outdated and complex
* Proposals for reform include:
  + Before/after comparison of income to partners upon a hypothetical sale of hot assets, including application of § 704(c) principles
  + Triggering a taxable sale to the partnership of a distributee partner’s relinquished hot assets at the time of distribution
* The notice request comments on the best way to proceed
* These regulations may be an area in which change occurs in the near future

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

**#Disguised Sales**

* *Canal Corp v. Commissioner* (Joint venture between Wisco, a Chesapeake subsidiary, and GP. W contributed 775m worth of assets w/ low basis for 5% interest; GP contributed 376.4m for 95%. Pship borrowed 755.2m from Bank of America, distributed loan proceeds to W, who then dividended out to Chesapake. GP guaranteed loan, and Wisco indemnified GP, with limitations. Issue: disguised sale?)`
  + **Yes. Taxable.** A distribution financed from the proceeds of a partnership liability may be taken into account for disguised sale purposes to the extent the distribution ***exceeds*** the distributee partner’s allocable share of the partnership liability 🡪 which equals ***portion for which P bears economic risk***. Here, indemnity was no more than a remote possibility that Wisco would be liable (W didn’t have the funds to back up indemnity), so should not be allocated any part of loan.
    - Need indebtedness to *increase outside basis* 🡪 otherwise, distribution would reduce OB to 0 and would trigger taxable gain. Indemnity was designed to claim full amount for OB.
    - AB: the whole point for the taxpayer was to NOT bear any economic risk. They left a little, trying to toe the line, but it ended up being not enough.

[Basic Principles]

* **§ 707(a)(2(B)**
  + If
    - (1) Partner transfers money or property
    - (2) Money or property is transferred to partner
    - (3) Viewed together, it looks like a sale/exchange (***single, integrated transaction***)
  + Then
    - We treat the partner as not a partner, and the sale/exchange is taxed
* The most common situation in which a disguised sale arises is a contribution of appreciated property to a partnership followed by either an actual distribution of cash to that contributing partner, or a deemed distribution arising from a reallocation of partnership liabilities in connection with the contribution of the encumbered property

[Disguised Sale Regulations]

* **§ 1.707-3(b)(1)**
  + A distribution may be part of a deemed sale if it would not have been made ***but for*** the partner’s transfer or property; or
  + If the two transactions are not simultaneous, the subsequent transaction is ***not dependent*** on the entrepreneurial risks of the partnership.
    - Based on all the facts/circumstances
* **§ 1.707-3(c)(1)**
  + Rebuttable two-year presumption if such a distribution occurs
* **§ 1.707-5(b)**
  + Debt-financed transfers can be excepted from the rules
  + You need the partner’s share of liability to be great enough
    - Use the rules of **§ 752** for determining a partner’s share of liability

[Contributions Of Encumbered Property]

* If a partner contributes **encumbered property** to a partnership, the encumbrance is allocated among the partners in accordance with the rules of §752
  + BUT for **nonrecourse debt** 🡪 only the tier three rules are used for disguised sales
* To the extent that some or all of the liability is allocated to the non-contributing partners, the liability *shifts away* from the contributing partner, and this debt shift can be treated as consideration received in exchange for the contributed property and so can form part of a disguised sale
* For determining whether a contributing partner has engaged in a disguised sale as the result of a contribution of encumbered property, ***2 special rules apply:*** 
  + 1) Many liabilities are ignored in determining whether the contributing partner is treated as having received a deemed distribution as a result of the contribution
  + 2) The rules for allocating nonrecourse liabilities under the disguised sales rules differs from the usual debt allocation rules 🡪 ***only tier three applies***
* Some time after a partner contributes property to a partnership, the debts of the partnership may be reallocated because of changes in the amount of the partnership’s outstanding indebtedness, changes in relative capital account balances, or changes in the terms of the indebtedness
  + **§752(b):** If the debt share of the partner declines, that decline is treated as a distribution of cash to the partner
  + In general, a deemed cash distribution of this kind will NOT be paired with an actual contribution of property to form a disguised sale
* **Reimbursement Exception:** distribution made to reimburse CP for capital expenditures on contributed property not a deemed sale *up to 20% of FMV* of contributed property, except that 20% limitation doesn’t apply if FMV < 120% B of contributed property
  + Example: CP makes 2m in capital improvements to property with B 1M and FMV 5m after improvements then contributes; Pship can reimburse up to 1M.
  + Avoid this limit 🡪 debt to finance capital expenditures is qualified (see 3) below)!

[Which Debts Count? Qualified Liabilities]

* **Qualified liabilities***will NOT* create disguised sales (default assumption is liability is ok)
* Must satisfy one of four tests
  + 1) liability was incurred by the partner more than 2 years ago and has encumbered the property continuously
  + 2) liability was NOT incurred in anticipation of contribution and has encumbered the property continuously
  + 3) liability is allocable under § 1.163-8T to capital expenditures with respect to contributed property
  + 4) liability was incurred in the ordinary course of the trade or business, BUT only if *all assets* related to the trade or business were contributed to the partnership

[Non-Simultaneous Disguised Sales: The Timing Rules]

* If a contribution and subsequent distribution are determined to constitute a disguised sale, the sale is deemed to occur when the contribution was made
  + Therefore need to *re-compute* the sale price
* For the partners other than the contributing partner, the disguised sale rules have no direct impact
  + If the contribution and distribution are separated in time, the agreement should provide that *any interest deemed paid* by the partnership as a result of a disguised sale is allocated exclusively to the contributing partner to ensure that the disguised sale rules do not impact the non-contributing partners

**Dispositions of Contributed Property**

* When appreciated property is contributed to a Pship in exchange for an equity interest, the appreciation is NOT taxed at the time of the exchange. This results in lower inside and outside basis, but also the requirement that it will be allocated to the contributing partner. How might this be avoided?

[Requirement]

* **§ 704(c)(1)(B)**
  + If contributed property is distributed within 7 years
  + Then
    - Original contributing partner gets allocated **§ 704(c)** gain/loss as though there had been a sale for fair market value at time of distribution
    - This gain increases both outside basis and the partnership inside basis
* After any **§ 704(c)**items are allocated, the usual procedure is followed
  + Book up asset as necessary inside partnership
  + Reduce distributee’s capital account and outside basis to reflect distribution

[Requirement Avoidance]

* **Three Potential Ways to Avoid 704(c) Gain**
  + (1) Get rid of property tax-free (e.g. like-kind exchange § 1031) 🡪 won’t work. 704(c) attributes *carry over* to new property.
  + (2) Get rid of property by giving to a *noncontributing partner* 🡪 won’t work if within *7 years*. Triggers 704(c) gain.
    - If you can wait 7 years, then no worries
  + (3) Get partner to leave somehow (make a distribution to reduce P’s interest in Pship) 🡪 **§ 737** – triggered by the distribution of property to a P who contributed appreciated property in the past, BUT perhaps will not capture all gain. Distributee will recognize gain equal to the ***lesser*** of
    - (i) the excess of the FMV of the property distributed over the distributee’s outside basis immediately prior to the distribution (reduced by any cash received in the distribution), OR
    - (ii) the net amount of the pre-contribution appreciation in all property *contributed* by the distributee within the past seven years

**Section #737**

* [Context for § 737] Consider the following situation:
  + A owns property X and would like to sell it and buy property Y
  + A has a low basis, X and Y are not like kind
    - Thus, there would generally be gain recognition on the desired transaction
  + Now suppose A and B are in partnership AB
    - A contributes X
    - B purchases Y and contributes it to AB
    - A receives a distribution of Y
  + Has A essentially gotten § 1031-like treatment on non-like-kind property?
  + This is the sort of thing **§ 737**is concerned about 🡪 triggered by distribution of property to P who contributed *appreciated* property in the past
* **§ 737(a)**
  + A distributee partner recognizes gain equal to ***lesser of***
    - (i) Excess of value distributed in excess of outside basis, or
    - (ii) The net pre-contribution gain of the partner 🡪 what is the 704(c) gain left for the stuff that P contributed?
      * Once gain is recognized 🡪 increase P’s OB by this amount, and increase basis of asset P originally contributed (not the property that was distributed to P)
  + 737 *only applies* when P is acting in the capacity of a partner. 737 came after 707 🡪 first see if it is a disguised sale, then look at 737.
* **§ 737(b)**
  + **Net pre-contribution gain** is equal to
    - All gain to partner under § 704(c)(1)(B) if all property in the partnership that had been contributed by the partner were distributed to another partner
      * Includes only the *pre-contributed* appreciation reaming in property contributed by the P within the last seven years and still held by the partnership
* Note the critical importance of the word ***“lesser”***in **§ 737(a)**
  + Note also the possibility of doing the “hokey pokey” (as the book calls it) with borrowing 🡪 increases OB and allows to take advantage of “excess of value distributed in excess of outside basis”
    - *You can do this!!* Example in regs blesses this.
* **§737** will NOT force recognition of income on a distribution of cash because the amount defined in §737(a)(1) will be $0
  + A distribution of cash triggers recognition of income under §731(a)(1) to the extent the cash distributed exceeds the distributee’s OB
  + Application of **§737** would be redundant because the measure of recognition in §731(a)(1) is the same measure employed by **§737(a)(1)** (with cash substituting for property)
* The application of **§737** is limited to the amount of pre-contribution appreciation that would be taxed to the contributing partner under **§704(c)(1)(B)** if the property were distributed to some other partner
  + The effect of §737 will be mitigated to the extent the contributing partner can *eliminate the §704(c) book/tax disparity*
  + If the contributed property is depreciable by the partnership, the §704(c) book/tax disparity may be eliminated over time by differing allocations of book and tax depreciation
* **Exceptions to §737**
  + §737 provides an exception for property distributed to the partner who originally contributed the property to the partnership
  + There is an implicit exception for swap transactions that have the effect of a like-kind exchange

**Capital Avoidance**

* **§707(a)(2)(A)**, like **§707(a)(2)(B)** (which governs disguised sales), is triggered by a transfer to the partnership (e.g. a building) and a related distribution from the partnership to a partner (e.g. cash)
* **§707(a)(2)(A)** is distinguished by the requirement that the contributing/distributee-partner receive an ***allocation of income*** to go along with the distribution of money or property
  + By reason of this allocation requirement, the contributing/distributee-partner will recognize income on the transaction, and so transactions described in **§707(a)(2)(A)** cannot represent attempts to reduce the tax burden imposed on the contributing/distributee-partner
  + Such transactions may represent an attempt by the partnership to avoid the capitalization requirement of **§263**
* Not all allocations are subject to re-characterization under **§707(a)(2)(A)**
  + (1) Most important factor is the extent to which ***distribution is subject to appreciable risk***
    - An allocation of net partnership income ordinarily should NOT fall within the scope of §707(a)(2)(A) because net income is ***dependent on the economic success*** of the partnership venture
    - Allocations of **gross partnership income** do not share this element of entrepreneurial risk and so are more liable to challenge under §707(a)(2)(A)
    - Even an allocation of net income can be virtually risk free as to both fact of payment and amount if the partnership’s income stream is assured
  + (2) If the distributee’s status as a partner is *transitory*, the allocation and distribution are more likely to be re-characterized as a fee for services or for property
    - Even if the distributee’s status as a partner is not transitory, if the distributee’s continuing interest in the partnership is small as compared with the special allocation and distribution, the transaction is likely to fall within §707(a)(2)(A)
  + Other factors include the proximity in time of the contribution of services or property and the distribution, the effect of the transaction on providing tax benefits to the partnership, and whether the contribution was booked in at less than FMV

