ST. MARY'S UNIVERSITY SCHOOL OF LAW

TAXATION OF BUSINESS ENTITIES -- LW8480

SPRING SEMESTER 1995

FINAL EXAMINATION

1. This examination consists of four pages, including this cover page. Please check to be sure you have all four pages.

2. You will have four hours to complete the exam. There are four questions of *roughly* equal value. In order to budget your time properly, you should read the entire exam **before** you begin answering any of the questions.

3. You may use your own copy of the Kwall casebook and your own copy of the Internal Revenue Code and Regulations. You may also use a pocket calculator.

4. As you are aware, some of your classmates might not have taken this exam yet. Accordingly, you should return your copy of the exam with your paper, and you should refrain from discussing any aspect of the exam, including its perceived difficulty, with anyone.

5. 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.

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

Lance and Marsha, unrelated individuals, decide to form a real estate investment partnership. Lance contributes Blackacre, and Marsha contributes Whiteacre. The partnership is formed on January 1 of year 1, at which time each of the contributed properties has a fair market value of 900. There are no buildings on either of the properties, and each property is a capital asset in the hands of the contributing partner. The partnership will hold the properties for investment and not for sale to customers. Lance's adjusted basis in Blackacre is 600, and Marsha's adjusted basis in Whiteacre is also 600. The partnership and both partners are calendar year, cash method taxpayers.

A. Please discuss the tax consequences of the formation of the partnership.

B. On July 1 of year 2, Kato, another unrelated, calendar year, cash method individual, joins the partnership. Kato contributes Greenacre -- unimproved real estate worth 900. Kato's adjusted basis in Greenacre is 300. At the time of Kato's contribution, Blackacre and Whiteacre are still worth 900 each, so Kato receives a 1/3 interest in the partnership in exchange for Greenacre. Kato is a real estate dealer, and he held Greenacre for sale to customers prior to contributing it to the partnership. The partnership will hold Greenacre as an investment. Please discuss the tax consequences to all parties resulting from Kato's contribution of Greenacre.

C. On July 1 of year 5, the partnership sells Greenacre for 1200 cash and distributes 400 to each partner. Please discuss the tax consequences to all parties. (You should assume that the partnership has not engaged in any taxable transactions other than those described herein.)

D. On July 1 of year 7, the partnership sells Blackacre for 1500 cash. At this point, the partners decide to liquidate the partnership. Marsha receives Whiteacre, which has declined in value to 300. Marsha also receives 300 cash. Kato and Lance each receive 600 in cash. Please discuss the tax consequences to all parties.

QUESTION II

A. The facts are the same as in Part A of Question I, except that the venture is organized as an S corporation rather than as a partnership.

B. The facts are the same as in Part B of Question I, except that the venture is organized as an S corporation.

C. The facts are the same as in Part C of Question I, except that the venture is organized as an S corporation.

D. The facts are the same as in Part D of Question I, except that the venture is organized as an S corporation.

QUESTION III

A. The facts are the same as in Part A of Question I, except that the venture is organized as a C corporation rather than as a partnership.

B. The facts are the same as in Part B of Question I, except that the venture is organized as a C corporation.

C. The facts are the same as in Part C of Question I, except that the venture is organized as a C corporation. You should assume that the corporation pays tax at a flat 30% rate on any gain that it recognizes on the sale of Greenacre, distributing the *after tax* sales proceeds equally among the three shareholders.

D. The facts are the same as in Part D of Question I, except that the venture is organized as a C corporation. You should assume that the corporation will pay tax on its year 7 taxable income at a flat rate of 30% and will withhold exactly enough cash to satisfy this liability. The remaining cash will be divided among Marsha, Lance and Kato in such proportions as will result in their receiving equal liquidating distributions. (Lance and Kato will receive equal amounts of cash, and Marsha will receive 300 less cash than the other shareholders because she is receiving Whiteacre in addition to cash.)

QUESTION IV

Andy, an individual, owns 80 percent of the outstanding stock of Mayberry Corporation. The remaining 20 percent of Mayberry's stock is owned by Busy Bee Corporation. Opey and Aunt Bea each own 50 percent of the outstanding stock of Busy Bee. Opey is Andy's son, and Aunt Bea is Andy's aunt . Mayberry has 500 of earnings and profits, and Busy Bee has a basis of 20 in its Mayberry stock.

A. Discuss the tax consequences if Mayberry distributes 200 cash to Busy Bee in complete redemption of Busy Bee's Mayberry stock. For purposes of this question, you should assume that Busy Bee and Mayberry are both C corporations.

B. How does your answer change if Busy Bee is an S corporation?

QUESTION I

A. Section 721 will provide non-recognition for Lance, Marsha, and the partnership. Per section 722, Lance and Marsha will each take a substituted basis of 600 in their respective partnership interests. Per section 723, the partnership will take a carryover basis of 600 in each asset.

