# St. Mary's University School of Law

## Taxation of Business Entities -- LW8480
## Fall Semester 1996
## Final Examination

1. This examination consists of three pages, not including this cover page. Please check to be sure you have all pages.

2. You will have four hours to complete the exam. There are four questions, and a suggested time allocation is provided for each question.

3. This is an open book exam. You may use any materials that you brought with you into the exam room. You may also use a pocket calculator. You may not share your materials with other test takers during the exam.

4. You may type your answers or write them in bluebooks. Please put your exam number on your paper, and please do not identify yourself in any other way. Any attempt by a student to identify himself or herself other than by exam number is a violation of the Code of Student Conduct.

**PLEDGE**

By placing my exam number below, I affirm that I have neither given nor received unauthorized assistance on this examination.

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Exam Number

# Question I

## Suggested Time: 30 Minutes

The stock of Stooge Corporation is owned in equal shares by Larry, Moe, and Curly. Stooge Corporation has been an S corporation since its formation and reports its income on the calendar year, as do all the shareholders. On July 1 of year three, Curly sells all of his Stooge stock to Shemp, an unrelated individual, for 400 cash. On January 1 of year three, Curly had an adjusted basis of 50 in his Stooge stock. From January 1 through June 30 of year three, Stooge had a loss of 300 from its operations. From July 1 through December 31 of year three, Stooge made a 300 profit. Please discuss the tax consequences to Curly and Shemp.

# Question II

## Suggested Time: 40 Minutes

Wilma and Betty are equal partners in Bedrock Jewelry, a general partnership. The partnership has no liabilities and holds the following assets:

| **Asset** | **Fair Market Value** | **Adjusted Basis** |
|---|---|---|
| Cash | 600 | 600 |
| Inventory | 300 | 300 |
| Capital Asset | 300 | 200 |

The partners have agreed to liquidate the partnership and go their separate ways. Wilma takes the inventory, Betty takes the capital asset, and each partner takes 300 of cash. Immediately before the liquidation, Wilma's adjusted basis in her partnership interest was 700, and Betty's adjusted basis in her partnership interest was 400. Please discuss the tax consequences to Wilma and Betty resulting from the liquidation of the partnership. (You may assume that the Inventory and the Capital Asset were purchased by the partnership for cash.)

# Question III

## Suggested Time: 80 Minutes

Smart Co. has 100 shares of stock outstanding. Grant and Logan, unrelated individuals, each own 50 shares. Smart Co. is a C corporation. Grant, Logan, and Smart Co. all report their incomes on the calendar year. Smart Co. uses the accrual method of accounting, and Grant and Logan both use the cash method. On July 1 of this year, Smart Co. redeems 10 shares of stock from Grant and 5 shares of stock from Logan. In exchange for his 10 shares, Grant receives Gainacre, which has a fair market value of 100. Smart Co.'s adjusted basis in Gainacre is 10. In exchange for his 5 shares, Logan receives Lossacre, which has a fair market value of 50. Smart Co.'s adjusted basis in Lossacre is 80. Gainacre and Lossacre are both capital assets in Smart Co.'s hands, and both have been held for more than one year. Smart Co. has no accumulated earnings and profits, and this year Smart Co. will break even from operations. (You may assume that Smart Co. pays tax at a flat rate of 33% on its taxable income.) Immediately before the transaction, Grant had an adjusted basis of 3 per share in his Smart Co. stock, and Logan had an adjusted basis of 5 per share.

A. Please discuss the tax consequences to Grant, Logan, and Smart Co. resulting from the transaction.

B. How does your answer change if Logan is Grant's father?

C. Assume Grant and Logan are unrelated. On September 1 of this year, Smart Co. redeems an additional 5 shares of Logan's stock for 50 in cash. What result?

# Question IV
## Suggested Time: 90 Minutes

Lucy and Ethel have decided to form a partnership to hold real estate. Lucy contributes Redacre, which has an adjusted basis of 10 and a fair market value of 90. Redacre is encumbered by a mortgage of 60, which the partnership assumes. Ethel contributes Whiteacre, which has an adjusted basis of 60 and a fair market value of 50. Whiteacre is encumbered by a mortgage of 20, which the partnership assumes. Lucy and Ethel have agreed to share all profits and losses equally.