**ACQUISITIONS OF PARTNERSHIP INTERESTS**

**Contributions of Property**

* **Accrued accounts payable** contributed to a partnership by an *accrual-basis transferor* fall within the scope of **§752**
* **Unaccrued accounts payable** contributed to a partnership by a *cash-basis transferor* are treated in accordance with **§704(c)** principles
* If a TP contributes his **own promissory note** (other than a readily tradable one) to a partnership, his CA is not increased until there is a taxable disposition of the note by the partnership or as principal payments are made by the partner on the note
  + Because such a note represents a promise by the partner to contribute additional funds to the partnership, contribution of such a note by a limited partner will permit that partner’s CA to go negative by the amount remaining unpaid on the note
  + A partner’s OB is NOT increased by the contribution of such a note

[Holding Period Rules]

* **Contributed property**in hands of partnership
  + Tacking for holding period under **§ 1223(2):** The holding period of property acquired in a carryover basis transaction ***includes*** the holding period of the transferor
    - Thus, if property is held for more than a year before it is contributed to a partnership and then is disposed of immediately by the partnership, any capital gain or loss on the disposition will be long term to the partnership
* **Partnership interest** in hands of partner
  + Tacking for holding period under **§ 1223(1):** 
    - But ***only if*** the contributed asset was capital or **§ 1231**property
    - It is irrelevant for application of **§1223(1)** whether the contributed property is a capital asset in the hands of the partnership once contributed
  + Bifurcated holding periods can happen
    - Occurs when properties with different holding periods are contributed
    - A partner having a bifurcated holding period can recognize both long- and short-term capital gain on the sale of his partnership interest or from a distribution of cash (including marketable securities treated as cash under §731(c)) in excess of OB
  + Query: why doesn’t **§ 1223(2)** apply in this case?
    - Hint: is the partner carrying over the partnership’s basis in the interest or rather carrying over the basis of his contributed asset?
* **Distributed property**in hands of partner
  + Generally tacking under **§ 1223**, pursuant to **§ 735(b)**

[Character Rules]

* *Distributed assets*
  + **Unrealized receivables**
    - Permanently ordinary **§ 735(a)(1**)
  + **Inventory items**
    - Ordinary for 5 years **§ 735(a)(2)**
* *Contributed assets*
  + **Unrealized receivables**
    - Permanently ordinary for gains and losses **§ 724(a)**
  + **Inventory items**
    - Ordinary for 5 years for gains and losses **§ 724(b)**
  + **Capital loss property**
    - Losses realized within 5 years are capital to the extent of any built-in capital loss at time of contribution **§ 724(c)**

[Dispositions Of Contributed Property]

* **§724(a):** Disposition of contributed property by a partnership will produce *ordinary income* if the property was an **unrealized receivable** in the hands of the contributing partner
* **§724(b):** Disposition of contributed property by a partnership will produce *ordinary income* if the property was an **inventory item** in the hands of the contributing partner, but ***only if*** the disposition by the partnership occurs within 5 years of contribution of the property to the partnership
* **§724(c):** The contribution of **capital loss property** will *taint subsequent loss* on disposition by the partnership up to the amount of the built-in loss at contribution

**Contribution of Services**

[§ 83(B) Elections – General Rules]

* Can’t get around getting a taxable wage by getting property rather than cash. Recall:
  + **§ 83(a)** imposes tax upon receipt of property in exchange for services
    - **Income amount:**FMV of property received, less FMV of any property given (excess of the FMV of property over the price paid by the service partner)
    - **Time of tax:**when property is transferable or not subject to risk of forfeiture 🡪 ***vested***. When it is *really yours*.
  + **§ 83(b)** Election
    - Allows tax to happen earlier (when you *receive the property*)
      * File within 30 days
      * For determining value, risk of forfeiture is ignored
    - What happens if there is a forfeiture of stock before it vests? ***No deduction allowed***. Only get loss for things you paid for.
* Why would you ever want to be taxed earlier? If you expect the value of property (stock of startup) *increase over time*. Risky, b/c shares might tank and then you’re left with a tax bill.
  + What happens after 83(b) election?

[Taxation Of The Contributing Partner]

* *Diamond v. Commissioner* (Service partner received profits interest and sold it almost immediately after receipt, enabling the IRS to use the subsequent sale price to value the partnership interest)
  + Held that partnership **profits interest** was taxable to partner 🡪the FMV of a partnership interest received in exchange for past services ***is*** taxable compensation
    - Prior to this, it was thought that profits interest was taxable only if the service partner received an immediate interest in partnership capital
    - **Capital Interest:** An interest in the current value of the partnership
    - **Profits interest:** An interest in future profits only
      * Does NOT give the holder the right to a share of the proceeds if the Pship were to immediately sell all of its assets and distribute proceeds in liquidation
  + Note special situation:  valuation was not a problem because interest was sold to an arm’s length party
  + ***Government gave back most of this victory***
* *Rev. Proc. 93-27*
  + Takes the opposite point of view of *Diamond*
  + If a person receives a **profits interest** for services, the IRS will NOT treat it as a taxable event
    - Unless,
      * Profits are substantially certain
      * Interest is disposed of within 2 years
      * Interest is in a publicly traded partnership (and thus would have a value on it)
    - Note that all of these go to valuation issues

[Rev. Proc. 2001-43]

* Extends the result of 93-27
  + *No income* to a P receiving nonvested profits interest for services
  + No income when vesting occurs either
    - TB: you really aren’t getting taxed on profits interest. But doesn’t this have value? Odd that IRS has said that, at time of grant, we’re assuming it is zero. IRS could have treated everything after as tainted ordinary income, but has instead taken most pro-taxpayer position possible.
* It seems **§ 83** is NOT applicable to profits interests in partnerships (!)
* *Planning Opportunity*
  + Will not get taxed at the time of profits interests, and to the extent you are getting profits (distributions) from the Pship, you will be taxed as capital asset (character of asset in the hands of the Pship)
  + TB: turning ordinary income into *capital gains* AND deferring. AND it’s leveraged. Real gain for taxpayers.
  + How do other partners feel? No deduction for wages b/c its deemed to be zero. Irritated UNLESS the money is coming from non-taxable entities (pension funds, universities, foreigners, etc.).
* Problem with proposed **§ 710** is that it is not a very principled solution.

[Taxation Of The Partnership]

* Partnership (non-service partners) is ***not*** taxed on issuance of a partnership interest in exchange for services
  + Can either ***deduct*** OR ***capitalize expense*** depending on whether the expense was ordinary and necessary
    - This preserves the equality of aggregate IB and OB
      * When the service partner is admitted in a taxable transaction, his OB should equal the FMV of his partnership interest
      * Because no new assets are added to the partnership by reason of the admission of the service partner, the service partner either reduces the non-service partners’ OB or increases the IB of some asset
      * Giving the partnership a deduction reduces the non-service partners’ OBs, while capitalizing the value of the services raises aggregate IB

[Non-Contribution Acquisitions]

* Partnership interests can be bought, received as a gift, or received from the estate of a decedent
* In any of these cases, the transferee assumes the CA of the transferor, and the CAs are NOT adjusted to reflect the current FMV of the partnership’s assets
  + That Pship’s assets are not revalued for book purposes seems to be a flaw in the regulations

**DISPOSITIONS OF PARTNERSHIP INTERESTS**

**Liquidating Distributions**

[Basic Liquidating Distributions: Gain/Loss]

* Gain not recognized
  + Except to the extent money received *exceeds* outside basis (**§ 731(a)(1)**)
* Loss not recognized
  + Except to the extent of *outside basis* over the sum of
    - Money
    - Basis in unrealized receivables and inventory
  + ***But only if***no other property is distributed (**§ 731(a)(2)**)

[Basic Liquidating Distributions: Basis]

* Basis in distributed assets
  + Reduce outside basis by *money distributed*
  + Then assign remaining outside basis to *other property distributed*
    - First to *unrealized receivables* and *inventory* to achieve carryover basis (**§ 732(c)(1)(A)**)
      * If insufficient, then decrease (**§ 732(c)(3)**)
        + first in proportion to unrealized depreciation
        + then in proportion to adjusted bases (which is the lowered basis of asset *after* basis has been allocated to unrealized depreciation)
      * Note that you do NOT exceed carryover basis target in any event (only downward adjustments)
    - Next to *everything else* (if anything else) **(§ 732(c)(1)(B)**)
      * If too much, then increase (**§ 732(c)(2)**)
        + first in proportion to unrealized appreciation
        + then in proportion to fair market values
      * If insufficient, then decrease (**§ 732(c)(3)**)
        + first in proportion to unrealized depreciation
        + then in proportion to adjusted bases
* NB: this is the same as for **nonliquidating distributions**, EXCEPT:
  + If there is too much basis for **§ 732(c)(1)(A)**assets and there are no **§ 732(c)(1)(B)**assets, then the remaining unused basis disappears (and you get a loss)

[§ 736 Payments: Overview]

* Payments in exchange for interest in **“partnership property” 🡪 § 736(b) payments**
  + Taxed as a distribution by the partnership (**§ 736(b)(1)**)
* NOT included in the above 🡪 **§ 736(a) payments**:
  + If (**§ 736(b)(3)**)
    - Retiring or deceased partner was a general partner, AND
    - Capital was not a material income-producing factor for the partnership (services partnership)
  + Then
    - *Unrealized receivables* (**§ 736(b)(2)(A)**), AND
    - *Goodwill* UNLESS partnership agreement specifies otherwise (**§ 736(b)(2)(B)**), AND
    - Evidently *any other payments* in excess of the value of the partner’s interest in the partnership property (e.g., deferred compensation)
    - Are taxed as:
      * A distributive share, if determined *with* regard to partnership income **§ 736(a)(1)**
        + Character follows from character for partnership
      * A guaranteed payment, if determined *without* regard to partnership income **§ 736(a)(2)**
        + Ordinary income under **§ 707(c)**
  + The idea is to prevent cashing out as capital treatment something that should be ordinary gain.