B. Section 721 will provide non-recognition for Kato and for the partnership. Kato will take a substituted basis of 300 in his partnership interest per section 722, and the partnership will take a carryover basis of 300 in Greenacre per section 723.

C. On the sale of Greenacre, the partnership will recognize a gain of 900 (amount realized of 1200 less adjusted basis of 300). Per section 724(b), this gain will be ordinary income. Per section 704(c), the first 600 of gain will be allocated to Kato. The remaining 300 will be allocated equally among the three partners. Thus, Kato will report 700 of ordinary income, and Lance and Marsha will report 100 each. There will be a corresponding increase in each partner's outside basis per section 705.

Under section 731, distributions are applied against outside basis. A partner receiving a distribution recognizes gain only to the extent that the partner receives cash in excess of his or her outside basis. The trick here is whether the distribution is accounted for before or after the basis adjustments described in the preceding paragraph. It doesn't matter to Lance and Marsha, because they have adequate outside basis to cover the entire distribution even without the upward adjustment for their respective shares of the gain on Greenacre. Kato, on the other hand, will recognize a gain of 100 (400 cash distribution minus 300 outside basis) unless his outside basis is adjusted upward before the distribution is taken into account. Section 731 requires recognition of gain if the cash distributed exceeds the partner's outside basis "immediately before the distribution." The basis adjustment under section 705 does not occur until year end. Thus, Kato would recognize a gain of 100 under the general rule. This result could be avoided by treating the distribution as a "draw," but there is no evidence that that has been done here. Cf. Regs. 1.731-1(a)(1)(ii). If the distribution represents a "draw," it is treated as being made at year end. In that case, Kato's basis would be increased for his share of the gain on Greenacre before applying section 731, so he would recognize no additional gain on the distribution. Just for fun, and consistent with Kato's devil-may-care persona, we will assume that the distribution is not a draw and thus triggers 100 of capital gain to Kato in addition to his 700 of ordinary income.

To recap, Kato will have 700 of ordinary income and 100 of capital gain. His outside basis is taken to zero as a result of the distribution and back up to 700 as a result of the income that passes through at year end. Lance and Marsha will each report 100 of ordinary income. Their respective outside bases are decreased from 600 to 200 by the distribution and then increased from 200 to 300 by their shares of the partnership's income for year 5.

Since Kato recognizes gain as a result of a distribution (assuming the distribution is not a draw), there would be a corresponding increase in the partnership's basis in its assets under section 734(b) if a section 754 election is in effect. If there were a 754 election, the basis of Blackacre would be increased by 50 and the basis of Whiteacre would be increased by 50. This basis increase would be "personal" to Kato. To keep life (and the arithmetic) simple, we will assume that no 754 election is in effect.

D. The sale of Blackacre results in a 900 capital gain to the partnership. 300 of this gain will be allocated to Lance per section 704(c). The remaining 600 will be allocated equally among the three partners. Thus, Lance will report a total gain of 500, and Marsha and Kato will report 200 each. Lance's outside basis is increased to 800, Marsha's outside basis is increased to 500, and Kato's outside basis is increased to 900. The distribution of 600 cash to Lance in liquidation will result in a 200 capital loss to Lance under section 731(a)(2). Kato will recognize a 300 capital loss. Marsha's cash distribution of 300 will take her outside basis down to 200. This 200 will become the basis of Whiteacre in Marsha's hands per section 732(b).

QUESTION II

A. Lance and Marsha are in control of the corporation immediately after the exchange, so they recognize no gain on the exchange of property for stock per section 351. The corporation recognizes no gain per section 1032. Lance and Marsha will each take a stock basis of 600 per section 358. The corporation will take a carryover basis of 600 in each piece of property per section 362.

B. Kato is not in control of the corporation immediately after the exchange. Therefore he will recognize 600 of gain on the exchange of Greenacre for stock. Since he held Greenacre for sale to customers, the gain will be ordinary income. Kato will take a tax cost basis of 900 in his stock. The corporation will recognize no gain (sec. 1032) and will take a basis of 900 in Greenacre.

C. The corporation will recognize a capital gain of 300 on the sale of Greenacre. Under the "per share / per day" rule, 100 of this gain will pass through to each of the three shareholders. Each shareholder's stock basis will be increased by 100. Thus, Lance and Marsha will each have a stock basis of 700, and Kato will have a stock basis of 1000. According to Regs. 1.1368-1(e)(1), these adjustments are made before we determine the tax consequences of the distributions (unlike the partnership treatment discussed above). After adjusting each shareholder's stock basis upward, we are ready to deal with the distributions. Since each shareholder has enough stock basis to cover the distribution, it will be a non-taxable recovery of capital for each shareholder. Kato's stock basis will be decreased to 600, and Marsha and Lance's respective stock bases will be decreased to 300.