A. Please discuss the tax consequences to Lucy, Ethel, and the Partnership.

B. During year six, the partnership sells Redacre for 130. The purchaser assumes the mortgage on Redacre, which still has a principal balance of 60. Lucy and Ethel divide the cash proceeds of 70 equally. Please discuss the tax consequences to Lucy, Ethel, and the partnership. You should assume the following: (1) Lucy and Ethel have the same adjusted bases in their partnership interests immediately before the sale that they had immediately after formation of the partnership; (2) the partnership has not made any capital improvements to Redacre nor claimed any depreciation with respect to Redacre; (3) the sale of Redacre is the partnership's only taxable event for year six; and (4) the cash proceeds of the sale are distributed on the last day of year six.

C. The facts are the same as in Question A except that instead of contributing Redacre and Whiteacre to a partnership, Lucy and Ethel contribute the properties to a newly formed S corporation in exchange for equal amounts of stock. Please discuss the tax consequences to Lucy, Ethel, and the corporation.

D. The facts are the same as in Question B, except that instead of equal partners in a partnership, Lucy and Ethel are equal shareholders in an S corporation. Please discuss the tax consequences to Lucy, Ethel, and the corporation resulting from the sale of Redacre and the distribution of cash to the shareholders.

Question I

In order to determine the amount of Curly's gain from the sale to Shemp, we must take into account his share of the corporation's income or loss for the year of sale and make the appropriate adjustment to the basis of Curly's stock. For the year, the corporation has net income of zero, meaning nothing will flow through to Curly (or Shemp), and there will be no adjustment to Curly's basis. This would give Curly a capital gain of 350 on the sale (amount realized of 400 minus adjusted basis of 50). Shemp would start with a stock basis of 400.

Section 1377(a)(2) provides that when a shareholder sells all his stock, the buying and selling shareholders can agree to "close the books" of the corporation as of the date of sale. This would result in Stooge corporation having a 300 loss for the short year ending July 1 and a 300 profit for the short year ending December 31. Curly's share of the loss would be 100, and Shemp's share of the profit would be 100 (under the per-share, per-day rule, as applied to the short years). Moe and Larry would be unaffected by the election, since their income and loss would offset. Curly would be able to deduct only 50 of his loss because of the basis limitations of section 1366(d). This would leave him with a stock basis of zero and a capital gain of 400 on the sale to Shemp. Thus, Curly is marginally better off, since he has traded 50 of ordinary loss for 50 of capital gain. Shemp is worse off if the books are closed, since he ends up with 100 of operating income that he would not have had absent the election. He gets a basis increase of 100 under section 1367, but it is problematic when Shemp will enjoy a tax benefit from this extra basis. Since Shemp will incur extra tax cost exceeding the modest benefit Curly will derive, it is unlikely that an election will be made in this situation. (Indeed, even if the agreement of sale provided for such an election, Shemp would be better of breaching the agreement and paying damages to Curly.)

Question II

A liquidating distribution of inventory to one partner and capital gain property to another partner potentially triggers a deemed distribution and exchange under section 751(b). In this case, however, 751(b) does not apply because the inventory is not appreciated (i.e., it's basis is equal to its fair market value, so there is no "lurking ordinary income" for section 751(b) to trigger). Since 751(b) does not apply, the liquidation of Bedrock Jewelry will fall under the general rules of sections 731 and 732.

Betty realizes a gain of 200 on the liquidation -- she receives 600 worth of cash and property in exchange for a partnership interest with a basis of 400. Per section 731, she will recognize this gain only to the extent she receives cash in excess of her outside basis. Since she receives 300 of cash, she will not recognize a gain. Rather, section 732 will preserve her 200 of gain for later recognition by giving her a basis in the capital asset equal to her outside basis, reduced by the amount of cash she receives. Thus, Betty will take a basis of 100 in the capital asset (400 outside basis less 300 cash received).