[Special § 751(B) Rules]

* If **§ 731**, **732** apply, **§ 751(b)** can override usual treatment 🡪 trigger ordinary income to the extent you are relieved of ordinary income from receivables or substantially appreciated inventory
  + Special Categories: unique treatment for *unrealized receivables/inventory* and *goodwill*. Why? Concern that these items were generating income, which would be ordinary. Worried that partner would distribute something that otherwise would be ordinary but distribute as capital.
    - **Inventory/Unrealized receivables:** 736(b) 🡪 general treatment or 736(a) 🡪 distributive share or guaranteed payment.
    - **Goodwill:** could be ordinary; partnership has discretion
* If liquidation is accomplished via an all cash payment, **§ 751(b)** is relatively easy to apply
  + Exiting partner is hypothetically distributed her share of “hot” assets
  + Carryover basis treatment
  + Hypothetical sale back to partnership for fair market value
  + Gain/loss to partner will be recognized, and partnership will take a fair market value basis
* NB: **§ 751(b)**only applies to **§ 736(b)** payments
  + **§ 736(a)** payments will generally tax unrealized receivables as ordinary income even without **§ 751(b)**

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

[Basic Rules]

* **§741:** The sale or exchange of a partnership interest produces gain or loss to the transferor, computed as the *difference* between the sale price and the transferor’s OB
  + Except as modified by **§751(a)**, this is a capital gain or loss
* **§752(d):** The amount realized in exchange for a partnership interest *includes* the transferor’s share of partnership liabilities
* **§751(a):** We divide the gain or loss realized on the sale of a partnership interest into *ordinary income* and *capital gain* components
  + The net gain (or loss) recognized by the transferor under **§751(a)** will always equal the gain or loss computed under **§741** *without regard* to **§751(a)**
  + The effect of §751(a), in other words, is only to *bifurcate the overall gain or loss* between ordinary and capital components
  + It may be the case that one of the components is positive (an ordinary or capital gain) while the other is negative (an ordinary or capital loss)

[Disposition Of A Partnership Interest: Application Of §751(A)]

* Application of **§751(a)** is computed in ***3 steps***
  + **Step 1:** The selling partner determines how much *ordinary income or loss* would be includible as distributive share if, instead of selling his partnership interest, the partnership sold all of its assets for FMV
    - This is computed by taking into account all provisions that affect the selling partner’s distributive share, including curative and remedial allocations under **§704(c)(1)(A)** principles in connection with reverse **§704(c)** adjustments
    - This is the amount of *ordinary income (or loss)* the selling partner reports under **§751(a)**
  + **Step 2:** The selling partner determines the gain or loss realized on the sale of his partnership interest, computed by ignoring the application of **§751(a)** – this is the selling partner’s net income or loss form the sale
  + **Step 3:** The selling partner determines the *capital gain or loss* from the sale by subtracting from the net income or loss as determined in step 2 the amount of ordinary income computed in step 1
* The capital gain or loss component on the sale of a partnership interest will ***not necessarily*** equal the selling partner’s share of the unrealized gain or loss in the partnership’s assets

**INSIDE BASIS ADJUSTMENTS**

**Section 734**

[§ 754 Election]

* **§ 754**
  + If an election is made under this section, then
    - **§ 734** adjustments must be made with respect to distributions
    - **§ 743** adjustments must be made with respect to transfers of partnership interest
  + The election is ***optional***
    - Once made, however, it can *only be revoked* according to rules set forth in regulations / with permission of the government. Not trivial and cannot switch back and forth year to year.
    - Note that **§ 734** adjustments need to be made with respect to “substantial basis reductions” even if no **§ 754** election has been made **§ 734(d)**
      * This subset of adjustments is NOT optional

[§ 734 Mechanics]

* **§ 734(b)** – Trying to make inside basis match outside basis
  + Requires inside basis adjustments upon distributions
  + **§ 734(b)(1)**
    - Increase inside basis to the extent
      * Gain is recognized by distributee, and
      * Increase in built-in gain, if any, and decrease in built-in loss, if any
        + This is excess of basis of distributed property before distribution over basis of distributed property after distribution
  + **§ 734(b)(2)**
    - Decrease inside basis to the extent
      * Loss is recognized by distributee, and
      * Decrease in built-in gain, if any, and increase in built-in loss, if any
  + Allocation of basis adjustments is specified by **§ 755**
  + Substantial basis reduction
    - Occurs if decreases in **§ 734(b)(2)** *exceed $250,000*

[§ 755 Allocation Rules]

* Allocation of **§ 734**basis adjustments are detailed in **§ 1.755-1(c)**
  + **§ 1.755-1(c)(1)(i)**
    - In general, keep similar character together
      * adjustments resulting from capital are made to capital
      * adjustments resulting from ordinary are made to ordinary
      * if not possible, *suspend* the adjustments until it is possible
  + **§ 1.755-1(c)(1)(ii)**
    - However, if the adjustment is from actual recognition of gain or loss, then
      * adjustments must all be *made to capital*. Overrides requirement of similar character 🡪 if gain/loss recognized, then capital adjustments even if recognition was ordinary (e.g. 751). If no capital assets, then suspend adjustment.
  + Once character is determined, follow rules similar to those in § 732(c)
    - **§ 1.755-1(c)(2)(i)**
      * Increases first allocated to remaining built-in gain property of like character in proportion to built-in gains
      * Then across all remaining property of like character in proportion to fair market values
    - **§ 1.755-1(c)(2)(ii)**
      * Decreases first allocated to remaining built-in loss property of like character in proportion to built-in losses
      * Then across all remaining property of like character in proportion to bases

**Section 743**

[§ 743 Mechanics]

* **§ 743(b)** 
  + Requires ***inside basis adjustments***upon transfers (if a § 754 election is made)
  + **§ 743(b)(1)**
    - Increase inside basis by
      * Excess of basis of transferred interest over proportionate share of partnership basis in property
        + This is essentially the built-in gain of partnership property attributable to the new partner
  + **§ 743(b)(2)**
    - Decrease inside basis by
      * Excess of proportionate share of partnership basis in property over basis of transferred interest
        + This is essentially the built-in loss of partnership property attributable to the new partner
  + Allocation of basis adjustments is specified by **§ 755**
  + Substantial basis reduction **§ 743(d)**
    - If this applies, then **§ 743**rules apply *regardless o*f whether **§ 754** election is made
    - Applies if overall built-in loss of partnership *exceeds $250,000*
      * Note, not just the partner’s share – the threshold is for the entire partnership built-in loss
  + NB: these adjustments are just with respect to the new partner (NOT like 734)
    - This means that a *new set of books needs to be opened* every time there is a new partner!

[§ 755 Allocation Rules]

* Allocations of **§ 743** basis adjustments are detailed in **§ 1.755-1(b)**
  + **§ 1.755-1(b)(2)**
    - Share of gain / loss from all assets is computed first
    - Share of gain / loss from hypothetical sale of ordinary income property is computed next
      * This is allocated to *ordinary income property*
    - Share of gain / loss from capital property is computed as the difference of the two items above
      * This is allocated to *capital income property*
      * If losses are *so large* that there is not enough basis to absorb them, then allocation of excess loss is made to ordinary property
        + This is the “last sentence” of **§ 1.755-1(b)(2)(i)**referred to below (not going to do an example…so don’t worry?)
  + **§ 1.755-1(b)(3)**
    - Allocate ordinary income adjustments first
      * Allocate in proportion to unrealized gain / loss
      * Include adjustment for any excess losses from last sentence of § 1.755-1(b)(2)(i), distributed pro rata according to fair market values
    - Allocate capital adjustments next
      * Allocate in proportion to unrealized gain / loss

[Summary of § 743 Rules from Casebook]

* Make a net adjustment equal to difference between
  + The transferee’s outside basis, and
  + The transferee’s “share of adjusted basis of partnership property”
* The “share of adjusted basis of partnership property” is
  + The transferee’s “share of previously taxed capital”, and
  + The transferee’s share of partnership liabilities
* The “share of previously taxed capital” is
  + Current capital account
  + + (Unrealized Book Gain – Unrealized Tax Gain)
  + – (Unrealized Book Loss – Unrealized Tax Loss)
    - Can (usually) avoid this messy calculation whenever there is no ***§704(c) issues*** (also be careful of liabilities). Basically, if no book/tax disparities, don’t have to worry about calculation.

**PARTNERSHIP LEVEL ISSUES**

**Classification Issues**

[Definition of Partnership]

* Used to be a bunch of judicial factors, hard to tell, but this changed in the 90’s
* **§ 761(a)**
  + Defines partnership
    - Must carry on some ***“business, financial operation, or venture”***
    - Must NOT be a corporation, trust, or estate
* **§ 7701(a)(2)**
  + The first sentence defining partnership is the same, except
    - The phrase “For purposes of this subtitle” does not appear in § 7701(a)(3)
    - The order in which corporation, trust and estate are listed is different
  + **§ 7701(a)(3)**
    - Defines a **corporation** as including associations, joint-stock companies, and insurance companies
    - The regulations (below) give more clarity

[Check-the-Box Regulations]

* **§ 301.7701-3**
  + Allows taxpayers to ***elect*** whether to be a partnership or corporation
    - Known as “check-the-box” election because you check a box on Form 8832
  + Election is available to “eligible entities”, both foreign and domestic
    - Eligible entities are anything not covered by the regulations in the next bullet point
* **§ 301.7701-2(b)(1),(3)-(8)**
  + **Defines corporations:** incorporated under state statutes
    - Limited liability companies NOT treated as corporations
  + There is a list of “per se” corporations in other countries (§ 301.7701-2(b)(8))
    - For example:
      * UK: PLC (Public Limited Company)
      * France: SA (Societe Anonyme)

[Election Possibilities]

* If you are an eligible entity, then
  + If you have only one member, you can be either
    - A **corporation**, or
    - A **“disregarded entity”** (*doesn’t exist for tax purposes*)
  + If you have more than one member, you can be either
    - A **corporation**, or
    - A **partnership**
      * Huge flexibility for tax payer. Remarkable that you can choose freely AND you can change it.
  + Note that there *cannot* be a single-member partnership, and there *cannot* be a multiple-member disregarded entity
* **Timing:**
  + You make an initial election
  + You can make a second election at any time
  + Thereafter, you can make more elections, but you have to wait ***5 years*** between further elections

[Changes without Election]

* If an additional member joins a disregarded entity, then the entity *switches to a partnership*
* If all but one partner leave a partnership, then the entity *switches to a disregarded entity*
* Contributing the assets or partnership interests of a partnership to a corporation can transform partnership into corporation without election
  + In order for this to be tax-free, you should satisfy **§ 351**

[Revenue Rulings]

* **99-5**
  + Situation 1
    - A is single owner of a disregarded entity
    - B purchases 50% interest from A
    - Result: B is treated as purchasing assets from A (so recognizes half of unrealized gain; basis is stepped up for both)
      * Immediately after the asset purchase, A and B are deemed to contribute the assets to a new partnership (with the usual formation rules applicable)
  + Situation 2
    - A is single owner of a disregarded entity
    - B contributes and receives 50% interest in exchange
    - Result: B and A are both treated as making contributions to a new partnership
      * In general this should NOT trigger a tax on any built-in gains in the assets
      * Different result than above. But does require B to contribute full value of assets to Pship to be 50/50 owner.
* **99-6**
  + Situation 1
    - A and B own an LLC treated as a partnership
    - A sells entire interest to B
    - Result:
      * A treats the transaction as a sale of partnership interest, taxed under § 741
      * For B’s treatment, both A and B are deemed to have received liquidating distributions
        + B is deemed to have purchased A’s share of assets (and takes a cost basis)
        + B treat’s his own share of assets under rules for liquidating distributions
  + Situation 2
    - C and D own an LLC treated as a partnership
    - C and D sell entire interests to E
    - Result: C and D are deemed to receive liquidating distributions of assets
      * E is then deemed to purchase assets from C and D
        + We imagine that the Pship evaporates first, then sells assets.

