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**Corporate Tax I & II**

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***Problems & Answers***

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# Unit I – Introductory Material

## Part 1: Why Corporate Income?

### Readings

* E&E: Chapter 1 - Introduction
* Code: §§1(a),(j),(h)(1),(h)(11), 1201(a), 1211(a), 1212(a), 1411, 7701(a)(1) through(5), (c).
* NYU Classes Materials:
  + Joseph J. Thorndike, Tax History: The Corporate Income Tax Has Always Been About Power, Tax Notes, September 2, 2014
  + Joint Committee on Taxation, Modeling the Distribution of Taxes on Business Income (JCX-14-13, 2013), pp 1-9,
  + Excerpt Kamuf Letter to Editor
  + Joint Committee on Taxation, Overview of Federal Tax System as in Effect for 2020, JCX-14-20 (2020), pp 13-20, 5-6.

### Problem Set

(a) Under the Internal Revenue Code, a corporation is a person. Like any individual taxpayer, a corporation pays a separate federal income tax based on a calculation of its annual gross income less certain business expenses. Would you describe the corporate income tax as an efficient way to raise revenue? Why or why not?

***Answer:***

* The standard is whether it distorts behaviour.
* It is not an efficient way to raise revenue because it affects choice of form (i.e., in a C corp., partnership, LLC), paying salary, debt capital structure.

(b) Why do we impose a separate tax on corporate income?

***Answer:***

* There are many policy reasons, including regulation of companies, promotion of progressivity, raising revenue, to reduce the economic power of corporate managers.

(c) In his letter to the editor, W. Rudy Kamuf addresses the problem of chewing gum deposits on city streets. He implies that the government should impose a “chewing gum tax” on corporations that manufacture the product as a way to ensure that they “pay something back to the community.” Do you think Mr. Kamuf’s proposal will achieve his objective? Why or why not?

***Answer:***

* The question is where is the incidence of the tax.
* Historical thinking was that the tax was borne by the shareholders.
* The new thinking is that it is borne by customers, labour, suppliers.

(d) Is there anything in pp 1-9 of JCX-14-13(2003) that influences your answer to (c)?

***Answer:***

* This article indicates that tax is borne entirely by labor.
* Therefore, the tax would not appear to reduce the overall amount of chewing gum consumption.

## Part 2: Choice of Form and Entity Classification

### Readings

* E&E: Chapter 2 – Choice of Form and Entity Classification
* Code: §§1(a) through (e), (h)(1), (h)(11), 11, 199A(a), (b), (c)(1), (d), 1201(a), 1211(a), 1361(a),(b)(1),(b)(2), 1363(a), 1366(a)(1), 1411, 7701(a)(1), through (5), (c), 7704 (omit (d)(3)-(5),(e),(g))
* Treas. Reg. §§301.7701-1, 2(a), -2(b)(1) through (8)(i), -2(c)(1), (2)(i); -3(a),-3(b)(1), -3(b)(2)(i).
* NYU Classes Materials:
  + Commissioner v. Bollinger, 485 U.S. 340 (1988).

### Problem Set

1. What is the impact of the Tax Cuts and Jobs Act of 2017 (TCJA) on Corporate Tax Rates?

***Answer:***

* The corporate tax rate was reduced to 21%.

(a) What is the purpose of §199A?

***Answer:***

* Because the maximum individual rate is 37%, the purposes of Section 199A is to bring the pass through rate more in line with the corporate rate.

(b) For tax purposes, how do we know if the business is being conducted as a partnership (a flow thru entity) or a as a corporation?

***Answer:***

* Other than per entities, an entity may elect to be treated as a corporation or a partnership.
* In the absence of an election, default rules will apply.

2. A and B walk into your office and tell you about a business they plan to conduct. They will manufacture widgets. They then ask what form that business should be conducted in.

(a) What choices do they have?

***Answer:***

* Sole proprietorship, Partnership, S corporation, C Corporation, REIT.

(b) Besides tax considerations, why would A and B choose to do business as a corporation?

***Answer:***

* For limited liability, for formal corporate structure.

(c) How do we determine whether a business entity will be taxed as a partnership or as an association taxable as a corporation? Does it matter if A and B actually incorporate the business under state law?

***Answer:***

* If A and B form a corporation, then the entity will be taxed as a corporation.
* Other than per entities, an entity may elect to be treated as a corporation or a partnership.
* In the absence of an election, default rules will apply.

3. X Co. is a U.S. entity taxable as a corporation under Subchapter C of the Code. X Co is an accrual method taxpayer that uses the calendar year. A and B, individuals who are both U.S. citizens, own 100% of the stock of X Co.

For 2019, X Co. has taxable income of $1,000,000. On December 31, 2019, X Corp. distributes to A and B, who are in the top marginal Federal income tax bracket, the (after-tax) proceeds of its pre-tax $100,000 of earnings.

(a) How much of the distribution do A and B retain after all applicable Federal income tax has been paid on the $100,000?

***Answer:***

* 20% at the corporate level, and either 20% long-term capital gain or 37% ordinary income at the shareholder level.

(b) What if X Co. were treated as a partnership (not subject to § 7704) for U.S. Federal income tax purposes instead of as a C corporation?

***Answer:***

* The income is subject to a 37% rate of tax at the partner level.

(c) What is the potential impact of §199A?

***Answer:***

* The partner is eligible for a deduction for qualified business income, which would bring the rate of tax at the partnership level down to 29.6%.

(d) Assume, instead, that A and B had organized their business as corporation. They now ask you whether they can disregard the corporate form. What is your advice?

***Answer:***

* No it’s a per se entity. Therefore it will be treated as a corporation for tax purposes.

# Unit 2 – Distributions

## Part 1 – Cash Distributions

### Readings

* E&E: Chapter 5 – Nonliquidating Distributions
* Code: §§243(a), (c), 275(a), 317(a), 301, 312(a) thru (d)(1), (d)(3), 312(f)(1), 316, 317(a)
* Regs: §§1.301-1(a)-(c), (e), (f) Ex 1; 1.312-1, -6(a), (b), -7(a), (b)(1); 1.316-1(a)(1), -1(e) Ex 1, -2(a), (b), (c)
* NYU Classes:
  + Rev. Ruls. 74-164
  + Rev. Ruls. 69-440
  + Rev. Ruls. 62-131
  + E&P Calculation

### Problem Set

T Corp is an accrual method, calendar year taxpayer. T Corp is owned equally by two shareholders, A Corp, a U.S. Corporation on the accrual method of accounting, and Mr. B, an individual on the cash method of accounting. Both shareholders are calendar year taxpayers. T Corp is subject to tax at a flat 20% rate. A Corp’s basis in its T Corp stock is $100, and Mr. B’s basis is $40.

During the taxable year 2019, T Corp engages in a like-kind exchange of real estate with a third party. In the exchange, T Corp realizes gain of $75, none of which is recognized. §1031(a). T Corp’s basis in the property received in the exchange is the same as that of the property T Corp transferred in the exchange. §1031(d). In addition, in 2019, T Corp has the following receipts and expenses:

Gross Income from Business $500

Municipal bond interest 100

Long term capital gain 100

Total Receipts $700

Deductible business expenses $420

Interest expense of $80 on a

loan incurred to buy the

municipal bonds (see § 265(a)(2)) 80

Capital losses 150

Total Expenses $650

Net Income $50

1. What are T Corp.’s earnings and profits for 2019?

***Answer:***

* The current year’s taxable income is:

|  |  |
| --- | --- |
| **Gross Income** |  |
| Gross Income from Business | $500 |
| Municipal bond interest | $0 |
| Long term capital gain | $100 |
| **TOTAL** | **$600** |
|  |  |
| **Deductions** |  |
| Deductible business expenses | $420 |
| Interest expense | $0 |
| Capital losses | $100  (can only take to the extent of capital gain) |
| **TOTAL** | **$520** |
|  |  |
| **TAXABLE INCOME** | **$80** |

* The adjustments for gross income exclusions include:
  + Municipal bond interest = +$100
* The adjustments for deductions not permitted in computing E&P include:
  + Federal income tax paid = -$16 ($80 \* 20%)
  + Interest and expenses related to tax-exempt income = -$80
* The adjustments due to timing differences include:
  + Capital losses in excess of capital gains = -$50
* The non-recognition transactions include:
  + Like-kind exchange of real estate = no-change.
* The current year’s E&P is:

|  |  |
| --- | --- |
| Taxable Income | $80 |
| Adjustments for Gross Income Exclusions | $100 |
| Adjustments for Deductions Not Permitted in Computing E&P | -$96 |
| Adjustments Due to Timing Differences | -$50 |
| Current Year E&P | **$34** |

2. On April 2, 2019, T Corp distributes $100 cash to A Corp and $100 cash to Mr. B. As of 12/31/2018, T Corp’s accumulated earnings and profits ("E&P") account was zero.

(a) What are the tax consequences of the distributions to the parties?

***Answer:***

* A Corp:
  + The E&P attributable to A Corp is equal to [E&P \* (Distribution to Shareholder / Total Distributions)] = ($34 \* $100/$200) = $17
  + Dividend Income = $17.
    - The DRD = 65%
    - Tax = 20% \* $17 \* (1-65%) = $1.2
  + Return of Basis = $83.
    - The adjusted basis is $17 ($100-$83)
* Mr. B:
  + The E&P attributable to A Corp is equal to [E&P \* (Distribution to Shareholder / Total Distributions)] = ($34 \* $100/$200) = $17
  + Dividend Income = $17
    - Tax = 20% \* $17 = $3.4
    - NIIT = 3.8% \* $17 =$0.6
  + Return of Basis = $40
    - The adjusted basis is $0 ($40-$40)
  + Capital Gain = $43
    - Tax = 20% \* $43 = $8.6
* T Corp.
  + Following the distributions, T Corp’s E&P is $0 ($34-$17-17)
  + The E&P is reduced by the FMV of the cash distributed as a dividend.

(b) Suppose the distribution is declared on 12/1/2019, payable on 12/31/2019 to shareholders of record on 12/15/2019. T Corp mails a $100 check to A Corp and a $100 check to Mr. B on 12/31/2019. The checks are received by A Corp and Mr. B on 1/3/2020. Do these facts change your answer to 2(a)?

***Answer:***

* For T Corp., the distribution occurred in 2019. Rev. Rul. 62-131.
* For A Corp, the distribution is included on its 2020 tax return because of the constructive receipt doctrine.
* For Mr. B, the distribution is included on his 2020 tax return because he is a cash method taxpayer.

(c) Suppose T Corp has current E&P of $100 in 2019 and an accumulated deficit of $100 in its E&P account as of 12/31/2018. Do these facts change your answer to Question 2(a)?

***Answer:***

* This situation is known as a nimble dividend.
* The answers to Question 2(a) are unchanged because the distribution first comes out of current E&P.

(d) Suppose T Corp had a deficit in current E&P of $100 in 2019 and accumulated earnings and profits of $100 as of 12/31/2018? Do these facts change your answer to Question 2(a)

* When a corporation makes a distribution or distributions in a year that it has a deficit in current E&P, the characterization of the distributions is dependent upon the accumulated E&P available through the date of each distribution. This requires that the corporation first compute an interim amount of current E&P on each distribution date, which is then combined with the accumulated E&P as of the beginning of the year to determine the accumulated E&P available through the date of distribution.
* The regulations provide that in determining this interim amount, if the exact amount of current E&P through a distribution date cannot be shown, the current E&P must be allocated evenly throughout the year to the date of distribution (not counting the date on which the distribution was made).
* See Rev. Rul. 74-164, situations 3 and 4.

(e) Same basic facts as described at beginning of Question 1. What if, in addition to the outstanding common stock, T Corp has 10 shares of preferred stock outstanding, each of which entitles the holder to an annual cumulative dividend of $3 per share payable on December 15th each year. Under T Corp’s charter, holders of T Corp common stock are not entitled to receive dividends unless all preferred cumulative dividends are paid each year. Assume that Q owns all 10 shares of T Corp preferred stock. Describe the federal tax consequences if, in addition to the April 2, 2019 common stock distributions, on December 15, 2019, T Corp distributes $30 to Q in respect of the T Corp preferred stock.

***Answer:***

* The charter rules are respected. Rev. Rul. 69‐440
* Total distribution to A Corp, Mr. B, and Mr. Q equal $230.
* The E&P is prorated first to the preferred, and then to the common.
* Q Corp:
  + The E&P = $30
  + Dividend Income = $30
    - Tax = 20% \* $30 = $6
    - NIIT = 3.8% \* $30 =$1.14
* A Corp:
  + The E&P attributable to A Corp is equal to [E&P \* (Distribution to Shareholder / Total Distributions)] = ($4 \* $100/$200) = $2
  + Dividend Income = $2.
    - The DRD = 65%
    - Tax = 20% \* $2 \* (1-65%) = $0.14
* Mr. B:
  + The E&P attributable to A Corp is equal to [E&P \* (Distribution to Shareholder / Total Distributions)] = ($4 \* $100/$200) = $2
  + Dividend Income = $2
    - Tax = 20% \* $2 = $0.4
    - NIIT = 3.8% \* $2 = $0.08
* T Corp.
  + Following the distributions, T Corp’s E&P is $0 ($34-$20-$2-$2)
  + The E&P is reduced by the FMV of the cash distributed as a dividend.

## Part 2 – Distribution of Property Including Debt Instruments

### Readings

* E&E: Chapter 5 – Nonliquidating Distributions
* Code: §§ 301(b), 311, 336(b)
* Regulations: §§ 1.312-3; 1.312-4 (skip example 3);1.316-1(a)
* Materials on NYU Classes:
  + General Utilities & Operating Co. v. Helvering

### Problem Set

T Corp., a U.S. corporation on the accrual method of accounting, is owned equally by two shareholders, A Corp., a U.S. corporation on the accrual method of accounting, and B, an individual on the cash method of accounting. Both are calendar year taxpayers. A Corp’s tax basis in its stock of T Corp. is $500 and B’s tax basis in her stock of T Corp. is $220.

On February 5, 2019, T Corp. distributed A Bonds of Microsoft with a fair market value of $400 to A Corp. and B bonds of Microsoft with a FMV of $400 to B. Prior to the distributions, T Corp. held the A Bonds of Microsoft with a basis of $150 and the B Bonds of Microsoft with a basis of $80.

T Corp.’s current earnings & profits for 2019 are $300. T Corp. has no accumulated earnings & profits.

(1) Describe the federal income tax consequences of the distribution of the Microsoft bonds to:

a. T Corp.

***Answer:***

* Distributions of property with built in gain result in taxable income.
* T Corp. will recognize taxable income of the following:
  + A Corp bonds = $250 ($400-$150)
  + Mr. B bonds = $320 ($400-$80)
  + Total = $570
  + Tax = $114 (20% \* $570)
* The current E&P of T Corp. will be increased by:
  + Taxable Income = $570
  + Less Adjustment for Tax = $114
  + Total = $456
* Total current year E&P therefore equals $756 ($300 + $456)
* Following the distributions, the current year E&P is $0 ($756-$400-$400)
  + The E&P is reduced by the FMV of the property distributed.

b. A Corp.

***Answer:***

* The E&P attributable to A Corp is equal to [E&P \* (Distribution to Shareholder / Total Distributions)] = ($756 \* $400/$800) = $378
* Dividend Income = $378
  + The DRD = 65%
  + Tax = 20% \* $378 \* (1-65%) = $26.5
* Return of Basis = $22.
  + The adjusted basis is $478 ($500-$22)

c. Mr. B

***Answer:***

* The E&P attributable to A Corp is equal to [E&P \* (Distribution to Shareholder / Total Distributions)] = ($756 \* $400/$800) = $378
* Dividend Income = $378
  + Tax = 20% \* $378 = $75.6
  + NIIT = 3.8% \* $378 =$14.4
* Return of Basis = $22
  + The adjusted basis is $198 ($220-$22)

(2) How would your answer to (1) above change if T Corp.’s tax basis in the Microsoft bonds that it distributed to B was $450 instead of $80?

a. T Corp.

***Answer:***

* T Corp. cannot recognize built-in-loss in a distribution.
* T Corp. will recognize taxable income of the following:
  + A Corp bonds = $250 ($400-$150)
  + Mr. B bonds = $0 ($400-$450)
  + Total = $250
  + Tax = $50 (20% \* $250)
* The current E&P of T Corp. will be increased by:
  + Taxable Income = $250
  + Less Adjustment for Tax = $50
  + Total = $200
* Total current year E&P therefore equals $500 ($300 + $200)
* Following the distributions, the current year E&P is $0 ($500-$400-$450)
  + The E&P is reduced by the FMV of the built-in-gain property distributed as a dividend.
  + The E&P is reduced by the adjusted basis of the built-in-loss property distributed as a dividend.

b. A Corp.

