ST. MARY'S UNIVERSITY SCHOOL OF LAW

CORPORATE TAXATION - LW8378

FINAL EXAMINATION

SPRING 1994

1. This examination consists of four (4) pages, including this page as the first page. There are three questions.

2. You will have three (3) hours to complete the examination.

3. St. Mary's University School of Law prohibits the disclosure of information that might aid a professor in identifying the author of an examination. Any attempt by a student to identify herself or himself in an examination is a violation of this policy and of the Code of Student Conduct.

4. You may use your own copy of the Internal Revenue Code and Regulations, annotated in your own handwriting. You may also use a pocket calculator. No other outside materials are permitted.

5. At the end of the exam period, you should turn in your bluebook(s) and your copy of the exam. Please be sure to write your exam number on each.

6. The Code of Student Conduct prohibits discussion of an examination with any person under circumstances likely to endanger the security of examination questions.

7. After reading the oath, place your exam number in the space below. If you are prevented by the oath from placing your exam number in the space below, notify the proctor of your reason when you turn in the examination.

I HAVE NEITHER GIVEN NOR RECEIVED UNAUTHORIZED ASSISTANCE ON THIS EXAMINATION, AND I HAVE NOT OBSERVED ANYONE ELSE DOING SO.

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Exam Number

QUESTION I

Suggested Time: One Hour and Ten Minutes

Aldo and Brenda are unrelated individuals. Brenda is a homebuilder, and Aldo buys and sells real estate. Aldo and Brenda decide to form a corporation, A.B. Corporation, which will build and sell homes.

Aldo contributes Purpleacre in exchange for 300 shares of A.B. Corporation stock. Purpleacre has a fair market value of 600 and is encumbered by a nonrecourse liability in the amount of 300. Aldo's adjusted basis in Purpleacre is 100. Since Aldo is in the business of buying and selling real estate, Purpleacre is inventory in his hands (*i.e.*, not a capital asset).

Brenda contributes Gainacre, Lossacre, and building materials in exchange for 1500 shares of A.B. Corporation stock. In addition to the 1500 shares of stock, Brenda receives Purpleacre, subject to the nonrecourse liability, as boot. Gainacre has a fair market value of 600, and Brenda's adjusted basis in Gainacre is 500. Lossacre has a fair market value of 600, and Brenda's adjusted basis in Lossacre is 800. The building materials have a fair market value of 600, and Brenda's adjusted basis in the building materials is 500. Gainacre and Lossacre are capital assets in Brenda's hands, and the building materials are stock in trade (*i.e.*, not capital assets).

A.B. Corporation will develop subdivisions on Gainacre and Lossacre, build homes, and sell the homes. Aldo and Brenda will receive salaries for their services to the Corporation. The Corporation does not make an S election.

Please discuss the tax consequences to Aldo, Brenda, and A.B. Corporation resulting from A.B. Corporation's formation.

QUESTION II

Suggested Time: One Hour

The Wright-Erhardt Corporation (WEC) is engaged in the charter air travel business under the trade name Wright Way Air. Wilbur owns half the stock of WEC, and Amelia owns the other half. The adjusted basis of Wilbur's stock is 500, and the adjusted basis of Amelia's stock is 500. WEC has accumulated earnings and profits of 200 and owns the following assets:

Asset	FMV	AB
Airplane	400	600
Cash	200	200
Goodwill*	200	-0-
*(trade name, customer lists, etc.)		

Amelia has decided to retire, and Maggie, a WEC employee, wants to buy into the business. WEC's accountant, Norm, has proposed the following plan. First, WEC will liquidate, distributing the airplane to Amelia and the cash and goodwill to Wilbur. Wilbur and Maggie will then form a new corporation, W.A.M. , Inc. Wilbur will contribute the goodwill and 100 cash in exchange for half of the W.A.M. stock. Maggie will contribute her airplane, which has an adjusted basis of 200 and a fair market value of 300, in exchange for the other half of the W.A.M. stock. W.A.M. will continue the air charter business of WEC, using the trade name Wright Way Air. You may assume that Amelia, Wilbur, and Maggie are unrelated individuals and that neither of the corporations is an S corporation.

Please discuss the tax consequences to Amelia, Wilbur, Maggie, WEC, and W.A.M. resulting from the transactions Norm has proposed.

QUESTION III

Suggested Time: Fifty Minutes

Stooges, Inc., has been an S corporation since its formation several years ago. Stooges has three equal shareholders, Larry, Moe, and Curly, who are unrelated individuals. The corporation and all three of its shareholders use the calendar year as their taxable year. As of January 1, 1995, Larry, Moe, and Curly each have an adjusted basis of 500 in their respective shares of Stooges, Inc. During 1995, the corporation has a 3600 loss from operations, which you should assume is incurred ratably during the year (*i.e.*, at the rate of 300 per month). This 3600 loss *does not* include the transactions described in the next paragraph.