[Publicly Traded Partnerships]

* **§ 7704(a)**
  + Publicly traded partnerships are taxed as corporations
* **§ 7704(b)**
  + **Publicly traded partnerships** are ones with partnership interests
    - Actively traded on an established securities market, OR
    - Readily traded on a secondary market (or substantial equivalent thereof)
      * Makes large law firms or accounting firms nervous

[Family Partnerships]

* **§ 704(e)(1)**
  + Distributive share of the donee is included in donee’s gross income, EXCEPT
    - To the extent such share is determined without allowance for reasonable compensation of services by the donor, and
    - To the extent that the proportion of donated capital is proportionately greater than the share of the donor attributable to the donor’s capital
      * Trying to prevent old trick of assigning away income to family
* **§ 704(e)(2)**
  + A purchased interest between family members will be deemed to have been received as a gift from the seller (!)

1. **Taxation of #Corporations**

**CORPORATE FORMATION**

**Introduction**

* Unlike partnerships, **corporations** are ***taxable entities*** 🡪 pays tax itself on earnings. Income is computed for the corporation and tax is levied according to a corporate rate schedule.
  + Shareholders, who do NOT pay taxes currently, eventually will have to pay tax of their own (dividends) 🡪 ***second level of tax*** = **double taxation**
    - Generally, no tax unless a divided is received or gain is recognized on sale
  + Historically corporations are taxed at lower rate than individuals. True today in that highest individual rate (39.5%) is higher than corporate rate (35%).
  + Which form you want (Pship v. Corporate) depends on applicable rates, income, timing, etc.
    - Can park money, to certain extent, in corporation and wait until your tax rate is lower to take $$ out
* What are corporations?
  + Defined (for tax purposes) by § 301.7701-2
  + Generally includes entities that are corporations for state law purposes
  + Also includes LLCs and other entities that “check the box” to be treated as corporations
* The Statutory Terrain
  + *Transferors*
    - **§ 351**and **§ 357** determine whether any gain or loss realized on the transaction is recognized;
    - **§ 358** and **§ 362(e)** determine the transferor’s basis in stock and property received from the corporation; and
    - **§ 1223(1)** may determine the holding period of stock received from the corporation
  + *Transferee Corporation*
    - **§ 351(f)** treats a corporation that distributes appreciated, nonqualified property as if it sold that property for its fair market value;
    - **§ 1032** provides nonrecognition for the corporation issuing its stock in exchange for money or other property;
    - **§ 362(a) & (e)** determine the corporation’s basis in property received; and
    - **§ 1223(2)** determines the holding period of the property received

**Qualification under § 351**

[Formation / Initial Contributions]

* **§ 351**
  + No gain or loss recognized on contribution, if:
    - (i) Contribution is of **“property”**
    - (ii) Transfer is solely in exchange for **stock**
    - (iii) Immediately after the exchange, the contributors are in**“control”**
      * Realization event, but NOT a *recognition* event
  + Each of the above three steps contemplates a transfer in which investment remains substantially the same
    - Compare this to **§ 721**
  + **§ 351**may also apply to a transaction in which more than one taxpayer is contributing property
    - For persons to be members of a transferor group, a plan must exist before the first transfer that defines the consideration that each member of the group will transfer and the consideration that each will receive and that plan must be executed expeditiously
    - 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.
  + **“Person”** under **§ 351***includes* trusts, estates, partnership, associations, companies, and corporations
* If **§ 351**applies and there is no recognition, then
  + Basis in stock received is carryover (§ 358)
  + Basis of property to corporation is *generally* carryover (§ 362(a))
    - BUT see **§ 362(e)** 🡪 contributing loss property: ***cannot get double loss***. If property is contributed with loss, corp gets FMV of basis. BUT ***can elect*** to have corp take loss, and outside party takes FMV as basis in stock.
  + Holding period for stock tacks on to holding period for property (§ 1223(1))
  + Holding period for property by corporation includes prior holding period (§ 1223(2))
* **§ 1032**
  + No gain or loss to corporation on dealings *in its own stock*

[Definition of “Property”]

* [Services Not “Property”] *James v. Commissioner* (James obtained 4 items—FHA commitment, Commitment from United Mortgagee, Contracts and agreements with architectural and construction services, and use of personal finance and credit for two years. James contributed all these to Chicora Corp. Issue: are these “property” within meaning of § 351?)
  + **No.** Contribution of ***services***. Looks like Talbot put up land, and James was builder. Clear from the *purposes* of **§ 351**that NOT every right will be treated as property. James never acquired anything for himself, but for the corporation.
    - TB: Court could have said that small portion of what James did was property, but the vast majority is services. Could have bifurcated the issue, but just said all services. If services are being preformed, decent chance they’ll be *taxed at ordinary rates*, like James.
  + Does this change the tax consequences for the Talbots? **Yes** 🡪 forces full gain recognition on their appreciated land they contributed to corporation. Could have avoided this outcome by contributing to corporation for 100% stock, then later paying James in stock for his services.
* [Services v. Property]
  + Simple performance of services is NOT property for § 351 purposes
    - This prevents the conversion of OI into capital gains when the worker sells received stock
  + “Repackaged” performance of services is not property either (see*James*)
  + What about *industrial know-how*?
    - Suppose you are given stock in exchange for your expertise
      * You will of course put your expertise to use in performing services
  + Consider *U.S. v. Frazell*
    - Geologist identified properties to acquire for a group of unincorporated investors
      * These people were essentially operating as a partnership
    - Geologist then received stock in a corporation that was formed
      * This was either in exchange for a partnership interest or for services
        + Does it matter which? No. Taxed either way.
  + But *patents* are considered property…
* Property must also be ***“transferred”*** 🡪 Must be a sale/exchange within meaning of **§ 1222** to qualify = exclusive unqualified right in perpetuity, or else transaction will be considered a license resulting income
  + BUT see *E.I. DuPont v. U.S.* (p. 16)
  + See p.16 for issues relating to *accounts receivable*
* If person transfers stock to a wholly owned corporation but receives no stock 🡪 stock is “deemed” issued to the person under *“meaningless gesture”* ***doctrine***
  + See p.17 for more “stock” issues

[Control under § 351]

* **§ 368(c)** defines **“control”** as “stock possessing ***at least 80%*** of total combined voting power of [corp’s voting stock] and ***at least 80%*** of total number of shares of *all other classes of stock* of the corporation
  + Rev. Ruling 59-259: the second 80% test applies to ***each class*** of nonvoting stock
  + Control can include *pre-exchange control* 🡪 the transferors can included their previously owned stock in satisfying the 80% rule
* Transferor group must be in control ***immediately after*** the transfer
* Transferor group consists of people whose rights
  + “have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure” (§ 1.351-1(a)(1))
* [De Minimis Tinkering] *Kamborian v. Commissioner* (International Shoe was owned predominantly by five people and entities. Campex was owned by four of the five same people/entities. Campex shareholders contributed Campex stock to International Shoe in exchange for IS stock. Four persons/entities brought in EK Trust—bought 42 shares—to be part of contributing group to hit 80% threshold. Issue: EK Trust part of controlling group?)
  + **No.** If you buy ***de minimis*** amount of stock to take advantage of § 351 🡪 not allowed. Court says regulation is valid AND applies in this instance.
    - Controlling interest *includes* shares person/entity owned in the past
  + **§ 1.351-1(a)(1)(ii):**
    - “Stock or securities issued for property which is of ***relatively small value***in comparison to the value of the stock and securities *already owned* (or to be received for services) by the person who transferred such property, shall NOT be treated as having been issued in return for property if the primary purpose of the transfer is to qualify under this section the exchanges of property by other persons transferring property.”
      * Designed to deal with form over substance problems
    - Ruling issued that states that for advance ruling, property will not be considered “of relatively small value” if it equals ***at least 10%*** of value of stock/securities already owned or to be received for services by transferor.

[“Immediately After the Exchange”]

* *Intermountain Lumber Co. v. Commissioner* (S and W each owned 50% of stock “immediately after” formation. S and W trying to argue that they did NOT trigger § 351. W did not contribute property, but had agreement to buy stock from S shortly thereafter, so S had 100% but had obligation to sale shortly after formation. Issue: § 351 triggered?)
  + **No.** Far more than a mere *change of form* was affected. S, as part of the “same transaction,” agreed to transfer stock to W. If transferee, as part of the transaction by which the shares were acquired, has ***irrevocably foregone or relinquished*** at that time the legal right to determine whether to keep the shares, ownership in such shares is *lacking* for purposes of § 351.
    - Looking through the form
  + Most of the litigation around “immediately after” deals with instances of only momentary control but thereafter dispose of enough shares to drop below 80% requirement. Here, court ruled in favor of taxpayer b/c of *preconceived plan* to sell stock.

**Tax Consequences of a § 351 Exchange**

[“Solely for Stock” Exchange]

* **§ 1001(a):** Person *realizes* gain or loss on her exchange of property, in whole or in part, for stock of a corporation
  + Under **§ 1001(c)** 🡪 this gain is *recognized* EXCEPT as Code provides. **§ 351** is one such exception.
* **§ 351(a):** If property is transfer *solely* for stock 🡪 person *recognizes* none of the gain/lossrealized
  + Holder period *tacks onto stock*, BUT ONLYif she held the property as a capital asset or **§ 1231** asset at the time of exchange
* **§ 1032(a):** Corporation *recognizes* no gain/loss when it acquires property in exchange for stock. If transferor recognizes no gain, then takes carryover basis, and tacking is allowed. **§ 1223(2)**

[Boot in § 351 Transactions]

* There *can* be **boot** (i.e., non-stock) from the corporation to the stockholder in an attempted § 351 transaction
  + There *is* gain recognition, to the extent of boot’s fair market value (§ 351(b)(1))
  + There is *no* loss recognition (§ 351(b)(2))
    - The recognized gain may be capital gain or OI, and its character depends on the nature of the property transferred
    - If TP transfers more than one asset, gain or loss must be computed separately for each asset
* Treatment of basis if gain is recognized
  + *Basis of transferor* in stock is increased by gain recognized (§ 358(a)(1)(B)(ii))
  + *Basis of corporation* in asset is increased by gain recognized (§ 362(a))

[Rev. Rul. 68-55]

* Y was organized by X and A
  + A transferred 20x dollars in exchange for Y stock worth 20x
  + X transferred three assets in exchange for Y stock worth 100x and cash of 10x
* The assets transferred by X have varied built-in gains and losses
  + Can these be netted together? **No.** Losses are different than gains 🡪 look on ***asset-by-asset basis*** (see slide). Allocate to *same portion* as fair market value.
    - In this way losses could effectively be used? Don’t get to *recognize loss*
  + Do they instead have to be treated individually? Yes.
    - If so, how much boot should be allocated to each? Recognize gain to extent of the boot received 🡪 for Asset 2 = 3; Asset 3 = 5.