***Answer:***

* The E&P attributable to A Corp is equal to [E&P \* (Distribution to Shareholder / Total Distributions)] = ($500 \* $400/$800) = $250
* Dividend Income = $250.
  + The DRD = 65%
  + Tax = 20% \* $250 \* (1-65%) = $17.5
* Return of Basis = $150 ($400-$250).
  + The adjusted basis is $350 ($500-$150)

c. Mr. B

***Answer:***

* The E&P attributable to A Corp is equal to [E&P \* (Distribution to Shareholder / Total Distributions)] = ($500 \* $400/$800) = $250
* Dividend Income = $250
  + Tax = 20% \* $250 = $50
  + NIIT = 3.8% \* $250 =$9.5
* Return of Basis = $150
  + The adjusted basis is $70 ($220-$150)

(3) How would your answer to (1) above change if the Microsoft bonds that that T Corp. distributed to A Corp. and B were each subject to a $100 non-recourse liability?

a. T Corp.

***Answer:***

* Distributions of property with built in gain result in taxable income.
* T Corp. will recognize taxable income of the following:
  + A Corp bonds = $250 ($400-$150)
  + Mr. B bonds = $320 ($400-$80)
  + Total = $570
  + Tax = $114 (20% \* $570)
* The current E&P of T Corp. will be increased by:
  + Taxable Income = $570
  + Less Adjustment for Tax = $114
  + Total = $456
* Total current year E&P therefore equals $756 ($300 + $456)
* Following the distributions, the current year E&P is $196 ($796-$400-$400+$100+$100)
  + The E&P is reduced by the adjusted basis of the property distributed.
  + But then the amount of the liability is added back

b. A Corp.

***Answer:***

* Amount of distribution = $300 ($400-$100)
* The E&P attributable to A Corp is equal to [E&P \* (Distribution to Shareholder / Total Distributions)] = ($756 \* $400/$800) = $378
* Dividend Income = $300
  + The DRD = 65%
  + Tax = 20% \* $300 \* (1-65%) = $21
* Basis in Bonds = $400

c. Mr. B

***Answer:***

* Amount of distribution = $300 ($400-$100)
* The E&P attributable to A Corp is equal to [E&P \* (Distribution to Shareholder / Total Distributions)] = ($756 \* $400/$800) = $378
* Dividend Income = $300
  + Tax = 20% \* $298 = $59.6
  + NIIT = 3.8% \* $298 =$11.3
* Basis in Bonds = $400

(4) How would your answer to (1) above change if, instead of distributing Microsoft bonds, T Corp. distributed to each of A Corp. and B its own negotiable (but not publicly traded) note with a face amount of $400 and a fair market value of $370?

a. T Corp.

***Answer:***

* Under §311(b)(1)(A), no gain or loss is recognized on the distribution of a company’s own note.
* Total current year E&P therefore equals $300
* Following the distributions, the current year E&P is $0 ($300-$370-$370)
  + The E&P is reduced by the FMV of the property distributed as a dividend.

b. A Corp.

***Answer:***

* Amount of distribution = $370
* The E&P attributable to A Corp is equal to [E&P \* (Distribution to Shareholder / Total Distributions)] = ($300 \* $370/$740) = $150
* Dividend Income = $150
  + The DRD = 65%
  + Tax = 20% \* $150 \* (1-65%) = $10.5
* Return of Basis = $220.
  + The adjusted basis is $280 ($500-$220)

c. Mr. B

***Answer:***

* Amount of distribution = $370
* The E&P attributable to A Corp is equal to [E&P \* (Distribution to Shareholder / Total Distributions)] = ($300 \* $370/$740) = $150
* Dividend Income = $150
  + Tax = 20% \* $150 = $30
  + NIIT = 3.8% \* $150 =$5.7
* Return of Basis = $220
  + The adjusted basis is $0 ($220-$220)

## Part 3 – Constructive Dividends

### Readings

* E&E: Chapter 5 – Nonliquidating Distributions
* Regs: §§ 1.301-1(j); 1.61-6(a)
* Blackboard Materials:
  + Alterman Foods
  + Weigel v. Commissioner
  + Rev.Rul. 58-1

### Problem Set

(1) C Corp, a U.S. corporation, has no current earnings and profits for its 2018 tax year and $10,000 of accumulated earnings and profits. At the start of 2018, C Corp entered into a leasing agreement with Gallihad, an individual, under which C Corp would rent its sugar refinery to Gallihad for a one-year period. Under the terms of the lease, Gallihad is obligated to make a one-time $6,000 rental payment directly to the equal shareholders of Corp, Dana and Josh. Describe the federal income tax consequences of the leasing agreement to Gallihad, C Corp, Dana and Josh.

***Answer:***

* The rules concerning assignment of income apply here. The owner of the property is taxed on the income generated by that property. See Old Colony Trust.
* The substance of the transaction will control over the form of the transaction. See Waterman Steamship.
* Gallihad will be deemed to have made rental payments to C Corp, and C Corp will be deemed to have made dividend payments to Dana and Josh.
* The tax consequences are as follows:
  + C Corp will pay tax of $1,260 (21% \* 6,000) on the rental payment.
  + The current year E&P of C Corp will be increased by $6,000 less the $1,260 of tax = $4,740
  + C Corp will have made a distribution of $3,000 to each of Dana and Josh., which is treated entirely as a dividend.
  + Dana and Josh will pay tax of $600 ($3,000\*20%).
  + The Total tax paid = $1,260 + $600 + $600 = $2,460
* If the form of the transaction controlled, then Dana and Josh would have each paid tax of $1,110 ($3,000 \* 37%), for total tax of $2,220.

(2) Same facts as Question 1, except that instead of entering into a leasing agreement with Gallihad, on October 15, 2018, C Corp distributed a candy-wrapping machine to Dana in complete satisfaction of a claim by Dana against C Corp for unpaid salary (Dana is also employed by C Corp as a candy inspector). C Corp held the candy-wrapping machine as a capital asset and with a tax basis of $2,000. At the time of the distribution the fair market value of the candy-wrapping machine was $10,000. Describe the federal income tax consequences of the distribution to C Corp and to Dana.

***Answer:***

* The substance of the transaction will control over the form of the transaction.
* The distribution of the candy-wrapping machine will be treated as payment of salary.
* The tax consequences are as follows:
  + C Corp will recognize gain of $8,000 on the built-in-gain of the candy-wrapping machine.
  + C Corp will pay tax of $1,680 ($8,000 \* 21%)
  + C Corp will be entitled to a deduction of salary expense equal to $10,000.
  + Dana will pay tax of $3,700 ($10,000 \* 37%)
* If the form of the transaction controlled:
  + C Corp will recognize gain of $8,000 on the built-in-gain of the candy-wrapping machine.
  + C Corp will pay tax of $1,680 ($8,000 \* 21%)
  + Dana will pay tax of $2,000 ($10,000 \* 20%)

(3) Heidi is the sole shareholder of P Corp, which has been consistently profitable since its incorporation and has accumulated E&P of $500,000. P Corp has never paid a dividend. Heidi is the president of P Corp and runs its operations, for which Heidi receives a fixed salary that generally comes to about 40% of P Corp’s income each year. Starting in 2016, P Corp made frequent cash advances to Heidi totaling $80,000 in 2016, $90,000 in 2017, and $130,000 in 2018. The advances are recorded on P Corp's books as "amounts due from Heidi on open account" and are shown on P Corp's financial statements as "loans due from shareholder." Heidi has never repaid any of these advances, nor has Heidi paid P Corp any interest. The IRS claims that the advances should be treated as dividends. Heidi says they are loans. Who wins?

***Answer:***

* Under Weigel, whether a transfer by a corporation to a shareholder is a loan or dividend is factual issue depending primarily on good faith intention of shareholder to repay amounts received and the intention of the corporation to require repayment. Transfers to shareholders of closely held corporations require special scrutiny because of control exercised. The factors the courts will consider include:
  + SH’s degree of control over corp
  + Existence of restrictions on amount of disbursements
  + Corp earnings and dividends history
  + Use of customary loan documentation – notes, mortgages, security agreements
  + Ability of SH to repay
  + Treatment of disbursement on corp records + financials
  + Creation of legal obligations – interest, repayment schedule, maturity dates
  + Corp’s attempts to enforce repayment
  + SH’s intention or attempts to repay the loan
* Here, these transactions will be treated as distributions because the factors weigh against Heidi.

(4) X Co, a U.S. corporation, has earnings and profits for its 2018 tax year of $300. X Co owns two parcels of land that are each worth $100 and its tax basis in each parcel is $60. On April 15, 2018, X Co sells one parcel of land to its 50% shareholder A Corp., a U.S. corporation, for $75 cash and the other parcel to its other 50% shareholder, Petunia, an individual, for $75 cash. Describe the federal income tax consequences of the sales to X Co, A Corp. and Petunia.

***Answer:***

* The substance of these transactions are a part sale and part distribution.
* Step 1: Determine sale and distribution portion
  + For each property, the sale is for $75, and the distribution is of $25
* Step 2: Allocate Basis to each portion to determine gain [1.61-6(a)]
  + Sale portion gets ¾ of total basis [75/100]
    - ¾ of tax base is $45 (45/60)
    - Gain = (75-45) = $30
  + Distribution portion gets ¼ of total basis [25/100]
    - ¼ of tax base is $15 (15/60)
    - Gain = (25-15) = $10
* Step 3: Tax Consequences:
  + X Corp has taxable gain of $80 [2 \* ($30 + $10)]
  + X Corp Taxes = 21% \* $80 = $16.8
  + Additional E&P = $96.8
  + Each shareholder receives a distribution of $25 which is treated as dividend.
  + Shareholder’s Taxes = $5 (20% \* 25)
  + The total taxes paid = $26.8 ($16.8 + $5 + $5)

## Part 4 – Dividends Received Deduction

### Readings

* E&E: Chapter 5 – Nonliquidating Distributions
* Code: §§ 243(a), (b)(1), (b)(2)(A), (c); 246(c); 1059 [only skimming (d)(6), (e),(3) & (f)]
* Materials on NYU Classes:
  + Litton Industries
  + TSN Liquidating Corp.
  + Waterman Steamship
  + Rev. Rul. 75-493
  + Rev. Rul. 82-11

### Problem Set

(1) T has owned 70% of the stock of TSub for several years. A taxpayer unrelated to T owns the other 30% of TSub. TSub has thousands of dollars of accumulated E&P. T has a basis of $75 in its TSub shares; they are worth $200. T wants to sell its TSub stock; P has expressed an interest in purchasing it. Although T and P have reached no formal agreement, they have agreed in principle to the following three-step deal.

First, immediately before selling its TSub shares to P, T will cause TSub to create and distribute a dividend to T in the form of TSub’s note with a face amount and FMV of $100. TSub will also distribute a note as a dividend to its minority shareholder.

Second, T will sell its TSub stock to P for $ 100, TSub's then FMV. (The dividend will cut TSub's value by $100);

Third and finally, P will make a capital contribution of $100 to TSub. TSub will use the funds to pay the note it distributed to T Corp

(a) If the form of the overall transaction is respected, what are the tax consequences to T Corp in light of the cases you have read. How might the government seek to recharacterize the transaction?

***Answer:***

* This is a dividends received deduction in a “bootstrap acquisition”
* See E&E, page 158.

(2) On January 1, 2018, T Corp purchases approximately 1% of the outstanding stock of SubCo for $10,000. At the time, T Corp had $1000 of capital gain from an unrelated transaction. On February 1, 2018, SubCo declares and pays a dividend, of which T Corp’s share is $1000. T Corp sells its SubCo stock in the open market for $9000 on February 10, 2018.

(a) Assume that neither §246(c) nor §1059 is in the Code. What advantage do these transactions offer to TCorp?

***Answer:***

* This is a dividends received deduction in a “dividends stripping” transaction
* See E&E, page 158.
* T corp is entitled to a DRD of 50%.
* T Corp pays tax of $105 ($1,000 \* 50% \* 21%)
* In addition, it recognizes capital loss on the sale of the stock, which it uses to offset the capital gain from the unrelated transaction.

(b) Do either §§246(c) or 1059 change that advantage, and if so, how?

***Answer:***

* §246(c) provides limits the DRD with respect to dividends received on stock held for less than 45 days during a specified 90-day period.
* T Corp held SubCo stock for 40 days between December 19, 2017 and March 19, 2017
  + Ex-dividend date = February 2, 2018
  + 45 days before February 2, 2018 is December 19, 2017
  + 45 days after February 2, 2018 is March 19, 2017
  + Holding Period = (January 2, 2018 to February 10, 2018)
* Because T corp held the SubCo stock for less than 45 days, it will not be eligible for the DRD.
* §1059(b) provides that for an “extraordinary dividend” issued on stock held for less than two years, the corporate shareholder must reduce basis in the stock by the non-taxed portion of the dividend.
* §1059(b) does not apply because there is no non-taxed portion of the dividend under §246(c).

(c) How would your answer to (b) change if the only change to the facts was that T Corp sells its SubCo stock on March 1st instead of February 10th?

***Answer:***

* §246(c) is inapplicable here because T Corp held the stock for more than 45 days during the specified 90-day period.
* T Corp held SubCo stock for 59 days between December 19, 2017 and March 19, 2017
  + Ex-dividend date = February 2, 2018
  + 45 days before February 2, 2018 is December 19, 2017
  + 45 days after February 2, 2018 is March 19, 2018
  + Holding Period = (January 2, 2018 to March 10, 2018)
* Under §1059(b), T Corp must reduce is basis in SubCo by the nontaxed portion of the dividend (i.e., $500).
* T Corp’s basis in SubCo is therefore reduced to $9,500.
* When T Corp. sells SubCo, it will only generate losses of $500, rather than $1,000.

(d) How would your answer to (b) change if the only change to the facts was that the amount of the dividend paid by SubCo was $800 instead of $1000?

***Answer:***

* §1059(a) only applies where the dividend equals or exceeds 10% of the corporate shareholder’s common stock basis. §1059(c).
* Dividend = $800.
* Basis = $10,000.
* Because the dividend does not exceed 10% of the basis, §1059(a) does not apply.

(e) How would your answer to (b) change if the only change to the facts was that instead of purchasing 1% of SubCo for $10,000, T Corp. purchased 50% of SubCo for $10,000?

***Answer:***

* This affects the amount of the DRD and the associated basis adjustments under §1059.

# Unit 3 – Redemptions

## Part 1 – Redemptions “Not Essentially Equivalent to a Dividend” and Substantially Disproportionate” Redemptions

### Readings

* E&E: Chapter 6 – Redemption Distributions
* Code: §§ 302(a),(b),(d), 312(n)(7), 317(b),1059(e)
* Regs: Reg. §§ 1.302-1, -2, -3
* Materials on NYU Classes:
  + United States v. Davis;
  + Himmel v. Commissioner (focus on last paragraph beginning on page 2);
  + Rev. Rul.75-502
  + Rev. Rul. 76-364
  + Rev. Rul. 76-385
  + Rev. Rul. 77-426
  + Rev. Rul. 78-401
  + Rev. Rul. 81-289.
  + Rev. Rul. 85-14

### Problem Set

(1) X Corporation is owned entirely by two individuals, A and B, who are unrelated unless otherwise stated. A owns 240 shares of X common stock with a basis of $40 per share. B owns 160 shares of X common stock with a basis of $120 per share. X's stock is worth $80 per share. X has current E&P of $2,000. Determine the results to A from the following alternative transactions (assume that all sales are for fair market value):

(a) A sells 40 of his X shares to B for $3200.

***Answer:***

* A’s basis = $40 \* 40 = $1,600
* FMV of shares = $80 \* 40 = $3,200
* §1001 gain = $3,200 - $1,600 = $1,600
* The gain is capital gain
* Tax = $1,600 \* 20% = $320
* NIIT = $1,600 \* 3.8% = $60.8

(b) A, instead, sells 120 of his X shares to X for $9600.