D. The corporation will recognize a gain of 600 on the sale of Blackacre. The distribution of Whiteacre to Marsha will trigger a loss of 300 under section 336. Thus, the partnership will have 300 of taxable income for the year, all of which will be capital gain. Each shareholder will report 100 of capital gain, and each shareholder's stock basis will be increased by 100 -- Kato's from 600 to 700, Lance's from 300 to 400, and Marsha's from 300 to 400. Section 331 governs the tax consequences to the shareholders when they recevie their respective shares of the liquidating proceeds. Each shareholder has an amount realized of 600 (the cash received by Lance and Kato and the cash plus the fair market value of the property received by Marsha). Accordingly, Kato will have a capital loss of 100, Lance will have a capital gain of 200, and Marsha will have a capital gain of 200. Marsha will take a fair market value basis of 300 in Whiteacre.

QUESTION III

A. As discussed in question II.A., Lance and Marsha will not recognize their gains and will take a substituted basis in their stock. The corporation will not have gain, and it will take a carryover basis in the assets.

B. As discussed in question II.B., Kato will recognize gain because section 351 does not apply. He will take a tax cost basis in his stock, and the corporation's basis in Greenacre will be increased to fair market value. The corporation recognizes no gain.

C. The sale of Greenacre generates a capital gain of 300. The tax on this gain, at a flat 30%, will be 90. This means that the corporation's earnings and profits will be 210, and the corporation will have 1110 to distribute. Thus, each shareholder will receive a distribution of 370. Of this amount, 70 will be a dividend (ordinary income), and the remaining 300 will be applied against each shareholder's stock basis. This will leave Lance and Marsha with a basis of 300 each (600 minus 300), and Kato with a basis of 600 (900 minus 300). Earnings and profits are reduced to zero.

D. The sale of Blackacre generates a capital gain of 900. The distribution of Whiteacre generates a capital loss of 300. Thus, the corporation ends up with a net capital gain of 600. At 30%, the tax on this gain will be 180. Accordingly, the corporation will distribute 1320 of cash and hold back the remaining 180 for taxes. In addition, the corporation is distributing property worth 300. Each shareholder will receive 540 on the liquidation (1620/3). Lance and Kato will receive cash of 540 each, and Marsha will receive 240 of cash plus Whiteacre. Lance and Marsha each will recognize a capital gain of 240, and Kato will recognize a capital loss of 60. Marsha will take a fair market value basis in Whiteacre.

QUESTION IV

A. We must look to section 302 to determine whether the redemption will be treated as and exchange or as a "section 301 distribution," i.e., a dividend to the extent of earnings and profits. A complete termination of Busy Bee's interest would appear to satisfy section 302(b)(3) (as well as (b)(1) and (b)(2)), but we must consider not only stock owned outright but also stock constructively owned by virtue of section 318. Here, Opey will be deemed to own the Mayberry stock owned by his father, Andy. Ownership of this stock will be further attributed from Opey to Mayberry under section 318(a)(3). Thus, by operation of the attribution rules, Busy Bee owns 100% of the stock of Mayberry before and after the redemption.

Since all of Busy Bee's stock is being redeemed, the possibility exists for waiver of section 318(a)(1) family attribution. In this case, we can break the link from Andy to Opey if Opey complies with the requirements of section 302(c)(2). See section 302(c)(2)(C). If Opey agrees not to acquire an interest in Mayberry for ten years, Busy Bee will be eligible to disengage the attribution of Andy's stock to Opey. By breaking this link, no stock would be attributed from Opey to Busy Bee, and the redemption would qualify for exchange treatment as a termination of Busy Bee's interest.

The next question is whether waiving family attribution is the smart thing to do, assuming the requirements can be met. If family attribution is waived, Busy Bee will have an amount realized of 200 and an adjusted basis of 20, yielding a capital gain of 180. (As a corporation, Busy Bee pays tax on its capital gains at its regular marginal rate.) If family attribution is not waived, Busy Bee will have a dividend of 200. This dividend will qualify for the dividends received deduction under section 243. Since Busy Bee owns 20% of Mayberry before the redemption, 80% of the dividend should be deductible, leaving Busy Bee with gross income of 40. This is actually a better result than exchange treatment, so the waiver of attribtion should not be filed. Moreover, a dividend of 200 will decrease Mayberry's E&P by 200 (compared to the 100 decrease under 312(n)(7) if the redemption is treated as an exchange). Finally, if the redemption is treated as a dividend, the basis of Andy's Mayberry stock will be increased by 20 under the "disapearing basis" rule of Regs. 1.302-2(c).

B. If Busy Bee is an S corporation, there will be no dividends received deduction. Thus, the result will be better if family attribution is waived (180 capital gain instead of 200 ordinary income). This capital gain will pass through to Opey and Aunt Bea as capital gain, eligible for the 28% maximum rate.