[§ 351, § 357 and Assumption of Liabilities]

* Suppose property is transferred to a corporation in exchange for stock, and the property is encumbered by a liability
  + **§ 357(a):** if this would otherwise be a valid § 351 transaction, then the liability does NOT disqualify it, and the liability is NOT treated as ***“money or other property”***
  + **§ 357(b):**however, if the ***principal purpose*** was tax avoidance (not a “bona fide business purpose”), then theliability *shall be treated as “money”* received by the transferor
  + **§ 357(c):** even if § 357(b) does not apply, gain must still be recognized to the ***extent*** the total debt principal exceeds the total of the adjusted basis of *all* contributed property
    - Can avoid this gain in two ways: (i) transfer additional assets with sufficient basis or (ii) by limiting the liabilities that the transferee corporation assumes
  + **§ 358(a)(1), (d)(1):** For purposes of calculating basis in stock 🡪 liability ***is*** treated as money (but NOT for calculating gain/loss under **§ 357(a)**)
* [Self-Made Note As Liability] *Peracchi v. Commissioner* (To avoid triggering gain under § 357 in transfer of property to his corporation, P includes promissory note at 11% to corporation of about $1m [§ 357 aggregates property contributed]. IRS argues P is creating basis out of nothing, basis should be zero, and no real obligation to repay—just alter ego [not true indebtedness; would have been no problem if contributed cash]. Issue: does note have face value basis for purposes of § 357(c)?)
  + **Yes.** Note represents a new and substantial increase in P’s investment in corporation. Why? Creditors can ***legitimately call note*** in bankruptcy 🡪 enough to confer substantial economic effect. ***Economic exposure*** is the ultimate measuring rod of a shareholder investment.
    - Also not a gift (IRS argument). There *is* consideration 🡪 implicit promise by corp to put $$ to good use, and FD of directors to generate highest return. If gift, then all contributions to corporations would be gifts.

**Additional Basis Rules**

* Generally, if a person transfers several properties to a transferee corp in a § 351 exchange, the person determines her basis in the transferee stock received by considering the *aggregate basis* of the property transferred. Are there circumstances where basis and holding period of stock received must be split?

[§ 357(c)(3) Liabilities and § 358(h)]

* **§ 357(c)(3)**
  + Exempts certain liabilities from general § 357(c) gain recognition
  + § 357(c)(3) liabilities include ones that generate a deduction when paid
    - This may include certain contingent liabilities or liabilities of cash-method taxpayers
  + § 357(c)(3) liabilities do NOT include ones that created basis when incurred
  + See problem 2-9 for some examples
* **§ 358(h)** – anti-abuse rule that targets duplicate loss at the shareholder and corporate levels
  + If basis in stock after § 351 exceeds value,
  + Then basis is reduced to the extent of § 357(c)(3) liabilities transferred, but NOT below value of the stock

[§ 362(d) and “Inflated Basis”]

* **§ 362(d)** – anti-abuse rule that says the corporation’s basis in any property cannot be increase above its FMV b/c of gain recognized via liability assumption
  + Suppose property transferred under § 351 is subject to a liability
    - If gain is recognized as a result of the liability assumption
    - Basis in property received by corporation cannot be increased above value as a result of the gain recognition
* [Multiple Basis/Holding Periods Rules] *Revenue Ruling 85-164* (see slide)
  + **Rule:** *Pool basis of all assets* 🡪 allocate basis pro rata according to FMV. *Holding period* is determined by referring to the assets deemed exchanged for each portion of the stock.
    - Total basis of contributed properties is 30. FMV is 100. 30 will be split up according to 60/40 ratios 🡪 Common gets 18, and Preferred get 12.
    - For holding period: 60% of assets have short-term period, and 40% have long-term. Thus, 60% of each share (for both command and preferred—across the whole) has short-term value, and 40% have long-term.

**Securities; Boot and the Installment Method**

* Debt received from corp. in § 351 transaction is boot
  + Securities such as debt are NOT “stock” under **§ 351(a)** (get *non-recognition*) and are instead boot under **§ 351(b)**
* Installment sale
  + If the transferor sells property (not a § 351 exchange) for debt, then the **installment sale method** is available for the sale
* **§ 351** and installment sale combined
  + The installment sale method can generally be applied to defer gain recognition with respect to debt received in a **§ 351 t**ransaction and treated as boot with respect to which gain is recognized
  + There are some exceptions
    - See, e.g., **§ 453(g)** regarding depreciable property, § 453(b) regarding inventory

**Interaction of § 351 with Other Code Sections and Legal Doctrines**

* [Sale, Not Contribution] *Bradshaw v. U.S.* (Farmer here selling land to corporation in order to preserve capital gains rates when land is subdivided and sold. If he had done this himself, he would have become an real estate agent and then converted land into ordinary asset [would yield ordinary income]. IRS argues this is basically a § 351(a) transaction—contributing something, rather than selling. Corp just your alter ego. Issue: is this a sale?)
  + **Yes.** Formality of sale is respected. Proper characterization of a transaction as a “sale” or “capital contribution” is a ***question of fact*** to be decided at time of the transfer on the basis of all objective evidence. Here, price is actual FMV. Additionally, various formalities were observed. Payment is structured over time.
    - TB: Nothing in the real economic world changed. Just shuffling paper around, and it works!! Power of working as alter ego. But be careful. Need to respect the formalities.
      * Case shows that even if you are sole owner of corp 🡪 you can still *transact with it*. Also example of installment sale.
  + Why else would TP want a *Bradshaw* transfer? Tax rate at corp level may be less. Limited liability. Easier access to financial markets.
    - Also, sale may be advantageous b/c if TP has capital lsoses, can only offset by $3k
* [Substance Trumps Form] *C-lec Plastics v. Commissioner* (Wash had molds with 0 basis, value of $37k. C-lec was 100% owned by Walsh and owed him $54k. Wash claimed two step\s—(1) receive $40k worth of shares in exchange for $40k in debt reduction; (2) sell the molds to C-lec with payment to be made in the future and evidenced by another $37k in debt [new total debt of $51k]. IRS says just § 351 transfer with 0 basis. Molds were lost in fire, and W wanted to deduct full value. Issue: how to characterize transaction?)
  + **One transaction.** W has basis of 0 in the molds, precluding casualty loss deduction. Transaction’s ***substance***, NOT form will control. Here, basic substance of the transaction was an exchange of common stock for the molds.
  + Other courts have found a § 351 transfer, denying a step-up basis, when there was undercapitalization, excessive purchase price, speculative repayment of purported indebtedness, and no business reason for separating attempted sale from § 351 transfer.
* [§ 351 Trumps Assignment of Income] *Hempt Bros., Inc. v. United States* (Pship has accounts receivable—basis of 0, value of $662,820. Pship transferred this to a new corp in a § 351 transaction. TP argues: When the corporation receives the payments, it should not be taxable because of assignment of income doctrine – the one who earned it should be taxable, and taxable at the time of transfer [most likely]. IRS argues 351 transaction [taxed twice with doubling of gains]. Clear conflict between § 351 and assignment of income. Issue: which trumps?)
  + **§ 351**. Get carryover basis. Congress spoke clearly on this issue. And receivables *are* **property** under § 351.

**CORPORATE OPERATION**

**Corporate Tax Rates and Base (**How much of the details from reading do we need to know? Only worry about in class stuff)

* § 11: Corporate Tax Brackets (1994-2015) – haven’t changed, and adjusted to make true 34% (spikes up to 39% and 38% as catch up bracket) [See slide]
* **“Qualified personal service corporations”** are taxed at a flat 35% rate
  + See test on p.80

[Corporate Taxable Income: Main Differences from Individual Taxable Income]

* Taxable income for a corporation has many similarities to individual taxable income, but there are important differences
  + No standard deduction (§ 63(b) applies to an “individual”)
  + No personal exemption (§ 151(a) is just for an “individual”)
  + No computation of AGI (§ 62(a) is “in the case of an individual”)
  + Limitation of charitable contributions to 10% of adjusted taxable income
    - §§ 170(b)(2)(A), 170(b)(2)(D)
* Capital gains and losses
  + Capital gains do NOT receive favorable rate treatment
    - **§ 11** applies to taxable income *including both* ordinary and capital gain income
  + Capital losses in excess of gains are NOT allowed (§ 1211(a)) – can deduct losses *only* to the extent of gains
    - Disallowed capital losses may generally be carried back 3 years and carried forward 5 years (§ 1212(a))
    - No ordinary income can be offset by capital losses

[Corporate Taxable Income: Other Special Considerations] – don’t worry beyond this slide, but good to know

* **Alternative minimum tax**
  + **§ 55** calculates the corporate alternative minimum tax
  + A corporation must generally pay tax at rates of at least 26% or 28% on its “taxable excess”, meaning so much of its “alternative minimum taxable income” as exceeds its “exemption amount”
    - Alternative minimum taxable income is determined in § 56,57,58
    - Exemption amount is determined in § 55(d)(2),(3)
* Limits on deductibility of high compensation
  + **§ 162(m)** – no deduction for public companies for employee pay over $1,000,000 (but see exceptions for performance-based compensation, etc.)
  + **§ 280G** – no deduction for “golden parachute” payments
* Limits on usage of NOLs (net operating losses) of acquired companies
  + **§ 382** imposes a complex set of limits
    - Have to keep company going, and only can use a percentage of the acquisitions value of NOLs
  + NOLs are essentially an asset—allows you to deduct future liabilities

**Capital Structure**

[Debt v. Equity: Basic Concepts]

* Classical view
  + Binary choice
    - **Equity** is “ownership”
    - **Debt** is a fixed repayment obligation (and not “ownership”)
    - **Hybrids** (such as preferred stock, convertible bonds, etc.) must get classified as either equity or debt – it is a binary choice
      * Note that bifurcation of instruments is possible in some situations, however
* More modern view from financial perspective
  + Continuum
    - Equity and debt are both *contingent claims* on underlying corporate assets
    - The concepts exist on a continuum rather than as a binary choice
    - The position of an instrument on the continuum can change over time
      * For example, debt becomes much like equity as bankruptcy approaches

[Debt vs. Equity: Does It Matter?]