***Answer:***

* The issue is whether the §302(b)(2) safe harbour applies.
* Before the transaction, A owns 240 of 400 shares (60%)
* Following the transaction, A owns 120 of 280 shares (43%)
* A’s ownership percentage after the transaction is 72% of his ownership percentage before the transaction (43% / 60%)
* Because A owns (1) less than 50% of the total combined voting power of all classes of stock entitled to vote, and (2) less than 80% of the percentage of voting stock than he owned immediately prior to the redemption, the transaction is treated as a sale.
* A’s basis = $40 \* 120 = $4,800
* FMV of shares = $80 \* 1,200 = $9,600
* §1001 gain = $9,600 - $4,800 = $4,800
* The gain is capital gain
* Tax = $4,800 \* 20% = $960
* The E&P is reduced under §312(n)(7):
  + The ratable share = 120/400 = 30%
  + The E&P = $2000
  + E&P is reduced by $600 ($2,000 \* 30%)
  + This leaves X Corp with $1,400 of E&P

(c) A, instead, sells 80 shares to X for $6400.

***Answer:***

* Before the transaction, A owns 240 of 400 shares (60%)
* Following the transaction, A owns 160 of 320 shares (50%)
* Because A does not own less than 50% of the total combined voting power of all classes of stock entitled to vote, the transaction does not qualify for the §302(b)(2) safe harbour.
* §302(b)(1) may apply because there has been meaningful reduction of the shareholder’s proportionate interest in the corporation. This is a facts and circumstances test.
  + Apply revenue rulings
* Assuming no safe harbour applies, the transaction will be treated as a distribution of $6,400.
  + §301(c)(1) - The first $2,000 will be treated as a dividend
    - Tax = $2,000 \* 20% = $400
  + §301(c)(2) – The remaining $4,400 will be a return of basis
    - A’s basis in the remaining shares will be $5,200 [(240 \* $40) - $4,400] or $32.5 per share ($5,200 / 160). §1.302-2(c)

(d) A, instead, sells 40 shares back to X for $3,200.

1. What is the effect of the transaction on X’s E&P?

***Answer:***

* Before the transaction, A owns 240 of 400 shares (60%)
* Following the transaction, A owns 200 of 360 shares (55%)
* Because A does not own less than 50% of the total combined voting power of all classes of stock entitled to vote, the transaction does not qualify for the §302(b)(2) safe harbour.
* Assuming no safe harbour applies, the transaction will be treated as a distribution of $3,200.
  + §301(c)(1) - The first $2,000 will be treated as a dividend
    - Tax = $2,000 \* 20% = $400
    - Tax = $2,000 \* 3.8% = $76
  + §301(c)(2) – The remaining $1,200 will be a return of basis
    - A’s basis in the remaining shares will be $6,800 [(200 \* $40) - $1,200] or $34 per share ($6,800 / 200)
* §312(n)(7) does not apply, because it only applies to sale/exchange treatment.

2. What if A were a corporation rather than an individual?

***Answer:***

* §301(c)(1) - The first $2,000 would still be treated as a dividend, but the DRD would apply
  + For the DRD deduction, look at the ownership percentage after the redemption.
  + Because A Corp owned 55% of the shares after the redemption, the DRD would be 65%
  + Tax = $2,000 \* 21% \* (1-65%) = $147
  + Do the extraordinary dividend rules apply?
    - Under §1059(e)(1)(a)(ii), the extraordinary rules always apply to redemptions.
    - Therefore, the amount of the DRD must be reduced from basis (i.e., $1300)
    - The amount of the basis is therefore be $8,300 ($9,600 - $1,300)
* §301(c)(2) – The remaining $1,200 will be a return of basis
  + A’s basis in the remaining shares will be $7,100 [$8,300 - $1,200] or $35.5 per share ($7,100 / 200)
* §312(n)(7) does not apply, because it only applies to sale/exchange treatment.

(e) Suppose that shortly after the transaction in (b), B also sold 40 shares back to X for $3200.

***Answer:***

* Transaction’s Aggregated:
  + Before the transactions, B owns 160 of 400 shares (40%)
  + After the transactions, B owns 120 of 240 shares (50%)
* Transaction’s Unaggregated
  + Before the transaction, B owns 160 of 280 shares (57%)
  + After the transaction, B owns 120 of 240 shares (50%)
* Under §302(b)(2)(D), in the absence of a plan, the two redemptions are analysed separately for purposes of the §302(b)(2) safe harbour. Rev. Rul. 85-106
* Because B does not own less than 50% of the total combined voting power of all classes of stock entitled to vote, the transaction does not qualify for the §302(b)(2) safe harbour.
* §302(b)(1) may apply because there has been meaningful reduction of the shareholder’s proportionate interest in the corporation. B would indicate that the facts and circumstances should take into account the combined redemptions.
* Assuming no safe harbour applies, the transaction will be treated as a distribution of $3,200.
  + §301(c)(1) - The first $2,000 will be treated as a dividend
    - Tax = $2,000 \* 20% = $400
  + §301(c)(2) – The remaining $4,400 will be a return of basis
    - A’s basis in the remaining shares will be $14,800 [(160 \* $120) - $4,400] or $123.3 per share ($5,200 / 120)

(f) Suppose that X has outstanding 800 shares of nonvoting preferred stock, of which A owns 400 shares. X redeems 120 shares of the common stock and all of the preferred stock owned by A?

***Answer:***

* The issue is whether the §302(b)(2) safe harbour applies.
* Before the transaction, A owns:
  + Voting Common: 240 of 400 shares (60%)
  + Non-Voting Preferred: 400 of 800 shares (50%)
* Following the transaction, A owns:
  + Voting Common: 120 of 280 shares (43%)
  + Non-Voting Preferred: 0 of 400 shares (0%)
* A’s ownership percentage reduction is:
  + Voting Common: 72% (43% / 60%)
  + Non-Voting Preferred: 0% (0%/50%)
* Because A owns (1) less than 50% of the total combined voting power of all classes of stock entitled to vote, and (2) less than 80% of the percentage of voting stock than he owned immediately prior to the redemption, the transaction is treated as a sale.

(g) Suppose A owned no common stock and owned only 400 shares of the nonvoting preferred and X redeems 160 of A’s preferred shares?

***Answer:***

* Under §1.302-3(a), the §302(b)(2) safe harbour does not apply to redemptions of solely non-voting preferred stock.
* §302(b)(1) may apply because there has been meaningful reduction of the shareholder’s proportionate interest in the corporation. This is a facts and circumstances test.
* Rev. Rul. 77-426 says §302(b)(1) was created for this situation.

## Part 2 – Attribution and Complete Termination

### Readings

* E&E: Chapter 6 – Redemption Distributions
* Code: §§302(b)(3), (c)(1), (c)(2), (e); 318
* Regs: Reg. §§1.302-4; 1.318-1 through -4
* Prop Regs: Skim Prop Reg. §1.302-5(a)(1), (2), (3), (b)(4)(i). Read Prop. Reg §1.302-5 (e), Ex 1.
* Materials on NYU Classes:
  + Lynch v. CIR
  + Notice 2001-45
  + Zenz v Quinlivan,
  + Rev. Ruls. 69-608
  + Rev. Ruls.75-447
  + Rev. Ruls. 85-14

Warning—these proposed regs were withdrawn. I will explain.

### Problem Set

Continue with the facts of Part 1. X Corporation is owned entirely by two individuals, A and B, who are unrelated unless otherwise stated. A owns 240 shares of X common stock with a basis of $40 per share. B owns 160 shares of X common stock with a basis of $120 per share. X's stock is worth $80 per share. X has current E&P of $2,000. Determine the results to A from the following alternative transactions (assume that all sales are for fair market value):

1. A sells 120 X Co shares to X Co for $9,600. What is the amount and character of gain or loss recognized by A if A and B are related in the following alternative ways?

(a) B is A’s brother.

***Answer:***

* Under §318(a)(1), constructive attribution does not apply to brother.
* The tax consequences are the same as Part 1, Question 1(b)

(b) B is a corporation in which A owns one half of the stock.

***Answer:***

* Under §318(a)(2)(C), A is treated as owning all of the stock owned by B corporation.
* Before the transaction, A owns 400 of 400 shares (100%)
* Following the transaction, A owns 280 of 280 shares (100%)
* §302(b)(3) does not applies because there has not been a complete termination.
* §302(b)(2) does not apply because neither requirement is satisfied.
* §302(b)(2) does not apply because A’s proportionate interest in the corporation has not been reduced.
* §302(b)(2) does not apply because there has not been a partial liquidation of a portion of the corporation’s business.
* Because no safe harbour applies, the transaction will be treated as a distribution of $9,600.
  + §301(c)(1) - The first $2,000 will be treated as a dividend
    - Tax = $2,000 \* 20% = $400
    - NIIT = $2,000 \* 3.8% = $76
  + §301(c)(2) – The remaining $7,600 will be a return of basis
    - A’s basis in the remaining shares will be $2,000 [(240 \* $40) - $7,600] or $16.7 per share ($2,000 / 120). §1.302-2(c)

(c) B is A’s equal partner in a partnership.

***Answer:***

* Under §318(a)(2)(A), A is treated as proportionately owning property owned by the partnership.
* Under §318(a)(3)(A), the partnership is treated as owning the property of owned by B (and A).
* However, under §318(a)(5)(C), stock constructively owned by a partnership by reason of the application of paragraph (3) shall not be considered as owned by it for purposes of applying paragraph (2) in order to make another the constructive owner of such stock.
* The tax consequences are the same as Part 1, Question 1(b)

(d) B and A are siblings and their father has an option to purchase B’s stock.

***Answer:***

* Under §318(a)(4), father is treated as owning B’s stock.
* Under §318(a)(1), A is treated as owning father’s stock. B’s stock is therefore reattributed to A.
* The tax consequences are the same as Part 2, Question 1(b)

2. Continue with the facts where A owns 240 shares and B owns 160 shares X’s common stock. What results to A under the following alternatives?

(a) X redeems all of A’s stock for $19,200 cash.

***Answer:***

* §302(b)(3) applies because there has been a complete termination of A’s interest.
* The transaction will therefore receive sale treatment
* A’s basis = $40 \* 240 = $9,600
* FMV of shares = $80 \* 240 = $19,200
* §1001 gain = $19,200 - $9,600 = $9,600
* The gain is capital gain
* Tax = $9,600 \* 20% = $1,920
* NIIT = $9,600 \* 3.8% = $365
* The E&P is reduced under §312(n)(7):
  + The ratable share = 240/400 = 60%
  + The E&P = $2000
  + E&P is reduced by $1,200 ($2,000 \* 60%)
  + This leaves X Corp with $800 of E&P

(b) X redeems all of A’s stock for $19,200 in cash, but B is A’s father.

***Answer:***

* Under §302(c)(2), the attribution rules of §318(a)(1) do not apply if the requirements are met.
* Because the requirements are met, §318(a)(1) does not apply.
* The tax consequences are the same as (a).

(c) Same as Question 2(b), except that immediately after the redemption, A continues to serve as a paid “consultant” to X.

***Answer:***

* The requirements of §302(c)(2) are not met because A continues to serve as a paid “consultant” to X. See Lynch.
* §302(b)(3) does not applies because there has not been a complete termination.
* §302(b)(2) does not apply because neither requirement is satisfied.
* §302(b)(1) does not apply because A’s proportionate interest in the corporation has not been reduced.
* Because no safe harbour applies, the transaction will be treated as a distribution of $19,200.
  + §301(c)(1) - The first $2,000 will be treated as a dividend
    - Tax = $2,000 \* 20% = $400
    - NIIT = $2,000 \* 3.8% = $76
  + §301(c)(2) – The next $9,600 will be a return of basis
  + §301(c)(3) – The remaining $7,600 will be treated as capital gain.
    - Tax = $7,600 \* 20% = $1,520
    - NIIT = $7,600 \* 3.8% = $289

(d) Same as Question 2(b), except that A purchased his stock in X for cash from B two years prior to the redemption by X.

***Answer:***

* The requirements of §302(c)(2) are not met because of the 10-year look back rule under §302(c)(2)(B).
* The tax consequences are the same as (c).

(e) Same as Question 2(d), except that since A’s purchase of the shares from his father, he and his father have become bitter enemies.

***Answer:***

* The relationship will not affect the bright line rules of §302(b)(3) and §302(b)(2).
* However, courts may take the relationship into account for purposes of §302(b)(1).
* Assuming no safe harbour applies, the tax consequences are the same as (c).

3. Continue with the facts that A owns 240 shares and B owns 160 shares of X common stock but assume A and B are not related. A sells 40 of his shares to X for $3,200 and sells the other 200 of his shares to B for $16,000. Does it matter whether A sells to B before after his sale to X?

***Answer:***

* This is a “Zenz-Out” transaction described in E&E, page 214.
* This will qualify as a §302(b)(3) complete termination, despite the ordering of the sale and the redemption. U.S. v. Carey; Rev. Rul. 77-226,

4. What if B is under a contractual obligation to purchase all of A’s shares when A retires. A retires and X, rather than B, buys all of A’s shares. What are the tax consequences to B?

***Answer:***

* This is a inter-shareholder transaction described in E&E, page 209.
* This will qualify as a §302(b)(3) complete termination, despite the potential beneficial tax consequences to B. Rev. Rul. 69-608.

## Part 3 – Section 304

### Readings

* E&E: Chapter 6 – Redemption Distributions
* Code: §304 (omit §304(b)(3)-(6)), 351(a),358(a),362(a),§1059(e)(1)(A)(iii).
* Regs: §1.302-2(c); 1.304-5
* Prop Regs: §1.304-1, -2

Warning—these proposed regs were withdrawn. I will explain.

### Problem Set

1. New facts. X Corporation and Y Corporation both have 100 shares of voting common stock outstanding; both have E&P of $100. A and B are individuals. All transactions described take place in the current year. Determine the tax consequences to the parties of the following alternative transactions.

(a) A owns all of the stock of X with a basis of $200 (or $2 per share). A and B each own 50 shares of the stock of Y with a basis of $100 each (or $2 per share). Y's stock has a FMV of $500 (or $5 per share). A and B are unrelated. A sells all 100 of his X shares to Y Corp for $500. (This question is designed to introduce §304(a)(1). You should conclude that the deemed redemption under §304(a)(1) may or may not qualify for exchange treatment under §302(a), depending on the facts and circumstances. Work through the problem assuming alternatively (1) that the acquisition by Y is a redemption qualifying for exchange treatment and (2) that it is a redemption treated as a dividend under §301.)

***Answer:***

* §304(a)(1) relating to brother-sister corporations applies to commonly controlled corporations.
* X Corp and Y Corp are commonly controlled because A owns at least 50 percent of each.
* The issue is whether the transaction is treated as a sale or as a dividend.
* §302(b)(3) does not applies because there has not been a complete termination.
* §302(b)(2) does not apply because A does not own less than 50% of the total combined voting power of all classes of stock entitled to vote
  + A is treated as owning 100% of the X Corp shares before the transaction.
  + A is treated as owning 50% of the X Corp shares after the transaction.
  + Because A does not own less than 50% of the total combined voting power of all classes of stock entitled to vote, the transaction does not qualify for the §302(b)(2) safe harbour.
* §302(b)(1) may apply because A’s proportionate interest in the corporation has been reduced.
* Sale or Exchange Treatment (i.e., a safe harbour applies)
  + §1001 gain = $300 ($500 - $200)
  + Tax = $63 ($300 \* 21%)
  + NIIT = $7.6 ($200 \* 3.8%)
  + The professor stated that is unclear whether E&P is reduced under §312(n)(7).
* Dividend Treatment
  + Under §304(a)(1), the transaction is treated as if:
    - A contributed the 100 shares of X Corp to Y Corp for Y Corp shares in a §351
    - Y Corp redeemed the Y Corp shares issued for $500.
  + To calculate the amount which is a dividend, §304(b)(2) first looks to the acquiring corporation to the extent of its E&P, and then to the issuing corporation to the extent of its E&P.
  + Amount distributed = $500
  + §301(c)(1) - The first $200 will be treated as a dividend
    - Tax = $200 \* 20% = $40
    - NIIT = $2,000 \* 3.8% = $7.6
  + §301(c)(2) – The next $300 will be a return of basis
    - A had an initial basis in Y Corp of $100.
    - A received an additional 100 shares in Y from the §351. The professor stated to use FMV to get to 100. A’s 50 shares in Y corp. have an FMV of $250. A contributes property worth $500, so receives deemed shares of 100.
    - The basis in the shares under the §351 is $200 (i.e., the basis in the X Corp shares).
    - Note: Y Corp’s basis in the X stock is $200 (i.e., the carry-over basis from the deemed §351). Y Corp. therefore does not receive a basis in the shares equal to the amount paid.
    - A therefore has a total basis in the shares of $300.
    - Under the proposed regs:
      * The $300 distribution comes out of the basis in the shares pro rata from the actual shares and the deemed shares.
      * So 1/3 from actual and 2/3 from the deemed
      * After the 304 there is a recapitalization of the 150 shares back into 50 shares of Y corp.
    - Since the 304 proposed regs were repealed, we don’t currently know how this transaction would be treated.