Wilma realizes a loss of 100 on the liquidation -- she receives 600 worth of cash and property in exchange for a partnership interest with a basis of 700. Section 731 provides that a partner recognizes a loss only in the case of a liquidating distribution in which the partner receives nothing other than cash and ordinary income property, which happens to be exactly what Wilma receives. She will recognize a loss equal to the excess of her outside basis (700) over the amount of money she receives plus the basis of any property she receives. Wilma receives 300 cash. Under section 732(c), Wilma will take a basis of 300 in the inventory. Thus, she will recognize a capital loss of 100 on the liquidation (700 outside basis minus 300 cash and 300 inventory basis).

Question III

A. Redemption of Grant & Logan

1. Consequences to Smart Co.

Under section 311, a corporation recognizes gains but not losses when it makes an operating distribution of property to shareholders. Accordingly, Smart Co. will recognize the 90 of gain lurking in Gainacre but will not recognize the 30 of loss lurking in Lossacre. The 90 of gain will give rise to tax of 30 at the assumed 33% rate. Thus, the distributions will generate current earnings and profits of 60 (the 90 of gain less the 30 of tax).

2. Exchange or 301 distribution?

Under section 302, we must look at the change in a shareholder's ownership resulting from the redemption to determine whether the redemption will be treated as a sale of the redeemed shares or as a "section 301 distribution." In this case, Grant and Logan each own half the corporation before the redemption. After the redemption, Grant owns slightly less than half and Logan owns slightly more than half. Since Logan's ownership *increases* as a result of the redemption, he will be treated as receiving a section 301 distribution. (The consequences are explored further below.) Grant, on the other hand, sees a decrease in his ownership. Is the decrease sufficient to result in sale treatment? Section 302(b)(2) provides a safe harbor of 80% -- i.e., if the percentage owned after the redemption is less than 80% of the percentage owned before, the redemption will be treated as a sale. Grant owned 50% of the stock before the redemption, so the magic number is 40%. After the redemption, Grant owns 40 shares out of 85 shares outstanding -- 43%. Thus, Grant doesn't qualify for the 302(b)(2) safe harbor. A reduction from 50% to 43% would seem to be a "meaningful reduction," however, since Grant goes from a position of equal ownership to one of a minority shareholder. Accordingly, Grant's redemption should qualify for exchange treatment under section 302(b)(1) as a redemption that is "not essentially equivalent to a dividend."

3. Consequences of Grant's Exchange

On the exchange of his stock, Grant will have an amount realized of 100 (the fair market value of the property received). The adjusted basis of the redeemed stock is 30 (10 shares x 3 per share). Thus, Grant will have a capital gain of 70. He will take a tax cost basis of 100 in Gainacre.

4. Consequences of Logan's 301 Distribution

A shareholder receiving a section 301 distribution will have ordinary income to the extent the distribution is a "dividend" -- i.e., to the extent that it comes out of earnings and profits. Because of the gain triggered on the distribution, Smart Co has 60 of earnings and profits available for distribution. We should adjust, however, for the simultaneous redemption of Grant's 10 shares. Generally, a distribution of loss property results in a decrease in E & P to the extent of the property's basis (here, 80). The "ceiling rule" of 312(n)(7) limits the adjustment on redemption to no more than an amount proportionate to the stock being redeemed. Since 10% of the stock is redeemed (Grants 10 shares), the adjustment for the redemption is 6 (10% x 60). This leaves 54 of E & P available for Logan -- enough to cover the entire distribution, giving him a dividend of 50. Logan will recognize 50 of ordinary income and take a fair market value basis of 50 in Lossacre. Since Lossacre has a basis of 80, Smart Co.s E & P will be wiped out by the distribution. Since negative E & P cannot result from a distribution, Smart Co's E & P will be reduced to zero but no further.

B. Logan is Grant's Father

The situation changes if Logan is Grant's father because, under section 318, each shareholder is considered to own the other's stock. Thus, each shareholder owns 100% of Smart Co's stock both before and after the redemption. Accordingly, neither shareholder satisfies section 302 and both receive section 301 treatment.