* Modigliani and Miller (M&M)
  + Capital structure is ***irrelevant***
    - At least in a world with no taxes and that is otherwise idealized as well (e.g. no transaction costs)
  + Reasoning:
    - Firm value is independent of leverage (M&M Theorem 1)
    - If a firm levers up (i.e., increases debt issuance), then a shareholder can “undo” the leverage by buying debt in her shareholder level portfolio
      * If we assume that the firm’s cost of debt and the shareholder’s cost of debt are the same, then the borrowing and investing in debt cancel and net firm value is unchanged
* Of course ***taxes make things different***
  + Rightly or wrongly, the tax code treats debt and equity differently
    - Interest payments on debt are *generally deductible* by the firm
    - Dividend payments on equity are *generally NOT deductible* by the firm
  + There is a tax incentive to have more debt
    - There are also other real-world incentives in the other direction, e.g., bankruptcy risks, associated costs increase with increased leverage, difficulty in obtaining financing, attracting investors
    - BUT little debt may make corp a likely takeover candidate

[Leverage Ratios]

* It is common to think in terms of leverage ratios
  + The debt to equity ratio is basically D/E, where
    - D is the value of debt outstanding
    - E is the value of equity outstanding
  + The “values” may be replaced by accounting/book values in various circumstances, and either term may be adjusted to account for other factors (e.g., long-term leases can look a lot like debt)
* The higher a leverage ratio, the more debt a firm has, on a relative basis
  + More debt = riskier 🡪 Makes debt look more like equity
* Other ratios are often calculated as well
  + For example, one may compute total assets over equity, A/E
  + Note that the balance sheet equality A=D+E tells us that A/E=1+D/E

[Value of Debt “Tax Shield”]

* It is common to speak of the interest deductions on debt as providing a “tax shield”

[Distinguishing Debt/Equity for Tax Purposes]

* **§ 385**
  + This section purports to give guidance on distinguishing debt from equity
  + The regulations promulgated under this section were finalized (early 80’s) and then withdrawn shortly thereafter
    - Concern that bright lines were too easily game-able
* There is *not much* by way of bright-line guidance
  + There are factors, and these include the items in **§ 385(b):**
    - Existence of a written, unconditional promise to pay on demand a specific sum on a specified date w/ fixed rate
    - Convertibility into stock
    - Subordination or preference over any indebtedness
    - Debt-equity ratio
      * There is no mathematical threshold here. Ration of 4-1 has been found excessive in light of surround circumstances (*Briggs*), but 700-1 was ok b/c of cash flow and earning power (*Baker Commodities*). A ratio that does not exceed 3-1 is likely to withstand attack.
    - Relationship between holdings of stock and of the interest in question
  + When characterizing financial assets, other factors include:
    - Whether repayment took place;
    - Whether formalities were observed when the “loan” was made; and
    - Whether proceeds were used for “essential assets
* **§ 385(c)** – characterization of issuer shall be binding on issuer and all holders of such interest, BUT can be overridden (obviously) by commissioner
* [Consider All Factors] *Bauer v. Commissioner* (B and H own Federal corporation in 25%/75% amounts. B and H make loans to Federal and receive payments on the loans. Federal would like to be able to take interest deductions. IRS wants different treatment—amounts to be paid are capital contributions; amounts paid out are dividends [not deductible to the corporation, and taxable to B and H]. Tax court agrees with IRS.Issue: debt or equity?)
  + **Debt.** Outward form of transaction is NOT controlling, characterization depends on the TP’s actual intent, as evidenced by circumstances/conditions in advance. Here, lower court miscalculated debt/equity ratio. And although lack of fixed maturity date is may suggest no intention to make full repayment, *no one factor is controlling*. Many other factors favor TP—the existence of notes; fixed and reasonable interest rates; actual timely payment of interest; corresponding treatment of the interest as income by TP; the cash-flow demands of the custom slaughter business, and the lack of subordination of shareholder debt to other corporate debt.
    - The purpose of examining ***debt/equity ratio*** is to determine whether corp is so thinly capitalized that a business loss would result in an inability to repay the advance; such an advance would be indicative of venture capital rather than a loan. Essentially, concerned with the risk of the loan.
    - TB: Sum certain is the threshold factor. Then courts typically like to look at debt/equity ratio. Other factors can be critical depending on how obviously weighted they are to one side or another.

**DISTRIBUTION OF CASH AND PROPERTY**

**Cash Distributions**

[§ 301]

* **§ 301(a)**
  + Distributions of **property** to a shareholder ***with respect to stock***are taxed under **§ 301(c)**
    - Property is defined in **§ 317(a)** and does NOT include stock
  + UNLESS another code section tells you otherwise
* **§ 301(b)**
  + The amount distributed is equal to
    - Money to shareholder
    - **Plus** *fair market value* of other property received
    - **Minus** liabilities received by shareholder
* **§ 301(c)**
  + The portion of a distribution which is a dividend is included in gross income
    - **Dividends** are defined in **§ 316** 🡪 basically, any distribution out of E&P at close of taxable year
      * To determine the *source of distribution* 🡪 (1) E&P of the taxable year, then (2) accumulated E&P
    - Recall special tax rate for shareholder in **§ 1(h)(11)**
  + The portion of a distribution which is NOT a dividend:
    - First reduces basis in stock
    - To the extent basis is exceeded, gain is recognized

[§ 316]

* **§ 316(a)** – a dividend is a distribution by a corporation
  + (1) out of its accumulated earnings and profits (since 1913)
  + (2) out of its current-year earnings and profits, and does NOT matter what E&P is *at the time* of the distribution
* Distributions are deemed to be made out of earnings and profits, to the extent thereof, and most recently accumulated earnings and profits ***come first***
  + Incredibly, **“earnings and profits”** is NOT defined *anywhere in the code*
  + If there is more than one distribution during a taxable year, current E&P are *prorated* among the distributions for purposes of determining whether a distribution is a dividend. Accumulated E&P, however, are allocated to distributions chronologically on a first come, first serve basis.
  + As E&P is distributed 🡪 corporation decreases its E&P according to **§ 312(a)**
* *Revenue Ruling 74-164*
  + Consider 4 situations in which a $15k distribution is made
    - All are covered under **§ 301(c)**
    - All are made half-through the taxable year
  + See slide
    - (1) Start by looking at E&P at *end of the year*, and as long as amount is positive, you don’t care what the E&P was at halfway or when distribution is made. 5k goes to current E&P, and remainder $10k goes to accum. E&P. No applied to basis/gain
    - (2) $5k is applied to current E&P. No accum. E&P. $10k is applied to basis/gain to shareholder (recovery of capital).
      * Code is trying to make you take dividend first, THEN go to return of capital.
    - (3) No current E&P, so none to be applied to current year. All $15k applied to accumulative E&P.
      * Take 5k loss in current year, pro rate to half way through year, THEN reduce it from accumulative before reduce dividend from accumulative.
    - (4) No current E&P. So take net E&P loss for current year, pro rate it half way ($27.5k), reduce from accumulative E&P of $40k = $12.5k. Take this much of dividend out of accumulative, then take remaining $2.5k as basis/gain.

**Property Distributions**

* If property *other than cash* is distributed to shareholders
  + The usual rules of **§ 301**apply to determine the extent of
    - Dividend treatment (§ 301(c)(1))
    - Recovery of basis (§ 301(c)(2))
    - Gain recognition (§ 301(c)(3))
  + *Amount distributed = FMV.* However, if the **shareholder** assumes a liability (or takes property subject to a liability), the amount distributed is reduced by the liability assumed (but NOT below zero) under **§ 301(b)(2)**
    - The **corporation**, under *Tufts* (codified in **§ 311(b)(2)** and **§ 336(b)**), must treat the liability distributed as the amount realized if liability amount is ***greater*** than FMV (if not greater 🡪 take FMV)
  + The *basis* of property received is FMV (§ 301(d))
* The corporation generally must recognize built-in *gain* (but NOT *loss*) on the distribution of an appreciated asset
  + **§ 311(b)** provides for gain recognition (as if it had sold the property for FMV to shareholder)
  + **§ 311(a)** provides for no other recognition (including losses)
    - Note that this was the rule for gains as well before the statutory repeal of the court-created *General Utilities* doctrine
  + **§ 312** provides for the effects on E&P
    - Recognized gain is included in E&P, and then
    - Distribution reduces E&P by *lesser* of FMV and (post-gain recognition) basis
      * E&P is never reduced below zero by a distribution, however, because of parenthetical in **§ 312(a)**

**Disguised or Constructive Dividends**

* Dividend treatment is an unattractive outcome for shareholder/corporation 🡪 taxable to SH as OI, but corp. does not get a deduction. According, TPs often try to avoid paying dividend while still pulling money out of the corporation:
  + (1) A distribution is disguised as a deductible item to the corp. even though it is taxable to the SH 🡪 e.g. excessive employee compensation
  + (2) A distribution is disguised as a nontaxable receipt for the SH even though corp gets no deduction 🡪 e.g. corporate loans
  + (3) [Less common] Corp deducts an expenditure while the SH excludes it 🡪 e.g. corp pays SH divorce legal fees in litigation that also threatens the business
* [Constructive Dividend] *Baumer v. United States* (Baumer, Sr. was the sole shareholder of Corp. Corp granted option to buy property to Baumer, Jr. Terms were to pay $100,000 in exchange for property that turned out to be worth $250,000 a year later. Baumer, Jr. exercised the option and sold the property for $250,000 to a third party. TP says should be taxed for 150k gain 🡪 basis of 100 in option [gift from corp], then purchase price and sale of 250k. IRS argues option should be taxed to father as constructive dividend at distribution of 150k [step 1], and under current law, corp would be taxed on 150k under 311(b) [did not exist at the time] 🡪 the value of the option. Corp E&P would the go up by 150k, then down by 150k. Also, no tax at step 2 and 3 b/c basis in option of 150k, and then pay 100k for property = 250k. Here, no 311(b), but timing and rate matter [taxed earlier, and father has higher rates]. Issue: who is right?)
  + **IRS.** *No* business purpose (distributed something valuable to the son). Constructive dividend. *Primarily* serves the interests of the father. If dress it up at business purpose, then can get away with. For closely held corporations, such transactions get ***special scrutiny*** 🡪 NOT entitled to the presumption that they are conducted at arm’s length.
    - *Intent* of the parties does NOT govern. Rather, courts look to the ***economic effect*** of transaction. If **“bargain sale”** (sell at less than FMV) 🡪 SH receives a dividend in the amount of the difference between FMV and price paid.
    - For valuation, use **“open transaction doctrine”** 🡪 hard to value option, so just wait until option is exercised, and see what value there is.
* [Goods/Services Provided at Cost] *Welle v. Commissioner* (Welle was sole shareholder of TWC corp. Welle had a house built for him. TWC did all the construction. W and his wife acted as general contractors on project. W paid all costs incurred by corporation. W did NOT, however, pay TWC its usual profit margin of 6-7%. IRS argues that that 6-7% margin was constructive dividend. Issue: dividend?)
  + **No.** Arrangement was NOT a vehicle for distribution of TWC’s current/accumulated E&P. W simply used the corp as a conduit in paying subs and vendors and obtained some limited services from TWC employees. W fully reimbursed corp for all costs, including overhead.
    - **Constructive dividend:** where corp confers an economic benefit *without expectation* of repayment, even though neither SH or corp intended a dividend 🡪 corp conferred benefit in order to distribute E&P w/ no repayment
    - TB: here, W and wife are actively engaged as contractors. So maybe 6-7% is partially from their efforts in normal cases? Court says not enough here to constructive dividend, but if the facts were changed slightly…
    - \*\*where is this line?
* Even a bona fide loan to SH may result in a disguised dividend if the loan bears no or inadequate interest. **§ 7872**
* Disguised dividend if a **bargain sale/purchase**
* If disguised dividend via transfer between commonly controlled corporations, there is a deemed distribution to the SH from one corp followed by a deemed contribution of property/cash by the SH to the other corp
* If corp pays personal expenses of SH, court will look to see if ***“primary benefit”*** was to corp or TP. If SH 🡪 may be treated as nondeductible disguised dividend.
* Excessive salary may re-characterized p. 142-3