(b) Same as (a) except A owns 45 shares of Y with a basis of $90, and B owns 55 shares with a basis of $110.

***Answer:***

* §304(a)(1) relating to brother-sister corporations applies to commonly controlled corporations.
* However, X Corp and Y Corp are not commonly controlled because A owns less than 50 percent of Y Corp.
* §1001 gain = $300 ($500 - $200)
* Tax = $63 ($300 \* 21%)
* NIIT = $7.6 ($200 \* 3.8%)
* §312(n)(7) does not apply because not a redemption.

(c) Same as (b) except the consideration paid by Y is ten shares of Y stock, worth $25 total, and $475 cash. (See §304(c)(2)(A).)

***Answer:***

* X Corp and Y Corp are commonly controlled because A owns at least 50 percent of each.
* Under §304(c)(2)(A), A must include the shares received in the exchange.
  + After the exchange A owns 55 of 110 shares = 50% control.
* Bifurcate into a part-cash (§1001) and part-304.
* The tax consequences of this transaction are outside the scope of this class.

(d) Same as (a) except A is a corporation and sells ½ its X stock to Y. (Assume that the redemption is treated as a dividend under §301.) (See §1059(e)(1)(A)(iii)).

***Answer:***

* Under §304(a)(1), the transaction is treated as if:
  + A Corp contributed 50 shares of X Corp to Y Corp for Y Corp shares in a §351
  + Y Corp redeemed the Y Corp shares issued for $250.
* To calculate the amount which is a dividend, §304(b)(2) first looks to the acquiring corporation to the extent of its E&P, and then to the issuing corporation to the extent of its E&P.
* Amount distributed = $250
* §301(c)(1) - The first $200 will be treated as a dividend
  + Tax = $200 \* 21% \* (1-65%) = $14.7
  + Under §1059(e)(1)(A)(iii), this is an extraordinary dividend. The untaxed portion will be subtracted from basis = ($200 \* 65%) = $130
    - However, the flush language notes: “only the basis in the stock redeemed shall be taken into account under subsection (a)”
  + A received additional shares in Y Corp from the §351.
  + The basis in the shares under the §351 is $100 (i.e., the basis in the X Corp shares). However, the basis in the pretend shares is reduced by $130 to $0 under 1059(e)(1)(A)(iii). Under the extraordinary dividend rules, the $30 extra is treated as capital gains under §1059(a)(2).
* §301(c)(2) – $25 will be treated as a return of basis of Y Corp shares
  + A had an initial basis in Y Corp of $100.
  + The basis in the deemed Y Corp shares has been reduced to zero, because of the extraordinary dividend.
  + Under the proposed regs:
    - The $50 remaining distribution comes out of the basis in the share’s pro rata from the actual shares and the deemed shares.
    - So 1/2 from actual and 1/2 from the deemed
    - So $25 is treated as a return of basis for the actual shares
    - And $25 from the deemed shares (but there is no
    - After the 304 there is a recapitalization of the 150 shares back into 50 shares of Y corp.
* §301(c)(2) – The remaining $25 will be treated as capital gain
* The professor seems confused. The handout seems unclear/incorrect.

2. New facts. D owns 80% of P Corp's 100 outstanding shares. P Corp in turn owns 100% of S Corp. (Shareholders unrelated to D own the other 20 P Corp shares.) Determine the tax consequences to the parties of the following transaction: D sells 35 of D's P shares (basis to D of $70) to S for $175.

***Answer:***

* See E&E, page 222.
* The parent-subsidiary situation will not be on the exam.

# Unit 4 – Stock Distributions

## Part 1 – Section 305

### Readings

* E&E: Chapter 7 – Stock Dividends
* Code: §305 (Skip §305(e)), 307, 311(a)(1), 312(d)
* Regs: §1.305-1, -2, -3 [omit -3(d) dealing with conversion adjustments], -4,-5(a),(b); -7(a), (b),(c)
* Materials on NYU Classes:
  + Eisner v. Macomber
  + Koshland
  + Rev. Rul.78-115

### Problem Set

(1) X Corp has only common stock outstanding and has ample E&P. X Corp distributes one share of preferred stock on each share of common stock outstanding. Assume that A owns a block of X Corp common stock with a basis of $1,000. In the distribution, A receives preferred stock worth $2,000 on the date of distribution. A's common shares are worth $4,000 immediately following the distribution. What are the tax consequences of the distribution?

***Answer:***

* Because the distribution has not encroached on existing preferred shareholders, the distribution is proportionate to each shareholder [very important caveat – see 2(d) below].
* Therefore, the §305(a) non-recognition rules should apply.
* Under §307(a), the adjusted basis of the original common stock should be allocated among the common stock and the new preferred shares based on FMV. §1.307-1(a)
* Applying the formula we get:
  + Common stock: $667 ($1,000 \* $4,000 / $6,000)
  + Preferred stock: $333 ($1,000 \* $2,000 / $6,000)

(2) Y Corp has two classes of stock outstanding, common and preferred. The preferred stock entitles the holder to a cumulative preferred dividend of $6 per year. Determine the tax consequences of the following alternative distributions by Y Corp, assuming Y Corp has ample E&P.

(a) One share of common on each ten shares of common outstanding.

***Answer:***

* Non-recognition treatment under §305(a).
* §302(b)(2) is not implicated because the preferred shareholders interest in the assets or earnings and profits of the corporation have not been affected by the stock split. They receive a $6 dividend on their shares regardless of the number of common shares.
* There are no income tax consequences to the corporation under §311(a)(1)
* There is no effect on the E&P under §312(d)(1)(B)
* Basis allocated under §307(a)
* Holding period of old stock is tacked onto new stock under §1233(4).

(b) What if, in (a), the common shareholders have the option to receive cash in lieu of stock?

***Answer:***

* Under §305(b)(1), the stock dividend will be treated as a §301 distribution to all shareholders receiving either cash or stock, because the shareholders may elect to take other property.
* The amount of the distribution is equal to the value of the stock on the date of distribution. §1.305-2(b) Ex. 5.
* The shareholders will receive fair market value basis in the shares received under §301(d).
* The E&P of the corporation is reduced under §1.312-1(d).
* There are no income tax consequences to the corporation under §311(a)(1).
* See additional hypos: §305(b)(1) still applies where:
  + 1.305-2(a)(5) – Whether all or part of the shareholders have the election.
  + 1.305-2(a)(1) – Whether the distribution is actually made in whole or in part in stock or in stock rights

(c) What if, in (b), the shareholders have no cash option but cash is paid in lieu of fractional shares?

***Answer:***

* Generally, under §305(b)(2) the stock dividend will be treated as a §301 distribution because the shareholders are receiving disproportionate distributions.
* However, there is a rule of convenience for this exact type of situation under §1.305-3(c). However, the purpose must be for avoiding the creation of fractional shares and not changing the interests of the shareholders. Also there is a 5% bright line safe harbour.
* The treatment of the cash received by a shareholder will be determined under §302. The fractional share is treated as if it was distributed and then redeemed by the corporation.
  + The transaction will almost always receive sale or exchange treatment, because the shareholders reduction in proportionate interest in the corporation is de minis. See Rev. Rul. 76-385.
* The stock dividends will not be taxed as distributions under §305(a).

(d) One share of preferred stock (of the same class as that outstanding) on each ten shares of common.

***Answer:***

* There are two requirements under §302(b)(2):
  + The receipt of property by some shareholders, and
  + An increase in the proportionate interests of other shareholders in the assets or earnings and profits of the corporation.
* Here,
  + “other shareholders” = common stock holders; and
  + “some shareholders” = preferred stock holders.
* The preferred stock holders are treated as receiving property on their $6 dividends. §1.305-3(b)(3).
  + No plan is required connecting the $6 dividend to the stock dividend. §1.305-3(b)(2)
  + However, the $6 dividend and the stock dividend need to occur within 36 months of each other. §1.305-3(b)(4)
* The common shareholders are receiving an increase in their proportionate interests through their encroachment on the preferred shareholders. §1.305-3(e)
* This is true even if the shareholders of the class A and class B shares are the same and hold proportionate interests in both. §1.305-3(b)(6)
* Under §305(b)(2), the stock dividend will be treated as a §301 distribution to all shareholders receiving a stock dividend.
* The shareholders will receive fair market value basis in the shares received under §301(d).

(e) One share of common on each share of preferred.

***Answer:***

* The general non-recognition rules of §305(a) will not apply, because this is a distribution on preferred stock.
* Under §305(b)(4), the stock dividend will be treated as a §301 distribution to all shareholders receiving either cash or stock.
* The shareholders will receive fair market value basis in the shares received under §301(d).

(f) Would your answer to (e) change if each share of preferred participates equally with each share of common after satisfaction of the preferred dividend?

***Answer:***

* Preferred shares that participates equally with each share of common are not treated as preferred shares. §1.305-5(a).
* Therefore §305(b)(4) would not apply.
* However, §305(b)(2) would apply because the preferred shareholders are receiving a disproportionate distribution.

(3) Z Corp. has two classes of common stock outstanding, 90 shares of Class A and 180 shares of Class B. Determine the tax consequences of the following alternative transactions.

(a) Z Corp distributes cash on the Class A common, and Class B common on the Class B common.

***Answer:***

* The cash distribution on the Class A common is a taxable distribution under §301
* The stock dividend on the Class B common is also a distribution under §302(b)(2).
* There are two requirements under §302(b)(2):
  + The receipt of property by some shareholders, and
  + An increase in the proportionate interests of other shareholders in the assets or earnings and profits of the corporation.
* Here,
  + “other shareholders” = Class B stock holders; and
  + “some shareholders” = Class A stock holders.
* The Class A stock holders received a cash distribution.
* The Class B stock holders are receiving an increase in their proportionate interests because they have additional claims to the assets and earnings and profits. §1.305-3(b)(2), -3(e).
* Under §305(b)(2), the stock dividend will be treated as a §301 distribution to all shareholders receiving a stock dividend.

(b) Z Corp distributes a new class of preferred stock on the Class A shares, and additional Class B common on the Class B common.

***Answer:***

* The general non-recognition rules of §305(a) will not apply, because this series of distributions results in some common shareholders receiving common stock and others receiving preferred stock.
* Under §305(b)(3), both stock dividends will be taxable as distributions.

(c) Z Corp purchases for cash one-third of the Class B common on a pro rata basis. Assume that the Z Corp shares are owned by two shareholders, P and Q, each of whom own 45 shares of Class A and 90 shares of Class B.

***Answer:***

* §305(a) is not implicated because there has been no distribution of Z Corp stock.
* This is a redemption distribution under §302. Because the shares are redeemed pro rata, the redemption is being treated as a §301 distribution.
* However, under §305(c), if a §301 redemption increases the proportionate interest of one shareholder’s interest in the earnings and profits or assets of the corporation, then a deemed distribution may have occurred. §1.305-7.
* Here because the redemption did not result in an increase in the proportionate interests of certain shareholders in the assets or earnings and profits of the corporation, then §305(c) is not implicated.

(d) Same as (c) except assume that P holds 90 shares Class A common and Q holds 180 shares Class B common. (Assume that Class A and Class B each have 1 vote per share, participate equally in dividends, and are of equal value, but that they have different preferences in liquidation.)

***Answer:***

* §305(a) is not implicated because there has been no distribution of Z Corp stock.
* This is a redemption distribution under §302.
  + Q initially has 180 of 270 shares (.667)
  + After the redemption Q has 120 of 210 (.57)
  + None of the 302(b)(2) safe harbours apply.
  + Therefore, §301 applies.
* However, under §305(c), if a §301 redemption increases the proportionate interest of one shareholder’s interest in the earnings and profits or assets of the corporation, then a deemed distribution may have occurred. §1.305-7.
  + A initially has 90 of 270 shares (.33)
  + After the redemption A has 90 of 210 (.429)
* There is an exception under 1.305-3(b)(3), -3(e) Ex. 10 & 11 for isolated redemptions
  + Isolated redemptions are one-offs for deaths, retirements, etc.
  + Not applicable here.
* The question is what is the amount the non-redeemed shareholder (i.e., P) received in a deemed stock dividend as a result of the redemption (i.e., Q).
  + P will be deemed to have received a stock dividend of the number of shares to bring his initial ownership percentage to 42.9%
  + P is deemed to have received a stock dividend of 45 shares
  + (90+45) / (270+45) = 42.9%
  + NOTE: The calculation of this is outside the scope of the exam.

(4) W Corp has 100 shares of common stock and 50 shares of convertible preferred stock outstanding. The preferred stock is entitled to a non-cumulative (no arrears owed) dividend of $6 per year and converts to the common on a 2:1 ratio (meaning that each share of preferred stock is convertible into two shares of common stock). What are the tax consequences of the following alternative transactions?

(a) W Corp distributes one share of common on each share of common outstanding. Assume that the preferred stock is not protected by an anti-dilution feature (so there is no adjustment to the conversion ratio to reflect issuance of common stock to the common shareholders).

***Answer:***

* §305(c) is not implicated because there was an actual stock dividend.
* Under §1.305-3(d)(1), - (e) Ex. 4, this is treated as if all of the holders of convertible preferred stock have converted into common.
* The distribution of the common stock has therefore reduced the proportionate interests of the preferred shareholders in the assets or earnings and profits of the corporation.
* Under §305(b)(2), the stock dividend will be treated as a §301 distribution.

(b) Same as (a) except the preferred stock is fully protected against dilution (that is, the conversion ratio is adjusted to take account of the issuance of common shares).

***Answer:***

* The antidilution provision will prevent application of §305(b)(2).
* Non-recognition treatment under §305(a).
* Basis allocated under §307(a)
* Holding period of old stock is tacked onto new stock under §1233(4).

(c) Same as (b) except the distribution on the common is cash not stock, and the anti-dilution provision adjusts for cash as well as stock distributions.

***Answer:***

* The distribution of cash to the common stock shareholders is a taxable distribution under §301.
* An adjustment in the conversion ratio or price to compensate for cash or property distributions to other shareholders that are taxable under §301will not be considered as made pursuant to a bona fide adjustment formula. §1.305-7(b).
* Presumably, the anti-dilution provision will increase the conversion ratio for the preferred stock to account for the decrease in the proportionate interests of the preferred shareholders in the assets or earnings and profits of the corporation.
* The change in conversion ratio will be treated as a distribution to the preferred shareholders under §305(c).
* The way to calculate this amount is from the proposed regulations. This is outside the scope of the exam.

## Part 2 – Section 306

### Readings

* E&E: Chapter 7 – Stock Dividends
* Code: §§306 (a)-(c)(3), 307, 1223(4)
* Regs: §1.306-1, -2, -3, 1.307-1, 1.312-1(e)
* Materials on NYU Classes:
  + Chamberlain; Pescosolido
  + Rev. Ruls. 76-386, 76-387, 77-455, 79-163, 81-91.

### Problem Set

(5) A and B, unrelated individuals, organized X Corp in 2015. Each contributed $100 in exchange for 100 shares of common stock. In June 2019, X Corp declares a dividend of one share of non-voting preferred stock on each share of common stock outstanding (thus 200 preferred shares are issued, one each on the 200 shares of common stock outstanding). The preferred stock is worth $1 per share when distributed. The common stock is worth $4 per share immediately after the preferred stock dividend.

On 1/1/2019, X Corp has accumulated E&P of $130; its E&P for all of 2019 is $30. On 1/1/2021, X Corp has accumulated E&P of $280; its current E&P for all of 2021 is $20.

What are the tax consequences of the following dispositions?

(a) In December 2021, A sells all of her preferred stock to G for $85; and in June 2022, A sells all of her common stock to M for $500.