On June 30, 1995, the corporation distributes Gainacre to Curly in redemption of all his shares. Gainacre has a fair market value of 600, and the corporation's adjusted basis in Gainacre is 300. On September 1, 1995, the corporation sells Lossacre to an unrelated buyer for 400 cash. The corporation's adjusted basis in Lossacre is 1000. Gainacre and Lossacre are both ordinary income assets in the hands of the corporation.

Please discuss the tax consequences to Larry, Moe, Curly, and Stooges, Inc.

QUESTION I

Since Purpleacre is encumbered by a liability that exceeds Aldo's adjusted basis, Aldo will recognize gain at least to the extent of the excess (200). This gain will be ordinary income to Aldo. The larger question is whether Aldo should qualify for section 351 at all, since the corporation immediately distributes Purpleacre as boot to Brenda. This question is discussed more fully below. Assuming for the moment that Aldo's transfer does qualify for section 351, he will have a gain of 200 (liability in excess of basis) unless the liability was incurred for tax avoidance purposes or lacked a business purpose, in which case the entire liability would be considered boot. We will assume that the liability is not "tainted," and Aldo will recognize a gain of 200. Aldo's stock basis will be zero -- substituted basis of 100, minus liability of 300, plus gain recognized of 200.

The corporation's basis in Purpleacre will be 300 -- carryover basis of 100 plus 200 gain recognized -- again assuming that the liability is not tainted. When the corporation distributes Purpleacre as boot, it will recognize a gain of 300 (fair market value of 600 minus adjusted basis of 300). Section 351(f). It now becomes apparent that Aldo has shifted to the corporation 300 of the 500 gain lurking in Purpleacre, if we follow the form of the transaction. The question of whether that should be allowed will be addressed later.

Brenda will realize a capital gain of 100 on Gainacre, a loss of 200 on Lossacre, and ordinary income of 100 on the building materials. Since Brenda is in control of the corporation immediately after the exchange, Brenda's loss will not be recognized and her gains will be recognized only to the extent of boot received. Brenda receives boot of 300 (the value of Purpleacre net of the liability), which will be allocated among the three assets in proportion to their relative fair market values. Since each asset is worth 600, the boot will be allocated equally among the three assets. Therefore, Brenda will recognize 100 of capital gain on Gainacre and 100 of ordinary income on the building materials. Brenda will take a fair market value basis of 600 in Purpleacre, and her stock will have a basis of 1700 (carryover basis of 1800, minus 300 net value of boot, plus 200 gain recognized).

The corporation will take a basis of 600 in Gainacre and 600 in the building materials (in each case, a carryover basis of 500 plus 100 of gain recognized). The corporation will take a carryover basis of 800 in Lossacre.

The foregoing analysis assumes that we follow the form of the transaction. As mentioned above, the blatant income shift from Aldo to the corporation raises a substance over form issue -- i.e., should Aldo be treated as having transferred Purpleacre directly to Brenda, since the corporation held Purpleacre only for an instant. For Aldo, this theory would result in recognition of the entire 500 gain lurking in Purpleacre, which would be ordinary income. Aldo would take a fair market value basis of 300 in his stock under *Philadelphia Park*.

The corollary of this analysis is that Brenda should be treated as receiving all 1800 shares in exchange for her assets. She would recognize no gains or losses, and would take a substituted basis of 1800 in her stock (the aggregate basis of her assets). When she gives Aldo 300 shares in exchange for Purpleacre, she will have an amount realized of 300 (net value received), an adjusted basis of 300 ($1 per share), and therefore will recognize no gain or loss. She will take a fair market value basis of 600 in Purpleacre (300 per *Crane* and 300 per *Philadelphia Park*). In effect, Brenda has been allowed to offset the gains in Gainacre and the building materials with the loss in Lossacre. Does this run afoul of the language in section 351 that precludes recognition of losses on transfers to controlled corporations? Arguably yes, but the better answer seems to be that Brenda's loss was not recognized on the transfer to the corporation, but rather it was indirectly recognized through substituted basis when Brenda exchanged 300 shares of stock for Purpleacre. Under our substance over form theory, the corporation was not a party to this exchange. We must also address the question of whether the immediate "sale" of 300 shares pursuant to a preexisting agreement breaks the control requirement, making section 351 inapplicable to Brenda. The answer is no, since Brenda retains 1500 shares (15/18 = 83.3%).

As mentioned above, the corporation is not a party to our deemed exchange between Aldo and Brenda. The corporation is still a party to a section 351 exchange with Brenda, however. The corporation will of course recognize no gain, and since there is no boot involved, and since Brenda recognizes no gain *on her exchange with the corporation*, the corporation will take each of the three assets with a straight carryover basis.