**Intercorporate Dividends**

[§ 243: Dividends Received Deduction]

* Dividends received by a corporation are deductible to a certain extent – attempt to reduce burdensome cascading taxes
* The fraction deductible is
  + 70% for situations other than those described below (§ 243(a)(1))
  + 80% for dividends from 20%-owned corporations (§ 243(c))
  + 100% for dividends from either
    - Small business investment company (§ 243(a)(2))
    - Qualifying dividends (§ 243(a)(3))
      * Includes dividend from affiliated group member payable out of post 1960s E&P
* [Reducing Sale Price via Dividend] *Litton Industries v. Commissioner* (Stouffers wholly owned subsidiary of Litton. Looking to sell S. S issued $30m note to L, then went and shopped S around/considered IPO. Eventually sold S to Nestle for $75m plus value of note. Issue: was L essentially trying to get value of S prior to the sale via deductible dividend; thus taxed on 75m – basis instead of 105m – basis?)
  + **No.** $30m note *was* a dividend. S could have raised revenue for not from other avenues (borrowing/IPO), and S committed itself to dividend (w/ tax consequences) ***regardless*** of the outcome of proposed sale. Distinguished *Waterman Steamship* because there, the transaction was essentially simultaneous. Here, sufficient uncertainty. Enough separation in time, didn’t appear to part of coordinated plan.
    - Well established that a TP is *entitled* to structure his affairs and transactions in order to minimize his taxes.
    - TB: you can get significantly favorable treatment, but *must be careful*.
* **§ 1059:** mandates a basis reduction for corporate SH in their stock on receipt of **“extraordinary dividends”** 🡪 includes dividends received having ex-dividend dates *within a 365-day period* if in the aggregate they exceed 20% of the TPs adjusted basis in underlying stock

**REDEMPTIONS AND PARTIAL LIQUIDATIONS**

[§ 302]

* **§ 302**
  + If stock is redeemed by a corporation, then either
    - **§ 302(a)**applies and there is exchange treatment; or
    - **§ 302(d)** applies and the distributions is handled under § 301
      * **Redemption:** distribution of property by a corp *in exchange for* its own stock
  + Exchange treatment applies in the following cases:
    - **§ 302(b)(1)**– not “essentially equivalent to a dividend”
    - **§ 302(b)(2)** – substantially disproportionate redemption of stock
      * For this, you must reduce your interest to less than 80% of what it was before with respect to all voting stock, and also less than 80% with respect to all common stock
      * Also, you must own less than 50% of all voting power after redemption
    - **§ 302(b)(3)** – termination of shareholder’s interest
    - **§ 302(b)(4)**– redemption in partial liquidation to non-corporate shareholder
  + Rough idea is to capture disproportionate gain to one shareholders, but need to fit it into one of the above categories
* **§ 317(b)**
  + Defines redemption as acquisition by corp of *its own stock* in exchange for property

[§ 318 Attribution Rules]

* **§ 302(c)**
  + Applies attribution rules of **§ 318(a)**
  + There is an exception for ***family attribution*** **§ 318(a)(1)**, if
    - You really have no interest in the corporation immediately after distribution (including as an employee, officer, etc.), other than an interest as a creditor, for 10 years from date of distribution, AND
    - You file appropriately with the government
      * An independent contractor is NOT an “employee” within the meaning of **§ 302(c)(2)(a)**. *Lynch v. Commissioner*
      * A **“creditor”** must have rights neither broader in scope than is necessary for the enforcement of he claim nor subordinate to the claims of general creditors. **Reg. § 1.302-4(d)**
      * Retaining the legal right to vote violates **§ 302(c)** waiver, even if TP has no equitable interest
  + The exception does NOT apply, however, if
    - Any person deemed related under **§ 318** acquires stock within the 10 year period or at time of distribution
* **§ 318(a)(1)** – Attribution between ***family members***
  + Individual is attributed stock of: spouse, children, grandchildren, and parents
* **§ 318(a)(2)** – Atrribution FROM ***p’ships, estates, corps*** TO beneficial owners
  + Partners and beneficiaries attributed proportionate share of stock of partnerships and estates
  + *50% shareholder* (direct or indirect) attributed proportionate (***pro rata***) stock held by a corporation
* **§ 318(a)(3)** – Attribution TO ***p’ships, estates, corps*** FROM their beneficial owners
  + Partnerships and estates attributed stock owned by partners and beneficiaries
  + Corporation attributed all stock held by *partners, beneficiaries, and shareholders* without regard to percentage ownership (direct or indirect)
* **§ 318(a)(4)** – ***Stock options***
  + Holder of an option to acquire stock attributed underlying stock
* **§ 318(a)(5)** – operating rules
  + Above provisions can be applied repeatedly, with some exceptions, including
    - No repeated application of **§ 318(a)(1)**
      * No grandparents *to* grandchildren (but other way around), and no siblings
    - No repeat application after stock is attributed under **§ 318(a)(3)** for purposes of apply **§ 318(a)(2)** in order to make another constructive owner of such stock

**Treatment of Shareholders: Complete Termination under § 302(b)(3)**

* *Seda v. Commissioner* (Mr. and Mrs. Seda were the shareholders of a corp, and also officers, directors, and employee. Getting older, wanted to redeem their shares. Pursuant to plan: Corp issued 1,000 shares to son for $1k. Corp redeemed 23,920 shares from Mr. and Mrs. Seda for $299k. After, Mr. Seda continued to work for the company (salary=$1,000/month). Otherwise, there was no ongoing interest of Mr. and Mrs. Seda. TPs wanted exchange treatment 🡪 wanted to avoid dividend taxation, and wanted to use basis; also wanted to get capital gains treatment. To escape § 318, need to qualify for waiver under § 302(c)(2)(A)(i) 🡪 make filings and stop working before distribution. IRS argued dividend 🡪 ordinary rates, and all taxed. IRS argued that there was not termination of interest under § 318 b/c son is still working. Issue: treatment?)
  + **Dividend treatment.** Mr. Seda kept working 🡪 failed to qualify for waiver rules.
    - TB: taking rules quite serious. Congress provided specific rules, and you need to follow closely.

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

* For a redemption to qualify under **§ 302(b)(2)**, three-part test:
  + (1) Shareholder must own less than 50% of total combined vote after redemption
    - § 302(b)(2)(B)
  + (2) Shareholder must reduce interest in voting stock below 80% of what it was before the redemption
    - § 302(b)(2)(C)
  + (3) Shareholder must reduce interest in common stock (voting or nonvoting) below 80% of what it was before the redemption
    - § 302(b)(2)(C), flush language at the end

**Treatment of Shareholders: Redemptions Not Essentially Equivalent to a Dividend under § 302(b)(1)**

* A redemption that is neither a complete termination under **§ 302(b)(3)** nor substantially disproportionate under **§ 302(b)(2)** still can be taxed as an exchange at the shareholder level if, considering all facts/circumstances, the redemption “is not ***essentially equivalent***dividend.” **§ 302(b)(1)**
* [Always Dividend for Sole Stockholder] *U.S. v. Davis* (Ownership of corporation: 250 shares directly owned by Davis; 750 shares owned by Davis’ wife and children. Corp issued preferred stock to Davis in exchange for $25,000. Corp later redeemed 100% of preferred stock. Issue: was this a redemption under § 302(b)(1))?
  + **No.** Business purpose is irrelevant for **§ 302(b)(1)**. Attribution rules apply, and ***always*** “essentially equivalent to a dividend” when sole shareholder’s stock is being partially redeemed. Always a dividend IF it does not alter shareholder’s “relative economic interests or rights.”
    - TB: We learn that you need to have honest reduction of ownership to qualify for exchange treatment under **§ 302(b)(1)**
    - This would apply for any fixed interest *before and after*
* [Meaningful Reduction] *Henry T. Patterson Trust v. U.S.* (Closely-held corporation with family disputes. See slide. Issue: qualify under § 302(b)(1)?)
  + [See slide]. Here, it was a ***meaningful reduction*** in stock (even though it was *only 4%!*). “Essentially equivalent to a dividend” is a question of fact. Need to look to record as a whole (all circumstance).
    - TB: Even with option (which is the correct analysis), won’t qualify under **§ 302(b)(2)** b/c doesn’t drop below 50% bar.
    - TB: Somewhat surprising given slight drop in percentage. But court is looking past § 318 and considering that Trust is cashing out 🡪 want to give them exchange treatment. Court is trying to minimize harm to family in tough spot?
      * A little change can be enough if facts/circumstances are right!
    - **§ 302(c)** waiver doesn’t apply to**§ 318(a)(3)**, so couldn’t waive attribution of trust to Ella
    - Also, shares constructively owned by Ella may be attributed to the trust under **§ 318(a)(5)** 🡪 shares owned by Ella’s children are attributed to Ella and then to the trust. BUT Hick’s shares cannot be attributed to his wife and then to Ella via **§ 318(a)(5)**
  + 85% to 61.7% was not essentially equivalent to a dividend when state law imposed a two-thirds voting requirement on certain corporate actions. *Wright v. U.S.* BUT opposite result when 90% to 60% and no action requiring a supermajority was contemplated. **Rev. Rul. 78-401**
  + 2nd Circuit in pre-*Davis* case looked at: (1) right to vote; (2) right to participate in nonliquidating distributions , and (3) right to share in net assets on liquidation. *Himmel v. Comissioner*
  + At minimum, **§ 302(b)(1)** requires a reduction of relative economic interest in corp. Then look to voting control.
* [Control Considerations]
  + Changes (or non-changes) in the degree of control can be important when deciding whether § 302(b)(1) applies
    - Rev. Rul. 75-502: 57% down to 50% is not essentially equivalent to a dividend when there is another shareholder with 50% and so control is lost
    - Rev. Rul. 76-385: 0.0001118% down to 0.0001081% is not essentially equivalent to a dividend because there is no control by shareholder
    - Rev. Rul. 56-183: 11% down to 9% is not essentially equivalent to a dividend when there is a large controlling shareholder
    - *Wright v. U.S.*: 85% down to 61.7% is not essentially equivalent to a dividend when 2/3 vote was needed for control
  + Some patterns:
    - For shareholders *with* control, loss of control *can* lead to redemption treatment
    - For shareholders *without* control, small reductions *can* lead to redemption treatment
    - Note: specific voting rules of the corporation can be relevant to the analysis here
* [Estate Taxes]
  + **§ 303(a)**
    - A redemption gets exchange treatment if the stock redeemed is included in the estate of a decedent and to the extent that it does not exceed the sum of death taxes and funeral/administrative expenses
  + **§ 303(b)(2)**
    - Only applies if the stock constitutes more than 35% of the estate value
    - However, stock in different corporations can be aggregated together to get to the 35% number, but *only* for corporations for which the estate holds at least 20% of all outstanding shares