***Answer:***

* The 2019 stock dividend was non-taxable under §305(a).
* Under §307(a), the adjusted basis of the original common stock should be allocated among the common stock and the new preferred shares based on FMV. §1.307-1(a)
* Applying the formula we get:
  + Common stock: $80 ($100 \* $400 / $500)
  + Preferred stock: $20 ($100 \* $100 / $500)
* The preferred stock is tainted §306 stock as defined in §306(c)(1)(A).
* Under §306(a)(1)(A), the amount distributed is the lesser of:
  + The amount realized on the sale = $85;
  + The amount that would have been treated as a dividend at the time of the stock dividend:
    - FMV of preferred stock = $100
    - Total 2019 E&P = $160
    - Ratable Share of 2019 E&P = $80 ($160 \* 50%)
* Because the §306(a)(1)(A) limitation applies, shareholder A must report $80 as dividend income.
  + Tax = $16 ($80 \* 20%)
  + NIIT = $3 ($80 \* 3.8%)
* The excess amount realized is $5. This is treated as a $5 return of basis. §306(a)(1)(B)
* The adjusted basis in the preferred shares is $15 ($20-$5).
* Shareholder A is permitted to add any unrecovered basis from the §306 shares of the common shares with respect to which the §306 shares were issued. §1.306-1(b)(2).
* The adjusted basis in the common stock is therefore $95 ($80 + $95).
* The sale of the common stock is taxable under §1001. Shareholder A will recognize gain of $405 ($500 - $95).
  + Tax = $81 ($405 \* 20%)
  + NIIT = $15 ($405 \* 3.8%)
* There is no effect on the E&P when the taxpayer sells the common stock. §1.312-1(e).

(b) What if, instead of selling her preferred stock to G, A transfers it to newly formed Newco in exchange for all of Newco's common stock. Then, either A sells the Newco common to G in December 2021, or, alternatively, Newco sells the X Corp preferred to G in December 2021.

***Answer:***

* The transfer of the preferred stock to NewCo will not result in application of §306(a), because §351 is a non-recognition provision. §306(b)(3).
* However both the stock of NewCo and the preferred shares will be §306 “tainted stock”. §306(c)(3).
* Subsequent sales of the NewCo common to G, or, alternatively, X Corp preferred to G, will trigger §306(a)(1). §1.306-3(e)

(c) Same as (a), except that the sales to M and G take place in reverse order, i.e., A sells all of her common stock to M for $500 in December 2021, and then A sells all of her preferred stock to G in June 2022 for $85.

***Answer:***

* Where there is a prior or simultaneous disposition of the underlying common stock with respect to which the preferred stock was issued, Shareholder A can avoid §306(a) by establishing to the satisfaction of the secretary that the disposition of the tainted preferred stock “was not in pursuance of a plan having as one of its principal purposes the avoidance of federal income tax.” §306(b)(4)(B).

(d) In 12/2021, X Corp redeems all of A's preferred for $90.

***Answer:***

* Under §306(a)(2), the redemption is simply treated as a §301 distribution.
* The amount distributed is $90.
* Since the E&P is $300, the entire distribution is a taxable dividend. §301(c)(1).

# Unit 5 – Liquidations

## Part 1 – General Rules (§331 et seq.)

### Readings

* E&E: Chapter 8 – General Liquidation Rules
* Code: §267(a)(1), (b)(2); 331; 334; 336; 346(a); (b); Glance at §'6901(a)-(c), (h).
* Regs: §1.331-1(b) thru (e); 1.332-2(c)
* Materials on NYU Classes:
  + Court Holding

### Problem Set

(1) A, an individual, owns all of T Corp's stock. A's basis is $10 total. T Corp has only one asset, rental property, owned since 1995, with a value of $100, basis of $30, and subject to a $40 mortgage. T Corp, a cash method taxpayer, has $20 of E&P. Its income is taxed at a flat 21% rate. P Corp (which is unrelated to A and T Corp) acquires the rental property as provided below. In each alternative, determine the consequences to the parties.

(a) Asset sale then liquidation. In 2010, T Corp adopts a plan of liquidation and then sells the property (subject to the mortgage) to P Corp for $60 in cash. Then in 2011 T Corp distributes the sales proceeds (net of any taxes) to A in complete liquidation.

***Answer:***

* Tax Consequences to the Corporation on the Sale of the Property (§1001)
  + Amount Realized = $60 Cash + $40 Assumption of Mortgage = $100 (From Crane)
  + Basis = $30
  + Gain = $70 ($100-$30)
  + Tax = $70 \* 21% = $14.7
  + E&P = $20 + $70 - $14.7 = $75.3
* Tax Consequences to A on the Liquidation of T Corp (§331)
  + Distribution Amount = $45.3 ($60-$14.7)
  + Basis = $10
  + Capital gain = $35.3 ($45.3-$10)
  + Tax = $7.06 ($35.3 \* 20%)
* Tax Consequences to T Corp on the Liquidation of T Corp (§336)
  + It holds cash at the time of liquidation.
  + Therefore, there are no tax consequences to T Corp.

(b) Liquidation in kind then asset sale by shareholders. In 2010, T Corp adopts a plan of complete liquidation and then distributes the property to A in 2010 pursuant to this plan. In 2011, A negotiates a sale of the property subject to the mortgage to P Corp for $60; the sale closes in 2011.

***Answer:***

* Tax Consequences to T Corp on the Liquidation of T Corp (§336)
  + Amount Realized = $100 FMV
  + Basis = $30
  + Gain = $70 ($100-$30)
  + Tax = $70 \* 21% = $14.7
  + E&P = $20 + $70 - $14.7 = $75.3
* Tax Consequences to A on the Liquidation of T Corp (§331)
  + Amount Realized = $100 Rental Property - $40 Assumption of Mortgage – $14.7 T Corp Tax = $45.3 (Rev. Rul. 72-137)
  + The distribution Amount = $45.3
  + Basis = $10
  + Capital gain = $35.3 ($45.3-$10)
  + Tax = $7.06 ($35.3 \* 20%)
* Tax Consequences to A on the sale of the Rental Property (§1001)
  + Amount Realized = $60 Cash + $40 Assumption of Mortgage = $100
  + Basis = $100
  + Gain = $0 ($100-$100)

(c) Stock sale by shareholders. A sells his stock in T Corp to P Corp in December of 2010 for $60 in cash.

***Answer:***

* Tax Consequences to A on the Sale of T Corp (§1001)
  + Amount Realized = $60
  + Basis = $10
  + Capital Gain = $50 ($60-$10)
  + Tax = $10 ($50 \* 20%)

(2) If, in Question (1), A's basis for his T Corp stock was $80, instead of $10, how would the results change for each part of the question?

(a) Asset sale then liquidation. In 2010, T Corp adopts a plan of liquidation and then sells the property (subject to the mortgage) to P Corp for $60 in cash. Then in 2011 T Corp distributes the sales proceeds (net of any taxes) to A in complete liquidation.

***Answer:***

* Tax Consequences to the Corporation on the Sale of the Property (§1001)
  + Amount Realized = $60 Cash + $40 Assumption of Mortgage = $100 (From Crane)
  + Basis = $30
  + Gain = $70 ($100-$30)
  + Tax = $70 \* 21% = $14.7
  + E&P = $20 + $70 - $14.7 = $75.3
* Tax Consequences to A on the Liquidation of T Corp (§331)
  + Distribution Amount = $45.3 ($60-$14.7)
  + Basis = $80
  + Capital loss = $34.7 ($45.3-$80)
  + Does §267 apply to disallow the loss:
    - A is an applicable person under §267(b)
    - However, §267 does not apply to complete liquidations under §267(a).
* Tax Consequences to T Corp on the Liquidation of T Corp (§336)
  + It holds cash at the time of liquidation.
  + Therefore, there are no tax consequences to T Corp.

(b) Liquidation in kind then asset sale by shareholders. In 2010, T Corp adopts a plan of complete liquidation and then distributes the property to A in 2010 pursuant to this plan. In 2011, A negotiates a sale of the property subject to the mortgage to P Corp for $60; the sale closes in 2011.

***Answer:***

* Tax Consequences to T Corp on the Liquidation of T Corp (§336)
  + Amount Realized = $100 FMV
  + Basis = $30
  + Gain = $70 ($100-$30)
  + Tax = $70 \* 21% = $14.7
* Tax Consequences to A on the Liquidation of T Corp (§331)
  + Amount Realized = $100 Rental Property - $40 Assumption of Mortgage – $14.7 T Corp Tax = $45.3 (Rev. Rul. 72-137)
  + The distribution Amount = $45.3
  + Basis = $80
  + Capital loss = $34.7 ($45.3-$80)
  + Does §267 apply to disallow the loss:
    - A is an applicable person under §267(b)
    - However, §267 does not apply to complete liquidations under §267(a).
* Tax Consequences to A on the sale of the Rental Property (§1001)
  + Amount Realized = $60 Cash + $40 Assumption of Mortgage = $100
  + Basis = $100
  + Gain = $0 ($100-$100)

(c) Stock sale by shareholders. A sells his stock in T Corp to P Corp in December of 2010 for $60 in cash.

***Answer:***

* Tax Consequences to A on the Sale of T Corp (§1001)
  + Amount Realized = $60
  + Basis = $80
  + Capital Loss = $20 ($60-$80)

(3) Suppose that T Corp received its rental property in a §351 exchange eighteen months ago when it was worth $100 and took a transferred basis (per §362(a)) of $150 (which you should assume has not changed). A owns two-thirds of T Corp's stock and B owns the other one-third. Determine the tax consequences of the following alternative transactions.

(a) In a liquidating distribution, A receives the rental property worth $100, subject to the $40 liability, while B receives $30 in cash.

***Answer:***

* Tax Consequences of Contribution of Property to T Corp
  + Under §362(e)(2), T Corp should have a basis of $100 in the rental property.
  + However, the problem states to assume that T Corp has taken a transferred basis in the property of $150.
  + It is unclear who contributed the rental property, but assume it is A.
  + A takes a basis in the T Corp stock of $150.
  + B contributed cash to T Corp, and therefore has a basis in the T Corp stock of $30.
* Tax Consequences to T Corp on the Liquidation of T Corp (§336)
  + Under §336(d)(1), A is a “related party”
  + §336(d)(1) applies to the liquidation, because the distribution of the loss property is non-pro rata.
  + Under §336(a):
    - Amount Realized = $100 FMV
    - Basis = $150
    - Loss = $50 ($100-$150)
  + However the loss is disallowed under §336(a)(1) for the corporation
* Tax Consequences to A on the Liquidation of T Corp (§331)
  + Amount Realized = $100 Rental Property - $40 Assumption of Mortgage = $60
  + The distribution Amount = $60
  + Basis = $150
  + Capital loss = $90 ($60-$150)
  + A’s basis in the rental property is $100 (i.e., the cost basis – treated as purchasing the rental property from T Corp for $100).
* Tax Consequences to B on the Liquidation of T Corp (§331)
  + The distribution Amount = $30
  + Basis = $30
  + Capital loss = $0 ($30-$30)

(b) A and B receive undivided interests in the rental property commensurate with their stock holdings, in each case subject to an appropriate share of the liability.

***Answer:***

* Tax Consequences to T Corp on the Liquidation of T Corp (§336)
  + §336(d)(1) does not apply to the liquidation because the distribution of the loss property is pro rata.
  + §336(d)(2) applies because this is a distribution of property contributed under §351 within 5 years of the liquidation.
  + Under §336(d)(2) the basis of the property is changed to its FMV at the time of contribution.
  + Under §336(d)(2):
    - Amount Realized = $100 FMV
    - Basis = $100
    - Loss = $0
* The tax consequences to A and B are the same above, except everything is prorated 2/3 to A and 1/3 to B.

## Part 2 – Liquidations of Controlled Subsidiaries (§332 et seq.)

### Readings

* E&E: Chapter 9 – Liquidation of Subsidiaries
* Code: §§332; 334(b); 337; 336(d)(3), (e); 381(a) & (c)(2)
* Regs: §§1.332-1, -2, -5.

### Problem Set

(1) T Corp is the sole shareholder of TSub Corp. T Corp has a $10 basis in its TSub Corp stock. TSub Corp's sole asset is worth $100, subject to a liability of $40, and has a basis of $30 in TSub Corp's hands. TSub Corp adopts a plan of complete liquidation in 2010 and distributes the asset to T Corp "in kind" pursuant to this plan in 12/2010. In 2011 T Corp negotiates a sale of the asset to P Corp for total consideration of $100 ($60 cash and $40 debt assumption). The sale closes in 2011.

(a) Describe the consequences to the parties.

***Answer:***

* Tax Consequences to T Sub on the Liquidation (§337)
  + There are no tax consequences to T Sub on the liquidation
* Tax Consequences to A on the Liquidation of T Sub (§332)
  + There are no tax consequences to T Corp on the liquidation
* Tax Consequences to T Corp on the sale of the Asset (§1001)
  + Amount Realized = $100 ($60 cash + $40 debt assumption)
  + Basis = $30 (§334(b))
  + Capital gain = $70 ($100-$30)
  + Tax = $14.7 ($70 \* 21%)

(b) Suppose instead that T Corp owned only 80% of TSub Corp's shares, and the other 20% were owned by M Corp (an unrelated shareholder). In the liquidation, T Corp and M Corp receive undivided 80% and 20% interests in the property, in each case subject to an allocable share of the liability. How do the consequences change?

***Answer:***

* The tax consequences will need to be bifurcated 80/20
* Tax Consequences to M Corp on the Liquidation of T Sub (§336)
  + Amount Realized = $20 FMV
  + Basis = $6
  + Gain = $14 ($20-$6)
  + Tax = $14 \* 21% = $2.94
* Tax Consequences to A on the Liquidation of T Corp (§331)
  + Amount Realized = $20 Asset - $8 Debt Assumption – $2.94 Corp Tax = $9.06 (Rev. Rul. 72-137)
  + The distribution Amount = $9.06
  + Basis = $2
  + Capital loss = $7.06 ($9.06-$2)
* Tax Consequences to A on the sale of the Asset (§1001)
  + Amount Realized = $12 Cash + $8 Assumption of Mortgage = $20
  + Basis = $20
  + Gain = $0 ($100-$100)
* Tax Consequences to T Corp on the sale of the Asset (§1001)
  + Amount Realized = $80
  + Basis = $24 (§334(b))
  + Capital gain = $56 ($80-$24)
  + Tax = $11.76 ($70 \* 21%)

## Part 3 – Stock Sales treated as Asset Sales (§338 elections)

### Readings

* E&E: Chapter 10 – Taxable Mergers and Acquisitions
* Code: §§338(a) thru (d), (g), (h)(1) thru (5), (h)(10); 336(e).
* Regs:
  + §1.338-1(a)(1); -(b)(1), (3)
  + §1.338-2(b)(1)-(7); -2(d)
  + §1.338-3(b)(1),-3(c)
  + §1.338-5(a), (b)(1),(2)(i), (e)(1), (g) Ex1
  + §1.338(h)(10)-1(b)(3), (c), (d)(1)-(3), (5), (6), -1(e) Ex 2.
  + §Glance at 1.338-4(b)(1), (c) thru (f), (g) Ex1
* Materials on NYU Classes: Kimball Diamond

### Problem Set

(1) Same facts as Part 2 of this Unit V. T Corp is the sole shareholder of TSub Corp. T Corp has a $10 basis in its TSub Corp stock. TSub Corp's sole asset is worth $100, subject to a liability of $40, and has a basis of $30 in TSub Corp's hands.

In 2012, T sells all the stock of TSub Corp to P Corp for $60, and P Corp continues to operate TSub as a subsidiary.

(a) In the absence of any election under § 338, was $60 the right price for P Corp to pay for the stock of TSub? If not, why?

***Answer:***

* If P Corp liquidated T Sub and sold the property, it would have §1001 gain of $70 ($100-$30). The gain would be subject to $14.7 of tax ($70 \* 21%). P Corp would therefore have cash in hand of $45.3 ($60-$14.7).
* If P Corp had purchased the property directly, it would have had a basis in the asset of $100. Therefore, a subsequent sale of the asset would have resulted in §1001 gain of $0 ($100 AR - $100 AB). P Corp would therefore have cash in hand of $60.
* Therefore, P Corps should only purchase T Sub for $45.3.

(b) Do you think that P Corp should have paid $45.30 for the stock of TSub? Would a purchase at that price solve all of P Corp’s tax concerns?

***Answer:***

* Yes, see calculation above.