QUESTION II

If we recognize the form of the transaction, WEC will recognize a gain of 200 on the goodwill and a loss of 200 on the airplane (the loss does not appear to be disallowed by section 336(d), since the airplane is not distributed to a controlling shareholder and does not appear to have been contributed within a year of the liquidation). The 1231 loss on the airplane will offset the capital gain on the goodwill. WEC's earnings and profits will disappear.

Amelia and Wilbur will each recognize 100 of capital loss per section 331. The capital loss might be converted to an ordinary loss if the requirements of section 1244 are met (we don't have adequate information to make this determination). Amelia will take a tax cost basis of 400 in the airplane, and Wilbur will take a tax cost basis of 200 in the goodwill.

Since the transferors -- Wilbur and Maggie -- together receive all of the WAM stock in exchange for the assets they contribute, section 351 will apply if we follow the form of the transaction. Thus, Maggie will not recognize the 100 gain lurking in her airplane and will take a substituted basis of 200 in her stock. WAM will take a carryover basis of 200 in the airplane (and a carryover basis of 200 in the goodwill, which will be amortizable under section 197).

The foregoing analysis assumes that we recognize the form of the transaction, but Norm's plan is too clever by a half. A persuasive argument can be made that we should not follow the form of the transaction. Since WAM continues WEC's business, in substance all we are doing is redeeming Amelia and bringing in Maggie as a shareholder. Under this theory, WAM is merely a continuation of WEC and should not be treated as a separate corporation. The details are explained below. Consistent with the theory that WAM should be viewed as a continuation of WEC, i.e., a single corporation, the remainder of this discussion will refer simply to "the corporation."

If we apply substance over form analysis and treat the transaction as a redemption of Amelia's stock and reissuance of the same stock to Maggie, the corporation's loss on the airplane distributed to Amelia is non-deductible by virtue of section 311(d). Amelia will still have a 100 capital loss, which still might be converted to an ordinary loss by section 1244, and Amelia still takes a tax cost basis of 400 in the airplane. Per section 321(n)(7), the redemption of Amelia's stock will decrease the corporation's earnings and profits by half (100).

Continuing with the substance over form theory, Wilbur should be treated as receiving a 100 cash dividend. Since he immediately recontributes the other 100 of cash and the goodwill, step transaction analysis dictates that we view them as never having been distributed at all. This impacts both the corporation and Maggie. From the corporation's standpoint, the goodwill will continue to have a zero basis. Maggie will no longer qualify for section 351, because now she is the only transferor, and she fails to satisfy the 80% control requirement. Thus, Maggie will recognize the 100 gain lurking in her airplane, and the corporation will take a fair market value basis of 300 in the airplane.

QUESTION III

When a shareholder of an S corporation is redeemed, the income and deductions for the year must be allocated. This can be done either by prorating each item over the entire year or by closing the books with regard to the redeemed shareholder. In our situation, this makes a difference because of the loss on Lossacre and the gain on Gainacre. (The gain is triggered under section 311, and it passes through to the shareholders).

If we choose to prorate, the gain on Gainacre will be netted against the loss on Lossacre, yielding a net loss of 300. This loss will be allocated on a per share, per day basis, so that Curly's share will be 50 (one-half of one-third), and Larry and Moe's respective shares will be 125 each (1/6 (one-third for 6 months) + 1/4 (one-half for six months).

If we choose to close the books, the gain on Gainacre will be allocated one-third (100) to each of the three shareholders. The loss on Lossacre will be allocated one-half (300) each to Moe and Larry.

Since the loss from operations is incurred ratably, Curly's share will be 600 (one-third of the loss for one-half the year) regardless of whether we choose to close the books or prorate. Larry and Moe's respective shares of the operating loss will be 1500 each (600 for the first six months and 900 for the second six months).

The following table shows the net results under each alternative:

Shareholder	**Net Loss if Prorate**	**Net Loss if Close Books**
Curly	650	500
Moe	1625	1700
Larry	1625	1700

Under either alternative, Curly's stock basis will be zero as of the date of redemption. His amount realized will be 600 (fair market value of Gainacre), resulting in a capital gain of 600 per section 302. Any suspended losses will disappear when Curly ceases to be a shareholder. Accordingly, we should elect to close the books in order to avoid any suspended loss for Curly (if we close the books, Curly's losses from the corporation will exactly equal his stock basis, resulting in an ordinary loss of 500 for Curly and a stock basis of zero). By contrast, if we do not close the books, 150 of losses will disappear when Curly's stock is redeemed.

By closing the books, the extra 150 of losses will be shifted to Moe and Larry, who will at least have some chance of using them later. Moe and Larry will each be able to claim 500 of loss from the corporation, reducing their respective stock bases to zero. The remaining losses (1200 each if we close the books, 1125 each if we do not) will be suspended for future use when Moe and Larry have adequate basis in the corporation.