**Treatment of Shareholders: Partial Liquidations under § 302(b)(4)**

* **§ 302(b)(4)**
  + Redemption gets exchange treatment if it is in partial liquidation and stock is not held by a corporation
* **§ 302(e)**
  + Partial liquidation (§ 302(e)(1))
    - “Not equivalent to a dividend” (determined at the corporate level)
    - Completed pursuant to a plan within one year (or the following year)
  + Safe harbor (§ 302(e)(2))
    - Termination of a line of business counts as a partial liquidation
* [Genuine Contraction] **Rev. Rul. 60-332**
  + M had E&P of 1500
  + M decided to reduce its business
    - Sell some inventory
    - Operate less
    - Eventually liquidate, if warranted
  + M distributes proceeds from sale of inventory and sale of bonds
  + Does this qualify under §302(b)(4)?
    - **No.** Does not represent a “***genuine contraction”*** of the business of corp
    - Doesn’t matter if distribution is pro rata in determining if partial liquidation (302(e)(4))
  + Genuine contraction when TP changed from department store to discount store 🡪 discontinued most of its operations and then changed the reaming business. **Rev. Rul. 74-296**
  + No genuine contraction when switching from general department stor to ladies’ ready-to-wear store b/c distributed cash came from surplus and the new store required as much working capital as prior store. *Chandler v. Commissioner*
  + If a corp reinvests the working capital of a ceased business in its other business, a subsequent distribution of cash will NOT be related back to the business cessation. **Rev. Rul. 67-299**

**Treatment of the Corporation**

* As a general rule, a corporation recognizes gain, but NOT loss, on a nonliquidating distribution of property
  + Because redemptions are a subclass of “distributions,” the redemption of stock with appreciated property ordinarily will result in the recognitions of gain to the distributing corporation
  + Redeeming shares affects corp in **two ways:**
    - **(1)** To the extent gain is recognized 🡪 *increase* E&P pursuant to **§ 312(b)**
    - **(2)** Because transaction involves a distribution 🡪 *decrease* E&P (amount depends on how redemption is taxed)
      * If taxed under **§ 301** 🡪 E&P reduced (but not below zero) by greater of the basis or value of each distributed asset
      * If taxed as an **§ 302(a) exchange** 🡪 some part of amount distributed might be treated as distribution of corp’s paid-in capital and NOT reduce E&P. See **§ 312(n)(7)**
* **§ 312(n)(7)**
  + A redemption under **§ 302(a)** reduces E&P by (no more than) the ratable amount of E&P attributable to the shares redeemed

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

* Suppose a corporation satisfies an unconditional obligation of its shareholder
  + In this case, the corporation should be deemed to make a distribution to the shareholder
  + And the shareholder should be deemed to use the proceeds of the distribution to satisfy the obligation himself

**Redemptions as Part of Bootstrap Acquisitions**

* Redemptions are sometimes utilized to “bootstrap” purchases of closely held corporations. Even outside purchasers can structure an acquisition so that all or a part of the funds for the acquisition come from the target’s assets. *Why do this?* (1) Eliminate or reduces E&P (allows from non-taxable dividends); (2) relieves buyer of having to come up with funds to by *all* of the shares. ***This was allowed in Zenz v. Quinlivan***
  + A sale and redemption may be linked under what is now called the **“*Zenz* doctrine”** 🡪 applies even when the redemption precedes the sale as long as two events are “clearly part of an overall plan”. *See examples*.

**DISTRIBUTIONS OF STOCK**

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

* Pro-rata stock dividends are NOT taxable. *Eisner v. Macomber* 
  + This rule is enshrined in **§ 305(a)**, BUT exceptions carved out in **§ 305(b)**
  + Note: this only applies to the distribution of a corporation’s own stock *made with respect to a shareholder’s stock* (e.g. distributions of stock as compensation to employee or to pay off debt or between two companies NOT covered)
* **§ 305**
  + **(a) In General** – Shareholder *excludes* a stock dividend from gross income. BUT exceptions:
  + **(b)(1) Election Plans –** A distribution payable, at the election of the shareholder, in *stock or property* will be taxable ***regardless*** of the taxpayer’s choice
    - If choose property 🡪 taxed directly under **§ 301**. If choose stock 🡪 same rules apply under **§ 305(b)(1)**
    - Designed to capture dividend election plans
  + **(b)(2) Disproportionate Distributions** – Taxes the receipt of dividend stock if the effect of the stock divided is to increase the *proportionate* corporate interests of some shareholders while giving *other* shareholders cash or other property
    - E.g. right to future dividends increases, right to participate in liquidation increases. Because most preferred stock has a preference as to dividends and a llimitaiton on liquidations, distributions *on* or *of* preferred stock often will trigger (b)(2)
    - **“Companion distribution”** requirement: does not need to be formal distribution, so long as they receive cash/property in their capacity as shareholders. Distributions of cash/property separated by 3+ years = presumed to be unrelated for **§ 305(b)(2)**
  + **(b)(3) Distributions of Common and Preferred** – Taxes stock dividends when *some common shareholders* receive common while *others* receive preferred
    - *Why won’t this trigger (b)(2)?* Common stock is not “property” under **§ 317(a)**
  + **(b)(4) Distributions on Preferred** – Applies to distributions of stock/stock rights made with respect to preferred
    - Excludes from this rule certain changes to the conversion ratio of preferred
  + **(b)(5) Distributions of Convertible Preferred** – Taxes the distribution of convertible preferred stock, UNLESS it is showed that distribution will *not* have effect described in **§ 305 (b)(2)**
  + **(c) Constructive Stock Distributions** – Authorizes regulations that subject certain transactions that have the effect of a stock dividend to the rules of **§ 305(b)**
    - **Treas. Regs. § 1.305-7:** the following may be treated as a **constructive dividend** 🡪 “a change in conversion ratio, a change in redemption price, a difference between redemption price and issue price, a redemption which is treated as a distribution to which **§ 301** applies, or any transaction (including a recapitalization) having a similar effect on the interest of any shareholder”
      * TB: sweeping a lot more into 305. Change in conversion ratio is covered here, but broader than in 305(b)(4). If covered here, constructive dividend. (b)(4) targeting narrow situations of stock split with no adjustment in conversion ratio.
  + TB: while it’s true that the general rule that distributions of stock dividends are not taxed, and the exceptions swallow up the rule, there *are* still ways to get around it 🡪 [look up rule about non-period distributions]. (e.g distributes shares to everyone, then some time later have a redemption)
* [Stock Basis] If shareholder receives stock tax free under **§ 305(a)** 🡪 basis in that stock is determined by **§ 307(a):** requires an allocation of the old stock basis *between* the old and new shares, make in proportion to relative FMV of each share

**LIQUIDATIONS**

* Liquidation rules apply to distributions in **“complete liquidation”** 🡪 a distribution that is “one a series of distributions in redemption of all stock of the corporation pursuant to a plan”
  + This does not pinpoint when liquidation begins. Need plan of liquidation and corp ceases to be a going concern (remaining activites merely for winding up affairs). Liquidation can occur w/o selling all assets, and a distribution in kind may be a liquidating distribution. Also, not necessary for corp to dissolve, and do NOT need a formal plan.

[General Rule]

* **§ 331& § 336**
  + Full taxation for BOTH corporation and shareholders. Treated like all assets sold for all stock.
    - TB: strong incentive to keep assets in corporate form
    - Significant loss limitations
      * **“Related person” rule** (owns more than 50% of stock): if distribution to related person is either non-pro rata or is of “disqualified property 🡪 no loss recognition allowed
        + **Disqualified property:** any property received in a **§ 351** contribution or contribution to capital during prior 5 years
      * **“Anti stuffing” rule** aimed at preventing double deductions. **§ 336(d)(2)**.
      * And if you try to sell assets too close to liquidation, can be considered part of same “plan.”
  + Corp should distribute pro rata share to each shareholder to determine corporate level gain/loss
  + Shareholder amount realize: FMV of property plus cash minus basis in stock (usually capital gain/loss)
    - E&P is NOT relevant

[Complete Liquidation of Subsidiaries]

* **§ 332 & § 337**
  + **Basic rule:** no tax paid by receive corporation when subsidiary is liquidated. Need to be 80% distributee (of both total voting power AND total value) 🡪 the bulk of corporation needs to remain in corporate form

**INTEGRATION OF CORPORATE AND INDIVIDUAL TAXES**

[Incidence]

* *Who actually pays the corporate tax?*
  + Shareholders
  + Debt holders
  + Customers
  + Suppliers
  + Employees
    - Not clear to what extent each of these groups bears the burden
* **Integration:** collapsing individual and corporate tax
  + Bad Ideas
    - Tax as partnerships? Very complicated
    - Tax at 0% rate? Problem of deferral. And huge problem with step-up basis at death.

[ALI Report]

* **Credit system**
  + Corporation pays taxes at corporate level
  + Shareholders receive cash dividend amount (D)
  + This corresponds to a grossed-up dividend amount (G)
  + Shareholder is taxed on G, but gets a credit for the corporation’s prior payment of tax in the amount G-D
    - Should credit be applicable to other income? Should it be refundable? Most ppl say no to both.
* **Deduction system**
  + Corporation pays taxes at corporate level
  + Corporation receives a deduction for dividends paid
    - This puts dividend payments at parity with interest payments
* What are the relative advantages of these two ideas?
  + Which would you want to implement?

**Review**

* *What form do you want?*
  + **Corporate form:** two layers of tax (disadvantage). BUT, if you can defer until lower tax rates or until death 🡪 eliminating second layer in tax.
  + **Partnership form**: huge flexibility to arrange tax affairs. Need to be careful though with anti-abuse and substantial economic effect.