(2) Can P Corp make a § 338(g) election? If P Corp made an election under § 338(g), would P Corp’s remaining tax concern(s) under (1)(b) be cured? If they would be, are there nevertheless reasons why P Corp would not want to make a § 338(g) election?

***Answer:***

* To make the election, P Corp must acquire 80% of T Sub with 12 months, and must make a timely §338(g) election.
* Some concerns of making a §338(g) election include:
  + The tax attributes of T Sub, including E&P, net operating losses, etc. are wiped out.
  + T Sub must recognize gain, and pay tax on the built-in-gain of the assets.
  + The mechanics of §338 may result in unfavourable allocations of basis in the assets.
* P Corp’s concerns regarding the built-in-gain of the assets are NOT satisfied. P Corp is still bearing the burden of the tax on built in gain of the assets, because T Sub must recognize the gain on the built-in-gain of the assets.

(a) Can you think of additional facts that might make a §338(g) election attractive to P Corp?

***Answer:***

* If the T Sub were a foreign corporation, then T Sub may not have any U.S. tax on the deemed sale of the assets.

(3) Alternatively, can P Corp and T Corp join in making an election under § 338(h)(10)? What are the basic effects of making such an election?

***Answer:***

* If a §338(h)(10) election is made, T Sub is deemed to have sold all of its assets to a new subsidiary of P Corp, and to have distributed the proceeds of the asset sale to T Corp in a deemed liquidation).
  + The sale of the assets will be taxable to T Sub.
  + The liquidation of T Sub will be tax-free to both T Sub and T Corp under §§332 and 337.
* P Corp will be treated as owning a new subsidiary corporation, with the assets of T Sub. However, the basis of the T Sub assets will be stepped up.

(a) Assume that absent a §338(h)(10) election, P Corp wants to pay 45.30 for the stock of TSub, but T Corp wants $60 for the stock of T Sub. If T Corp and P Corp file a § 338(h)(10) election, would a sale at $60 be more likely?

***Answer:***

* Yes, the sale will be more likely because the tax will be imposed on T Sub, and ultimately T Corp.

(b) If P buys all of the stock of TSub for $60, what would be the effect of a 338(h)(10) election?

***Answer:***

* P Corp will be treated as owning a new subsidiary corporation, with the assets of T Sub. However, the basis of the T Sub assets will be stepped up.

# Unit 6 – Non-Recognition Transactions; Transfers to Controlled Corporations (§351)

## Part 1 – Section 351 Generally

### Readings

* E&E: Chapter 4 – Incorporation and Other Contributions to Capital
* Code: §§83(a),(h), (b); 267(a)(1), (b)(2), (3), (10), (11), (12), (c); 351(a)-(c)(1),(d); 357; 358(a), (b)(1), (d),(h); 362(a),(e); 368(c); 1032; 1221(4); 1223(1), (2)
* Regs: §§ 1.351-1(a), (b), -2; 1.357-1, -2; 1.362-4(a)(1), (b), (d)(1), (2), (g)(1)-(5), (h) Ex 1 and Ex 6; 1.1032-1
* Materials on NYU Classes:
  + American Bantam Car, Hempt Bros.,
  + Rev. Ruls. 68-55, 79-194, 95-74;
  + Notice 2001-17;
  + Rev. Proc. 77-37
  + House Report on Non-Qualified Preferred Stock;
  + Conference Report on Non-Qualified Preferred Stock;
  + House Report on Technical Corrections to Non-Qualified Preferred Stock.
  + Peracchi

### Problem Set

A, B, C, and D, four unrelated cash method taxpayers, have decided to join together to form X Corp, which will manufacture baseball bats. X Corp will be an accrual method taxpayer. A, B, C, and D will each receive 25 shares of X Corp stock and will each transfer the following property to X Corp:

|  |  |  |  |
| --- | --- | --- | --- |
| **Transferor** | **Property transferred to X Corp** | **AB** | **FMV** |
| A | Trade accounts receivable (an entitlement to payment for services rendered by A to a customer) | $0 | $25 |
| B | Equipment | $10 | $25 |
| C | Building | $35 | $25 |
| D | Cash |  | $25 |

(1) Determine the tax consequences of these transfers to A B, C, and D (including realization and recognition of any gain or loss on the exchange, and the basis and holding period of the X Corp stock received), and to X Corp (including the basis and holding period of the property received).

***Answer:***

* The requirements of §351(a) are:
  + One or more persons transfer(s) property
  + Solely in exchange for stock; and
  + Immediately after that transaction, the group of persons who transferred property for stock in that transaction are in control of the corporation.
* Shareholder A:
  + The trade account receivable is likely property for purposes of §351.
  + It should not be services because it was not performed as an employee of X Corp.
  + A debt obligation (i.e., account receivable) is property as long as it is evidenced by a security.
  + Since A is treated as contributing property, she is part of the control group. Therefore, A, B, C, and D own 80% of the corporation after the contributions.
  + §351: Shareholder A realizes $25 of gain, but recognizes $0 of gain under §351
  + §358: Shareholder A takes a basis in the X Corp stock of $0.
  + §1223(1): Shareholder A’s holding period in X Corp stock is not tacked (i.e., equal to holding period in AR) because AR is not §1221 or §1231 property.
  + §1032: X Corp recognizes no gain or loss on the issuance of its stock.
  + §362(a): X Corp takes a basis in the AR of $0.
  + §1223(2): X Corp’s holding period in AR is tacked, because it is always tacked.
* Shareholder B:
  + §351: Shareholder B realizes $15 of gain, but recognizes $0 of gain under §351
  + §358: Shareholder B takes a basis in the X Corp stock of $10.
  + §1223(1): Shareholder B’s holding period in X Corp stock is tacked (i.e., equal to holding period in equipment) because equipment is §1221 property.
  + §1032: X Corp recognizes no gain or loss on the issuance of its stock.
  + §362(a): X Corp takes a basis in the Equipment of $10.
  + §1223(2): X Corp’s holding period in equipment is tacked, because it is always tacked.
* Shareholder C:
  + §351: Shareholder C realizes $10 of loss, but recognizes $0 of loss under §351
  + §358: Shareholder C takes a basis in the X Corp stock of $35.
  + §1223(1): Shareholder C’s holding period in X Corp stock is tacked (i.e., equal to holding period in real property) because real property is §1231 property.
  + §1032: X Corp recognizes no gain or loss on the issuance of its stock.
  + §362(e)(2): X Corp takes a basis in the Building of $25, or Shareholder C can elect the alternative.
  + §1223(2): X Corp’s holding period in real property is tacked, because it is always tacked.
* Shareholder D:
  + §351: Shareholder D realizes $0 of gain or loss, and recognizes $0 of gain or loss under §351
  + §358: Shareholder D takes a basis in the X Corp stock of $25.
  + §1223(1): Shareholder D’s holding period in X Corp stock is not tacked because cash is not §1221 or §1231 property.
  + §1032: X Corp recognizes no gain or loss on the issuance of its stock.
  + §362(a): X Corp takes a basis in the Cash of $25.
  + §1223(2): X Corp’s holding period in cash is tacked, because it is always tacked.

(2) Same as Question (1), except that A received her 25 shares of X Corp stock in exchange for services A will perform for X Corp

***Answer:***

* Services are not property for purposes of §351. §351(d).
* Because Shareholder A is not contributing property, she is not part of the control group.
* Therefore, the other shareholders are not within control of X Corp following the contributions.
* §351 will not apply to any of the contributions.
* Shareholder A:
  + §83: Shareholder A recognizes $25 of ordinary income for the stock compensation.
  + §1012: Shareholder A takes a basis in the X Corp stock of $25.
  + §83: X Corp can deduct the compensation for services to Shareholder A.
* Shareholder B:
  + §1001: Shareholder B recognizes $15 of gain.
  + §1012: Shareholder B takes a basis in the X Corp stock of $25.
  + §1032: X Corp recognizes no gain or loss on the issuance of its stock.
  + §1012: X Corp takes a basis in the Equipment of $25.
* Shareholder C:
  + §1001: Shareholder C recognizes $10 of loss.
  + §1012: Shareholder C takes a basis in the X Corp stock of $25.
  + §1032: X Corp recognizes no gain or loss on the issuance of its stock.
  + §1012: X Corp takes a basis in the Building of $25.
* Shareholder D:
  + §1001: Shareholder D realizes $0 of gain or loss, and recognizes $0 of gain or loss
  + §1012: Shareholder D takes a basis in the X Corp stock of $25.
  + §1032: X Corp recognizes no gain or loss on the issuance of its stock.
  + §1012: X Corp takes a basis in the Cash of $25.

(a) How is C's tax outcome affected if B and D are C's child and grandchild, respectively?

***Answer:***

* The related party rules of §267 prohibit Shareholder C from recognizing loss in such a transaction.
* Because of the constructive ownership rules of §267(c)(4), Shareholder C is treated as owning more than 50% of the value of X Corp’s stock, and is therefore related to the corporation for purposes of §267.

(3) Same as Question (1), except that A received 5 shares of X Corp stock in exchange for $5 in cash, and the other 20 shares in exchange for services A will perform for X Corp.

***Answer:***

* Since A is treated as contributing property, she is part of the control group.
  + Since A contributed both services and property, all of her shares are counted toward meeting the control test, unless the property contribution was of nominal value and made primarily for purposes of qualifying the property contributor for nonrecognition treatment. §1.351-1(a)(1)(ii); 1.351-1(a)(2), Ex. 3.
  + The value of the property transferred must be at least 10% of the value of the stock to be received for services.
* Therefore, A, B, C, and D own 100% of the corporation after the contributions.
* Shareholder A:
  + §83: Shareholder A recognizes $20 of ordinary income for the stock compensation.
  + §1012: Shareholder A takes a basis in 20 shares of X Corp stock of $20.
  + §83: X Corp can deduct the compensation for services to Shareholder A.
  + §351: Shareholder A realizes $0 of gain, but recognizes $0 of gain under §351
  + §358: Shareholder A takes a basis in 5 shares the X Corp stock of $5.
  + §1032: X Corp recognizes no gain or loss on the issuance of its stock.
  + §362(a): X Corp takes a basis in the Cash of $5.

(4) Same as Question (1), except that A sold her X Corp stock to E a week after the transfer to X Corp.

***Answer:***

* The transfer will not violate the immediately after control requirement, as long as E is an unrelated party.

(5) Same as Question (1), except that B received, in exchange for his equipment, $5 cash and 20 shares of X Corp stock.

***Answer:***

* Shareholder B:
  + §351(b):
    - The amount realized is $15 ($25-$15)
    - Shareholder B recognizes gain of $5 from the boot
    - Shareholder B realizes a remaining $10 of gain ($15-$5), but recognizes $0 of gain
  + §358:
    - Shareholder B takes a basis in X Corp of the amount of the exchanged basis ($10) decreased by the amount of boot received ($5), increased by the amount of gain recognized ($5) = $10
  + §1223(1): Shareholder B’s holding period in X Corp stock is tacked (i.e., equal to holding period in equipment) because equipment is §1221 property.
  + §1032: X Corp recognizes no gain or loss on the issuance of its stock.
  + §362(a):
    - X Corp takes a basis in the Equipment the same as it would be in the hands of the transferor ($10), increased in the amount of gain recognized to the transferor on such transfer ($5) = $15.
  + §1223(2): X Corp’s holding period in equipment is tacked, because it is always tacked.

(a) What if, in Question (5), B had taken $15 of depreciation deductions on the equipment?

***Answer:***

* §1245(a)(1)(B) generally says that Shareholder B should recapture all depreciation deductions as recognized ordinary income.
* However, §1245(b)(3) provides that the recapture of depreciation is limited to the amount of recognized gain under §351.
* Shareholder B will therefore recognize the $5 of gain as ordinary income.
* Under §1245(a)(2)(A), the Equipment will continue to be tainted by §1245 in the hands of X Corp.

(b) What if, in Question (5), B transferred to X Corp equipment with a $25 AB and $10 FMV, and land with a $5 AB and $15 FMV?

***Answer:***

* In question 5, Shareholder B received $5 cash and 20 shares of X Corp stock.
* Shareholder B contributed two assets
  + Land: $15 FMV - $5 AB = $10 BIG
  + Equipment: $10 FMV - $25 AB = ($15) BIL
* Shareholder B:
  + §351(b):
    - Boot is allocated to the property according to FMV. Rev. Rul. 68-55
      * Land: $3
      * Equipment: $2
      * Total: $5
    - X Corp stock is also allocated to the property according to FMV. Rev. Rul. 68-55
      * Land: $12
      * Equipment: $8
      * Total: $20
    - Land
      * The amount realized is $10
      * Shareholder B recognizes gain of $3 from the boot
      * Shareholder B realizes a remaining $7 of gain ($10-$3), but recognizes $0 of gain
    - Equipment
      * The amount realized a loss $15
      * Shareholder B recognizes gain of $0 from the boot
      * Shareholder B realizes $15 in loss, but recognizes $0 of loss
  + §358(a)(1):
    - Shareholder B takes a basis in X Corp of the amount of the exchanged basis ($30) decreased by the amount of boot received ($5), increased by the amount of gain recognized ($3) = $28
  + §1223(1): Shareholder B’s holding period in X Corp stock is tacked (i.e., equal to holding period in real property) because real property is §1231 property.
  + §1032: X Corp recognizes no gain or loss on the issuance of its stock.
  + §362(e)(2)(B): §1.362-4(g)(1)(ii); §1.362-4(h) ex. 6
    - X Corp takes a basis in the Land the same as it would be in the hands of the transferor ($5), increased in the amount of gain recognized to the transferor on such transfer ($3) = $8.
    - The aggregate FMV = $25 ($10 + $15)
    - The aggregate basis = $33 ($30 + $3)
    - The aggregate basis reduction = $8 ($33 - $25)
    - The basis reduction is allocated to the assets in proportion to their built-in-losses. Therefore, X Corp takes a basis in the property as follows:
      * Equipment = $25 – $8 = $17
  + §1223(2): X Corp’s holding period in real property is tacked, because it is always tacked.

(6) Same as Question (1), except that B received, in exchange for his equipment, $12 in cash and 13 shares of X Corp stock, B had taken $5 of depreciation deductions on the equipment, and C and D were B's children (the result here is to be compared with Question (5), Part (a)).

***Answer:***

* Shareholder B:
  + §351(b):
    - The amount realized is $15 ($25-$15)
    - Shareholder B recognizes gain of $12 from the boot
    - Shareholder B realizes a remaining $3 of gain ($15-$12), but recognizes $0 of gain
  + §358:
    - Shareholder B takes a basis in X Corp of the amount of the exchanged basis ($10) decreased by the amount of boot received ($12), increased by the amount of gain recognized ($12) = $10
  + §1223(1): Shareholder B’s holding period in X Corp stock is tacked (i.e., equal to holding period in equipment) because equipment is §1221 property.
  + §1032: X Corp recognizes no gain or loss on the issuance of its stock.
  + §362(a):
    - X Corp takes a basis in the Equipment the same as it would be in the hands of the transferor ($10), increased in the amount of gain recognized to the transferor on such transfer ($5) = $15.
  + §1223(2): X Corp’s holding period in equipment is tacked, because it is always tacked.
* Depreciation
  + §1245(a)(1)(B) generally says that Shareholder B should recapture all depreciation deductions as recognized ordinary income.
  + However, §1245(b)(3) provides that the recapture of depreciation is limited to the amount of recognized gain under §351.
  + Shareholder B will therefore recognize the $5 of gain as ordinary income.
  + Under §1245(a)(2)(A), the Equipment will continue to be tainted by §1245 in the hands of X Corp.
* Does it matter that B, C and D are related?
  + Under §1239, the gain resulting from the sale or exchange of property, directly or indirectly, between related persons is treated as ordinary income (i.e., not capital gain) if the transferred property qualifies for depreciation in the hands of transferee pursuant to §1239.
  + §1239 recharacterizes the remaining gain from sale of the sale of the equipment as ordinary income.
  + There is an ordering rule: §1245 applies before §1239.
  + It picks up the additional $7 of gain ($12-$5) as ordinary income.

(7) Same as Question (1) except that the building C transferred to X Corp is worth $35 (not $25), the building is subject to a $10 mortgage, and C's basis in his transferred building is $15 (not $35, so that C realizes a $20 gain, not a $10 loss, on the contribution). C incurred the $10 debt several years prior to the incorporation for valid business reasons.