As outlined above, the distribution of Gainacre generates 60 of E&P (the after-tax profit). This 60 will be allocated in proportion to the distributions. Grant receives a distribution of 100 and Logan receives a distribution of 50. Thus, 40 of E&P will be allocated to Grant and 20 will be allocated to Logan. Grant will have 40 of ordinary income, and Logan will have 20 of ordinary income, and the distribution will take Smart Co's E&P to zero. The remaining portions of the distributions -- 60 for Grant and 30 for Logan -- will be applied against the basis of their stock. Thus, Grant's stock basis will be reduced from 150 (50 x 3) to 90. Logan's stock basis will be reduced from 250 (50 x 5) to 220. Each shareholder will take a fair market value basis in the distributed property per section 301(d).

Ironically, Grant and Logan are both better off under this scenario than if Grant qualifies for exchange treatment. Grant ends up with 40 of ordinary income instead of a capital gain of 70, and Logan ends up with 20 of ordinary income instead of 50 of ordinary income.

C. Redemption of 5 additional shares from Logan

The crucial question here is whether the July and September redemptions are treated as a single transaction or as two separate transactions. The significance is described below, followed by a discussion of the likely treatment.

If the redemption of 5 additional shares from Logan is treated as a separate transaction, it should qualify for exchange treatment because Logan is going from 53% ownership (45 out of 85 shares) to 50% ownership (40 out of 80). Control-to-deadlock would appear to be a meaningful reduction. Thus, Logan will have an amount realized of 50 and an adjusted basis of 25 (5 shares x 5 per share), giving him a capital gain of 25. The September redemption would have no effect on the July redemption.

If the July and September redemptions are treated as a single transaction, neither Grant nor Logan will qualify for exchange treatment because their relative stock ownership is unchanged after the dust settles. Since Grant and Logan receive equal distributions of 100 each, the 60 of earnings and profits generated by the distribution of Gainacre will be allocated 30 to Grant and 30 to Logan, giving each shareholder 30 of ordinary income. The remaining 70 received by each shareholder will be applied against his stock basis per section 301(c)(2), bringing Grant's stock basis to 80 (150 minus 70) and Logan's stock basis to 180 (250 minus 70).

Grant and Logan are both better off if the July and September redemptions are treated as a single transaction. If the redemptions are treated as a single transaction, each shareholder has ordinary income of 30. If the redemptions are treated as separate transactions, Grant has a capital gain of 70 and Logan has 50 of ordinary income and 25 of capital gain. Since both shareholders are better off if the redemptions are treated as a single transaction, that is the position they can be expected to take. The problem is that they will be arguing to apply the step transaction doctrine to a transaction that they themselves structured. Whether they will be successful depends on the facts -- i.e., *why* did they structure the transaction as they did? If they relied on a professional advisor, they might be able to assert a negligence claim if their step transaction argument fails.

Question IV

A. Contribution to Partnership

Generally, contribution of property to a partnership is not a taxable event to the partners or the partnership. Section 721. Each partner takes an outside basis equal to the basis of the property she contributed. Section 722. The partnership takes a carryover basis in the property. Section 723. Applying these principals gives the partnership a basis of 10 in Redacre and a basis of 60 in Whiteacre. Lucy starts with an outside basis of 10, and Ethel starts with an outside basis of 60.

We must consider the liabilities, however. Under section 752, a decrease in a partner's share of libilities is treated as a distribution of cash, and an increase in a partner's share of liabilities is treated as a contribution of cash. Before formation of the partnership, Lucy had liabilities of 60 and Ethel had liabilities of 20. In order to determine each partners share of liabilities immediately after formation, we must go through the "belly-up" scenario. If the partnership goes belly-up, there will be a loss of 140 (property with an aggregate fmv of 140 becomes worthless). Per the agreement, this loss will be borne equally by the partners. Each partner started with a capital account of 30 (net value of property contributed), so a loss of 70 takes each partner's capital account to -40. Thus, if the partnership goes belly-up, each partner will be required to contribute 40 cash. This 80 of cash will be used to pay off the liabilities.