***Answer:***

* Real Property:
  + FMV = $35
  + Mortgage = $10
  + Basis = $15
* Shareholder C:
  + §351:
    - Shareholder C realizes $20 of gain, but recognizes $0 of gain under §351
    - Under §357(a), the assumption of the $10 mortgage is not treated as boot.
  + §358:
    - Shareholder C takes a basis in X Corp of the amount of the exchanged basis ($15) decreased by the amount of boot received ($10), increased by the amount of gain recognized ($0) = $5
    - §358(d)(1) provides that the assumption of the $10 mortgage is treated as money received by the taxpayer on the exchange.
  + §1223(1): Shareholder C’s holding period in X Corp stock is tacked (i.e., equal to holding period in real property) because real property is §1231 property.
  + §1032: X Corp recognizes no gain or loss on the issuance of its stock.
  + §362(a):
    - X Corp takes a basis in the Equipment the same as it would be in the hands of the transferor ($15), increased in the amount of gain recognized to the transferor on such transfer ($0) = $15.
  + §1223(2): X Corp’s holding period in real property is tacked, because it is always tacked.

(8) Same as Question (7), except that the building C transferred to X Corp is worth $45 and is subject to a $20 mortgage.

***Answer:***

* Real Property:
  + FMV = $45
  + Mortgage = $20
  + Basis = $15
* Shareholder C:
  + §351:
    - Under §357(c), because the sum of the amount of the liabilities assumed ($20) exceeds the total of the adjusted basis ($15), the excess ($5) shall be considered as a gain from the sale or exchange of property.
    - Shareholder C realizes $30 of gain ($45-$15).
    - Shareholder C recognizes $5 of gain because of §357(c).
    - The remaining $25 of gain is not recognized under §351(a).
  + §358:
    - Shareholder C takes a basis in X Corp of the amount of the exchanged basis ($15) decreased by the amount of boot received ($20), increased by the amount of gain recognized ($5) = $0
    - §358(d)(1) provides that the assumption of the $20 mortgage is treated as money received by the taxpayer on the exchange.
  + §1223(1): Shareholder C’s holding period in X Corp stock is tacked (i.e., equal to holding period in real property) because real property is §1231 property.
  + §1032: X Corp recognizes no gain or loss on the issuance of its stock.
  + §362(a):
    - X Corp takes a basis in the Building the same as it would be in the hands of the transferor ($15), increased in the amount of gain recognized to the transferor on such transfer ($5) = $20.
  + §1223(2): X Corp’s holding period in real property is tacked, because it is always tacked.

(a) What if C issues his own note to X Corp in the face amount of $5, bearing interest at a market rate?

***Answer:***

* Real Property:
  + FMV = $45
  + Mortgage = $20
  + Basis = $15
* Note Payable (Shareholder C is the debtor, and X Corp is the debtee):
  + FMV = $5
  + Basis = $5 (Lessinger and Perrachi) (typically the basis in a note is $0; concept of basis seems strange here; you can’t sell a note payable, it would be an assumption of a liability; probably why normally a note payable does not have basis.)
* Shareholder B
  + §351:
    - Real Property
      * The amount realized is $30
    - Note Payable
      * The amount realized is $0
    - §357(c) is inapplicable because the sum of the amount of the liabilities assumed ($20) does not exceed the total of the adjusted basis ($20 = $15+$5).
    - Under §357(a), the assumption of the $20 mortgage is not treated as boot.
    - Shareholder C realizes $30 of gain, but recognizes $0 of gain under §351
  + §358:
    - Shareholder C takes a basis in X Corp of the amount of the exchanged basis ($20) decreased by the amount of boot received ($20), increased by the amount of gain recognized ($0) = $0
    - §358(d)(1) provides that the assumption of the $10 mortgage is treated as money received by the taxpayer on the exchange.
  + §1032: X Corp recognizes no gain or loss on the issuance of its stock.
  + §362(a):
    - X Corp takes a basis in the Real Property the same as it would be in the hands of the transferor ($15), increased in the amount of gain recognized to the transferor on such transfer ($0) = $15.
    - X Corp takes a basis in the Note Payable the same as it would be in the hands of the transferor ($5), increased in the amount of gain recognized to the transferor on such transfer ($0) = $5.

(b) What if C had borrowed $12 of the $20 immediately before contributing the building worth $45 (the other $8 having been borrowed years ago for a valid business reason) and invested the newly borrowed $12 in the stock market?

***Answer:***

* Real Property:
  + FMV = $45
  + Mortgage = $20
  + Basis = $15
* Shareholder C:
  + §351:
    - Under §357(b), because the assumption of $12 was not for a bona fide business purpose, the entire $20 assumption of liability will be considered as boot.
    - Shareholder C realizes $30 of gain ($45-$15).
    - Shareholder C recognizes $20 of boot to the extent of amount realized. §351(b).
    - The remaining $10 of gain is not recognized under §351(a).
  + §358:
    - Shareholder C takes a basis in X Corp of the amount of the exchanged basis ($15) decreased by the amount of boot received ($20), increased by the amount of gain recognized ($20) = $15
  + §1223(1): Shareholder C’s holding period in X Corp stock is tacked (i.e., equal to holding period in real property) because real property is §1231 property.
  + §1032: X Corp recognizes no gain or loss on the issuance of its stock.
  + §362(a):
    - X Corp takes a basis in the Building the same as it would be in the hands of the transferor ($15), increased in the amount of gain recognized to the transferor on such transfer ($20) = $35.
  + §1223(2): X Corp’s holding period in real property is tacked, because it is always tacked.

(9) Same as Question (1), except that A transferred to X Corp an account receivable, with a zero basis and $40 FMV and a $15 trade account payable.

***Answer:***

* Account Receivable:
  + FMV = $40
  + Basis = $0
* Account Payable = $15
* Shareholder A:
  + §351:
    - Under §357(c)(3), the account payable is not treated as a liability for purposes of §357(c)(1).
    - Shareholder A realizes a gain of $55 ($40 + 15), but recognizes $0 of gain under §351
  + §358:
    - Shareholder C takes a basis in X Corp of the amount of the exchanged basis ($0) decreased by the amount of boot received ($0), increased by the amount of gain recognized ($0) = $0
    - Under §358(d)(2) the assumption of an accounts payable will not cause a reduction in basis.
  + §1223(1): Shareholder A’s holding period in X Corp stock is not tacked (i.e., equal to holding period in AR) because AR is not §1221 or §1231 property.
  + §1032: X Corp recognizes no gain or loss on the issuance of its stock.
  + §362(a):
    - X Corp takes a basis in the AR the same as it would be in the hands of the transferor ($0), increased in the amount of gain recognized to the transferor on such transfer ($0) = $0.
  + §1223(2): X Corp’s holding period in AR is tacked, because it is always tacked.

(10) Same as Question (1), except that B received, in exchange for his equipment ( $25 FMV, $10 AB) 15 shares of X common stock and X Preferred stock that is nonvoting, has a par, liquidation preference and a FMV of $10, has a cumulative annual dividend of 6% of par, and gives the holder the right exercisable 5 years after issuance to require X to redeem the stock for $10.

***Answer:***

* Preferred shares will be considered stock for purposes of determining control under §368(c). Therefore, the preferred shares will not affect the §351(a) treatment.
* Equipment:
  + FMV = $25
  + Basis = $10
* Preferred Stock = $10
* Shareholder B:
  + §351:
    - Under §351(g), the preferred shares are treated as boot.
    - Shareholder B realizes $15 of gain
    - Shareholder B recognizes boot as gain to the extent of AR = $10.
    - Shareholder B does not recognize the remaining $5 AR as gain.
  + §358:
    - Shareholder B takes a basis in the X Corp common stock of the amount of the exchanged basis ($10) decreased by the amount of boot received ($10), increased by the amount of gain recognized ($10) = $10
    - Shareholder B takes a basis in the X Corp preferred shares of FMV.
  + §1223(1): Shareholder B’s holding period in X Corp stock is tacked (i.e., equal to holding period in equipment) because equipment is §1221 property.
  + §1032: X Corp recognizes no gain or loss on the issuance of its stock.
  + §362(a):
    - X Corp takes a basis in the Equipment the same as it would be in the hands of the transferor ($10), increased in the amount of gain recognized to the transferor on such transfer ($10) = $20.
  + §1223(2): X Corp’s holding period in equipment is tacked, because it is always tacked.

(a) Suppose instead that B receives only X common stock on his exchange, but C receives only the X Preferred stock in exchange for her building.

***Answer:***

* Equipment:
  + FMV = $25
  + Basis = $35
* Preferred Stock = $25
* The answer will be the same, because Shareholder C only recognizes boot to the extent of gain.

# Part 7 – Acquisitive Reorganizations: Asset Acquisitions - “(A)” and “(C)” Reorganizations

## Part 1 – “(A)” Reorganization

### Readings

* E&E: Chapter 11 – Introduction to Basic Corporate Reorganization Principles
* E&E: Chapter 12 – Acquisitive Reorganizations
* Code: §§ 354(a); 356; 357; 358 [omit § 358(b), (c) & (g)]; 361; 362(b); 368(a)(1)(A) & (C), (a)(2)(A), (B), (G); 368(b), (c); 381(a), (c)(1) [skip A-C], (c)(2), 1032.
* Regs: §§ 1.368-1(a), (b), (c),(d)(1),(2),(3), (e)(1), (e) (2)(i),(ii),(iii),(v) ex 1 and 4; 1.368-2(a), (b)(1)(ii),-2 (d), (g); 1.368-3(a); 1.356-3, -6(a); 1.358-2(a)(1), -2(a)(2)(i),(ii), (vii), -2(c) ex 1 and 4; 1.354-1.
* Materials:
  + Helvering v. Minnesota Tea
  + John A. Nelson Co.
  + Southwest Consolidated
  + Clark
  + Rev. Ruls. 66-224, 76-385, 2004-78;
  + Rev Proc. 77-37 sections 1-3.
  + Regs: §§ 1.368-1(e)(8) ex 1, 3, 4, 9.
  + Rev. Ruls. 81-25, 99-58.
  + Rev. Ruls. 57-518, 88-48

### Problem Set

T Co. is a closely held corporation incorporated under the laws of the State of Delaware with 100 shares of voting common stock outstanding, owned 50 shares by A (basis $200), 30 by B (basis $400), and 20 by C (basis $150). T Co. has the following assets:

|  |  |  |
| --- | --- | --- |
|  | **Basis** | **Value** |
| Nonoperating Assets | $200 | $300 |
| Operating Assets | $700 | $900 |
| **Total** | **$900** | **$1,200** |

T Co. has outstanding liabilities of $200 (in the form of 20-year registered bonds), and accumulated earnings of $400. The aggregate value of T’s outstanding stock is $1,000($10 per share).

P Co. is a publicly held corporation incorporated under the laws of the State of Delaware, the stock of which is listed in the New York Stock Exchange.

What are the tax consequences to T. Co., A, B, C and P Co. of the following transactions?

Assume throughout that all debt instruments of P Co. are not publicly traded and bear interest payable annually at 1% above the federal rate [see §1274(d)] applicable to the maturity in question).

1. Statutory Merger (“A” reorganization): In a statutory merger under the laws of the State of Delaware, T. Co. merges into P Co. As a result of the merger, the following events occur by operation of law: the transfer of all T assets to P Co.; the assumption by P of all of T’s liabilities; the dissolution of T. As consideration, P Co. issues the following to A, B, and C, the former T shareholders, proportionate to their interests in T:

(a) $1,000 of P Co.’s 8% registered bonds, payable after 20 years, and convertible into P Co. voting common stock at the election of the bondholder after 5 years.

***Answer:***

* The issue is whether the COSI rules are satisfied.
* Because this is an A reorg, we are under the common law rules.
* There are two requirements. The T Corp shareholders must receive a proprietary interest that meets:
  + The qualitative requirements; and
  + The quantitative requirements.
* Here, the P Co convertible bonds will likely not meet the qualitative requirements of a proprietary interest. See Southwest Consolidated.
* Therefore the transaction will be treated as a taxable exchange.

(b) $1,000 worth of P Co.’s 8% cumulative nonvoting preferred stock.

***Answer:***

* Here, the nonvoting preferred will likely meet the qualitative requirements of a proprietary interest. See John A. Nelson Co. §1.368-1(e)(1)(i).
* Shareholder A:
  + §354: Does not recognize gain on the exchange
  + §358: Takes a “carry-over basis” in the P Corp shares
  + §1223(1): Holding period in the P Corp shares is the same as in the T Corp shares
* Shareholder B:
  + §354: Does not recognize loss on the exchange
  + §358: Takes a “carry-over basis” in the P Corp shares
  + §1223(1): Holding period in the P Corp shares is the same as in the T Corp shares
* Shareholder C:
  + §354: Does not recognize gain on the exchange
  + §358: Takes a “carry-over basis” in the P Corp shares
  + §1223(1): Holding period in the P Corp shares is the same as in the T Corp shares
* Target
  + §361: There are no tax consequences to Target as a result of the reorganization.
* Acquiring
  + §1032: Does not recognize gain or loss on the issuance of its own stock.
  + §362(b): Takes a carry-over basis in the assets
  + §1223(2): Holding period in the assets is the same as in the hands of T Corp
* Assumption of Liabilities:
  + T Corp’s liabilities simply become the liabilities of P Corp, with not tax consequences.

(c) Same as (1)(b) except that the preferred stock is entitled to one vote per share, but such stock constitutes 1% of P Co.’s outstanding stock.

***Answer:***

* Here, the issue is the quantitative requirements of COSI.
* Minnesota Tea.
* 1.368-1(e)(2)(i); 1.368-1(e)(8) ex. 1.
* Even though the T shareholders will only own 1% of P Corp following the reorganization, the COSI requirements are met.
* Under common law, the T shareholders must receive 40% of the consideration in an asset constituting a proprietary interest in P Corp.
* Because the T shareholders are not receiving any boot in the transaction, the COSI requirements are met.
* It does not matter that the T shareholders own such a small percentage of P corp following the reorganization.

(d) $100 of P Co.’s 8% short-term notes, $500 of P Co.’s 8% 20-year registered bonds, and $400 worth of P Co.’s voting common stock.

***Answer:***

* The T shareholders are receiving 40% of the consideration in an asset constituting a proprietary interest in P Corp.
* Therefore, the COSI requirements are met. §1.368-1(e)(2)(v), ex. 1
* For COSI requirements:
  + Short term-debt is boot.
  + Long-term debt is stock.
* For tax consequences, all debt is boot.
* Under the default rules, the boot will be allocated pro rata.
* Shareholder A:
  + §356(a)(1):
    - Receives $300 of boot ($600\*50%).
    - Recognizes boot to the extent of gain.
    - Gain = $300 ($500 - $200)
    - Therefore recognizes the full $300 of gain.
    - §356(a)(2) will not apply, because the reorganization does not change the respective ownership of the shareholders.
  + §358:
    - Takes a basis of the amount of the exchanged basis ($200) decreased by the amount of boot received ($300), increased by the amount of gain recognized ($300) = $200
  + §1223(1): Holding period in the P Corp shares is the same as in the T Corp shares
* Shareholder B:
  + §356(c):
    - Receives $180 of boot ($600 \* 30%).
    - Recognizes boot to the extent of gain.
    - Loss = ($100) ($300 - $400)
    - Does not recognize gain or loss.
    - §356(a)(2) will not apply, because the reorganization does not change the respective ownership of the shareholders.
  + §358:
    - Takes a basis of the amount of the exchanged basis ($400) decreased by the amount of boot received ($180), increased by the amount of gain recognized ($0) = $220
  + Takes a “carry-over basis” in the P Corp shares
  + §1223(1): Holding period in the P Corp shares is the same as in the T Corp shares
* Shareholder C:
  + §356(a)(1):
    - Receives $120 of boot ($600\*20%).
    - Recognizes boot to the extent of gain.
    - Gain = $50 ($200 - $150)
    - Therefore recognizes $50 of gain.
    - §356(a)(2) will not apply, because the reorganization does not change the respective ownership of the shareholders.
  + §358:
    - Takes a basis of the amount of the exchanged basis ($150) decreased by the amount of boot received ($120), increased by the amount of gain recognized ($50) = $80
  + §1223(1): Holding period in the P Corp shares is the same as in the T Corp shares
* Target
  + §361: There are no tax consequences to Target as a result of the reorganization.
* Acquiring
  + §1032: Does not recognize gain or loss on the issuance of its own stock.
  + §362(b): Takes a carry-over basis in the assets
  + §1223(2): Holding period in the assets is the same as in the hands of T Corp

(i) What if P Co.’s voting common stock traded at $10 a share on the NY Stock exchange when the merger agreement was signed, but traded at $6 per share when the merger was completed 4 months later?