Lucy starts out with 60 of liabilities and ends up with 40 of liabilities. Accordingly, she is deemed to receive a cash distribution of 20. Ethel, on the other hand, starts out with 20 of liabilities and ends up with 40. She is deemed to make a cash contribution of 20.

Lucy's deemed distribution is applied against her outside basis of 10, per section 731, giving Lucy a basis of zero and a gain of 10. Ethel's deemed contribution increases her outside basis from 60 to 80. The partnership is unaffected, unless the partners make a 754 election. In that case, section 734(b) provides for an increase of 10 in the basis of the partnership's assets to reflect the gain recognized by Lucy on the deemed distribution. This increase would be allocated to Redacre, since the basis of Whiteacre already exceeds its fair market value.

B. Sale of Redacre

The sale of Redacre generates a gain of 120 (AR 130 minus AB 10). If the partners made a 754 election, the basis of Redacre would be 20, and the sale would result in a gain of 110. Part of this gain must be allocated to Lucy, the contributing partner, under section 704(c). A gain of 80 was lurking in Redacre when Lucy contributed it, so 80 of gain must be allocated to Lucy. (If the partners made a 754 election, 10 of the gain would have been eliminated by the basis step-up, so only 70 would be allocated to Lucy under 704(c). The remaining 40 of gain (120 minus 80 or 110 minus 70, as the case may be) is divided equally between the partners. Thus, Lucy ends up with gain of 100 (or 90 if there was a 754 election). Ethel ends up with gain of 20. Each partner's outside basis is increased by the amount of gain she recognizes. Thus, Ethel's outside basis goes from 80 to 100, and Lucy's outside basis goes from zero to either 90 or 100.

In addition to an actual distribution of 35, each partner is deemed to receive a cash distribution of 30 because of the buyer's assumption of the liability (see section 752). Each partner has sufficient outside basis to cover the distribution, so it is a recovery of capital (section 731). Ethel's outside basis ends up at 35 (100-65). Lucy's outside basis ends up at 35 (or at 25 if a 754 election was made).

C. Contribution to S Corp

Contributions to an S corp are governed by the same principles applicable to corporations generally -- i.e., sections 351, etc. Since Lucy and Ethel transfer property to the corporation in exchange for stock constituting control of the corporation, the transaction qualifies for non-recognition under section 351. Ethel's realized loss of 10 will not be recognized, and Lucy's realized gain of 80 will be recognized only to the extent she receives "boot," or to the extent that the contributed property is encumbered by a liability that exceeds its basis.

A liability encumbering contributed property generally is not treated as "boot" unless the liability lacks a business purpose. If the 60 of liability encumbering Redacre was incurred for other than a business purpose, Lucy will be treated as receiving 60 of boot and will recognize a gain of 60. We will assume that the loan was incurred for a business purpose and is thus not treated as boot. In that event, we must address the fact that the liability of 60 exceeds Lucy's basis of 10. This excess of liability over basis triggers a gain of 50 to Lucy.

Lucy's stock basis will be zero, determined as follows: substituted basis of 10, minus liabilities of 60, plus recognized gain of 50. The corporation will take a basis of 60 in Redacre -- a carryover of 10 increased by the 50 of gain recognized by Lucy.

Ethel will take a basis of 40 in her stock -- substituted basis of 60 minus liability of 20. The corporation will take a carryover basis of 60 in Whiteacre.

D. Sale of Redacre

When the corporation sells Redacre, it will recognize a gain of 70 (AR130 minus AB60). This gain will flow through to Lucy and Ethel in equal amounts (35 each), and each shareholder's stock basis will be increased by 35. Thus, Lucy's stock basis will go from zero to 35, and Ethel's stock basis will go from 40 to 75. The cash distribution of 35 to each shareholder will be applied against her basis. Lucy's basis will end up back at zero, and Ethel's stock basis will end up at 40. Since each shareholder has adequate basis to cover the distribution, neither will recognize income (other than the income from the sale).