***Answer:***

* The proprietary interest is valued on the last business day before the first date the reorganization contract is binding. Treas. Reg. 1.368-1(e)(2)(v).
* The decline in value of the P corp stock is irrelevant.

2. Statutory merger (“A” reorganization) - Miscellaneous continuity issues: In a statutory merger under the laws of the State of Delaware, T Co. merges into P Co. solely in exchange for P Co. voting stock. What is the effect of the following alternative fact patterns:

(a) B exercises dissenter’s rights under Delaware law and is paid in cash for her shares.

***Answer:***

* The issue is whether a pre-reorganization redemption or distribution will be considered as part of the reorganization.
* If the pre-reorganization redemption or distribution was directly or indirectly funded by P Corp, the cash paid for the shares will be treated as boot. §1.368-1(e)(1)(ii)
* If the pre-reorganization redemption or distribution was completely funded by T Corp, it should not affect continuity of interest. §1.368-1(e)(8) ex. 9.
* Either way the pre-reorganization redemption or distribution should not cause the COSI requirements to not be satisfied.

(b) A, B and C agree to the merger transaction only on the condition that P Co. give its binding promise to assist them in selling their P Co. shares at a future date if they request its help. Immediately after the merger, as they had planned all along, A, B and C sell all of their P Co. stock to unrelated parties with P’s help.

***Answer:***

* The regulations turn off the step transaction doctrine to target shareholder’s sales of stock to unrelated parties. §1.368-1(e)(1)(i); §1.368(e)(8) exs. 1, 3, and 4.

(c) Shortly after the merger, Zulu Co., a wholly-owned operating subsidiary of P Co. Corp., buys all the P Co. stock issued to A and C in the merger, using cash that Zulu Co had accumulated over the years.

***Answer:***

* Post-transaction transfers to related parties are considered part of the integrated transaction. §1.368-1(e)(1)(i).
* Two corporations are considered “related” for purposes of the regulations if they are members of the same affiliated group, as defined in §1504, or if the purchase of one corporation of stock of the other would be considered a redemption under §304(a)(2). §1.368-1(e)(4)(i).
* Because Target shareholders only received 30% of shares in the reorganization, the transaction will fail the COSI requirements.

(d) Several months before the merger with T Co., P Co.’s directors approved a "stock buyback" program, whereby P announced its intention, on a discretionary basis, and depending on market conditions, to purchase P Co. shares in the open market. P Co. had made a few such purchases before the merger. Would it make any difference if the stock buyback program had been announced after P Co. began negotiations with T Co.?

***Answer:***

* Rev. Rul. 99-58:
  + Continuity can be preserved when the T Shareholders are selling back to P Corp.
  + This was an existing buy back program, and the buy backs occurred on a public market. The corporation did not know whether the shares it was buying on the open market came from the T shareholders.
  + Continuity is preserved if the buyback was not part of the reorganization.
* It will not matter that the stock buyback program was announced after P Co. began negotiations with T Co., if the buyback program is not in connection with the reorganization.

(e) T was in the business of manufacturing widgets under a patented process and selling them at retail in the United States under the T brand name. Immediately after the merger, P sells T’s manufacturing plants and stores and continues to manufacture widgets on its own plants under T’s patented process, selling them under the T brand name in P’s own retail outlets. Rev. Rul. 81-25.

***Answer:***

* COBE requires that P corp either continue T corps historic business or use a significant portion of T corp’s historic business assets in its business. 1.368-1(d)(5) exs. 3, 4, and 5.
* Use of intangible assets in a manufacturing process will satisfy the COBE requirements if a significant part of T Co’s business. §1.368-1(d)(3).

## Part 2 – “(C)” Reorganization

### Readings

* E&E: Chapter 11 – Introduction to Basic Corporate Reorganization Principles
* E&E: Chapter 12 – Acquisitive Reorganizations

### Problem Set

3. “C” reorganization - In a transaction not structured as a statutory merger, T Co. transfers all its assets to P Co. for the following alternative types of consideration, after which T Co. promptly liquidates:

(a) $1,200 of P Co.’s 8% registered bonds, payable after 20 years, and convertible into P Co. voting common stock at the election of the bondholder after 5 years.

***Answer:***

* The P Co convertible bonds are not voting stock for purposes of §368(a)(1)(C).
* Because P Co. is acquiring 100% of T Co.’s assets for non-voting stock, the acquisition will not qualify as a C reorganization.

(b) $1,200 worth of P Co.’s 8% cumulative nonvoting preferred stock.

***Answer:***

* The nonvoting preferred stock is not voting stock for purposes of §368(a)(1)(C).
* Because P Co. is acquiring 100% of T Co.’s assets for non-voting stock, the acquisition will not qualify as a C reorganization.

(c) $1,200 worth of P’s 8% cumulative preferred stock that is entitled to one vote per share and that constitutes 1% of P’s outstanding stock.

***Answer:***

* Shareholder A:
  + §354:
    - Will receive $500 of P Corp shares on the liquidation of T Corp.
    - Gain Realized = $300 ($500-$200)
    - Does not recognize gain on the exchange
  + §358:
    - Takes a basis of the amount of the exchanged basis ($200) decreased by the amount of boot received ($0), increased by the amount of gain recognized ($0) = $200
  + §1223(1): Holding period in the P Corp shares is the same as in the T Corp shares
* Shareholder B:
  + §354:
    - Will receive $300 of P Corp shares on the liquidation of T Corp.
    - Loss Realized = ($100) ($300-$400)
    - Does not recognize loss on the exchange
  + §358:
    - Takes a basis of the amount of the exchanged basis ($400) decreased by the amount of boot received ($0), increased by the amount of gain recognized ($0) = $400
  + §1223(1): Holding period in the P Corp shares is the same as in the T Corp shares
* Shareholder C:
  + §354:
    - Will receive $200 of P Corp shares on the liquidation of T Corp.
    - Gain Realized = $50 ($200-$150)
    - Does not recognize gain on the exchange
  + §358:
    - Takes a basis of the amount of the exchanged basis ($150) decreased by the amount of boot received ($0), increased by the amount of gain recognized ($0) = $150
  + §1223(1): Holding period in the P Corp shares is the same as in the T Corp shares
* Debt Holders:
  + §1.354-1(a): The debt holders are exchanging debt for a security. Therefore, they do not recognize tax on the exchange.
* Target
  + The Target receives $1200 of P Corp shares on the exchange of its assets.
  + To satisfy its $200 of liabilities, it must transfer $200 of P Corp shares to the lenders.
  + The remaining $1000 of P Corp shares are distributed to the shareholders in liquidation.
  + §361:
    - §361(a): The exchange of assets for P Corp shares is tax-free
    - §361(c)(1): The distribution of P Corp shares to the shareholders is tax-free
    - §361(c)(3): The exchange P Corp shares in satisfaction of the liabilities is tax-free
  + There are no tax consequences to Target as a result of the reorganization.
* Acquiring
  + §1032: Does not recognize gain or loss on the issuance of its own stock.
  + §362(b): Takes a carry-over basis in the assets
  + §1223(2): Holding period in the assets is the same as in the hands of T Corp

(d) $1,000 worth of P’s 8% cumulative preferred stock that is entitled to one vote per share. P assumes T’s liabilities of $200.

***Answer:***

* P’s assumption of T’s liabilities is not considered boot for purposes of §361. §357(a).
* However, P’s assumption of T’s liabilities may be considered boot for purposes of the “solely voting stock requirement.”
  + Here, we are not in boot relaxation rule of §368(a)(2)(B). This only applies if T received property other than the assumption of liabilities as boot.
  + Rather, we are under the general rule of §368(a)(1)(C), which disregards liabilities in determining whether the exchange is “solely for voting stock.
  + Because P Co. is acquiring 100% of T Co.’s assets for voting stock, the acquisition will qualify as a C reorganization.
* Target
  + The Target receives $1000 of P Corp shares on the exchange of its assets.
  + P’s assumption of T’s liabilities is not considered boot for purposes of §361. §357(a).
  + The remaining $1000 of P Corp shares are distributed to the shareholders in liquidation.
  + §361:
    - §361(a): The exchange of assets for P Corp shares is tax-free
    - §361(c)(1): The distribution of P Corp shares to the shareholders is tax-free
  + There are no tax consequences to Target as a result of the reorganization.

4. “C” reorganization - “solely” relaxation rule: T Co. transfers all of its assets to P Co. for the following alternative consideration, and T Co. immediately liquidates after the asset transfer.

(a) $200 worth of P Co.’s 8% cumulative nonvoting preferred stock, and $950 worth of P Co.’s voting common stock. P also assumes $50 of T’s liabilities.

***Answer:***

* The $200 of nonvoting preferred stock is boot for purposes of the boot relaxation rule of §368(a)(2)(B), but not for purposes of determining gain. §354.
* The $50 of assumed liabilities is boot for purposes of the boot relaxation rule of §368(a)(2)(B), but not for purposes of determining gain. §354.
* P Corp is purchasing T assets valued at $1200, with $9500 of P Corp stock.
* The percent is 79% ($950/$1200).
* Because this is below the 80% thresholder under §368(a)(2)(B), the acquisition does not qualify as a C reorganization.

(b) $200 worth of P Co.’s 8% cumulative nonvoting preferred stock, and $1,000 worth of P Co.’s voting common stock. To satisfy its bondholder’s claims, T transfers $200 of P common stock to its bondholders.

***Answer:***

* The $200 of nonvoting preferred stock is boot for purposes of the boot relaxation rule of §368(a)(2)(B), but not for purposes of determining gain. §354.
* P Corp is purchasing T assets valued at $1,200, with $1000 of P Corp stock.
* The percent is 83% ($1000/$1200).
* Because this is above the 80% thresholder under §368(a)(2)(B), the acquisition qualifies as a C reorganization.
* §368(b): There are two parties to the reorganization.
* Shareholder A:
  + §354:
    - Will receive $400 of P Corp common ($800\*50%) and $100 of P Corp non-voting ($200\*50%) on the liquidation of T Corp.
    - Gain Realized = $300 ($500-$200)
    - Does not recognize gain on the exchange
  + §358:
    - Takes a basis of the amount of the exchanged basis ($200) decreased by the amount of boot received ($0), increased by the amount of gain recognized ($0) = $200
    - The basis is allocated between the voting and non-voting based on FMV. §1.358-2(a) and (b).
  + §1223(1): Holding period in the P Corp shares is the same as in the T Corp shares
* Shareholder B:
  + §354:
    - Will receive $240 of P Corp common ($800\*30%) and $60 of P Corp non-voting ($200\*30%) on the liquidation of T Corp.
    - Loss Realized = ($100) ($300-$400)
    - Does not recognize loss on the exchange
  + §358:
    - Takes a basis of the amount of the exchanged basis ($400) decreased by the amount of boot received ($0), increased by the amount of gain recognized ($0) = $400
    - The basis is allocated between the voting and non-voting based on FMV. §1.358-2(a) and (b).
  + §1223(1): Holding period in the P Corp shares is the same as in the T Corp shares
* Shareholder C:
  + §354:
    - Will receive $160 of P Corp common ($800\*20%) and $40 of P Corp non-voting ($200\*20%) on the liquidation of T Corp.
    - Gain Realized = $50 ($200-$150)
    - Does not recognize gain on the exchange
  + §358:
    - Takes a basis of the amount of the exchanged basis ($150) decreased by the amount of boot received ($0), increased by the amount of gain recognized ($0) = $150
    - The basis is allocated between the voting and non-voting based on FMV. §1.358-2(a) and (b).
  + §1223(1): Holding period in the P Corp shares is the same as in the T Corp shares
* Debt Holders:
  + §1.354-1(a): The debt holders are exchanging debt for a security. Therefore, they do not recognize tax on the exchange.
* Target
  + The Target receives $1200 of P Corp voting and non-voting on the exchange of its assets.
  + To satisfy its $200 of liabilities, it must transfer $200 of P Corp voting shares to the lenders.
  + The remaining $800 of P Corp voting shares and $200 of non-voting shares are distributed to the shareholders in liquidation.
  + §361:
    - §361(a): The exchange of assets for P Corp shares is tax-free
    - §361(c)(1): The distribution of P Corp shares to the shareholders is tax-free
    - §361(c)(3): The exchange P Corp shares in satisfaction of the liabilities is tax-free
  + There are no tax consequences to Target as a result of the reorganization.
* Acquiring
  + §1032: Does not recognize gain or loss on the issuance of its own stock.
  + §362(b): Takes a carry-over basis in the assets
  + §1223(2): Holding period in the assets is the same as in the hands of T Corp

(i) What if instead of issuing preferred stock, P pays T $200 in cash and T uses the cash to pay bondholders.

***Answer:***

* Shareholder A:
  + §354:
    - Will receive $500 of P Corp shares on the liquidation of T Corp.
    - Gain Realized = $300 ($500-$200)
    - Does not recognize gain on the exchange
  + §358:
    - Takes a basis of the amount of the exchanged basis ($200) decreased by the amount of boot received ($0), increased by the amount of gain recognized ($0) = $200
  + §1223(1): Holding period in the P Corp shares is the same as in the T Corp shares
* Shareholder B:
  + §354:
    - Will receive $300 of P Corp shares on the liquidation of T Corp.
    - Loss Realized = ($100) ($300-$400)
    - Does not recognize loss on the exchange
  + §358:
    - Takes a basis of the amount of the exchanged basis ($400) decreased by the amount of boot received ($0), increased by the amount of gain recognized ($0) = $400
  + §1223(1): Holding period in the P Corp shares is the same as in the T Corp shares
* Shareholder C:
  + §354:
    - Will receive $200 of P Corp shares on the liquidation of T Corp.
    - Gain Realized = $50 ($200-$150)
    - Does not recognize gain on the exchange
  + §358:
    - Takes a basis of the amount of the exchanged basis ($150) decreased by the amount of boot received ($0), increased by the amount of gain recognized ($0) = $150
  + §1223(1): Holding period in the P Corp shares is the same as in the T Corp shares
* Debt Holders:
  + This is repayment of the liability, which may or may not be a taxable event. Interest to the bond holders may be taxable?
* Target
  + The Target receives $1,000 of P Corp shares and $200 of cash on the exchange of its assets.
  + To satisfy its $200 of liabilities, P Corp transfers $200 of cash to the lenders.
  + The remaining $1000 of P Corp shares are distributed to the shareholders in liquidation.
  + §361:
    - §361(b)(1): The exchange of assets for P Corp shares is tax-free, because all cash is distributed.
    - §361(c)(1): The distribution of P Corp shares to the shareholders is tax-free
    - §361(b)(3); §361(c)(2)(A): The exchange cash in satisfaction of the liabilities is tax-free, because cash is not appreciated property.
  + There are no tax consequences to Target as a result of the reorganization.
* Acquiring
  + §1032: Does not recognize gain or loss on the issuance of its own stock.
  + §362(b): Takes a carry-over basis in the assets
  + §1223(2): Holding period in the assets is the same as in the hands of T Corp

5. “C” reorganization - “Substantially All”:

(a) T Co. transfers all of its operating assets to P Co. solely in exchange for $900 of P Co. voting stock. T holds back its $300 of non-operating assets, a portion of which it uses to pay its liabilities. T then liquidates and distributes all of its property (including the P shares that T received in the exchange) to its shareholders.

***Answer:***

* Substantially All:
  + Means 90% of the FMV of T’s net assets and 70% of the FMV of T’s gross assets.
  + T’s gross asset = $1,200
  + T’s net assets = $1,200 - $200 = $1,000
  + T transferred 75% ($900 / $1,200) of gross assets
  + T transferred 90% ($900 / $1,000) of net assets
  + Therefore, the substantially all requirement is met.
* Target
  + The Target recognizes built-in-gain on the assets used to pay off the liability. (2/3) \* (300-200) = $67. §361(c)(2).
  + The target also recognizes built-in-gain on the remaining asset distributed to the shareholders. (1/3) \* (300-200) = $33. §361(c)(2).
  + Therefore, Target recognizes $100 of gain, and pays $21 of tax.
  + The $100 of non-operating assets less the $33 of tax will be recognized by the shareholders as boot under §361.

(b) T Co. transfers all of its operating assets to P Co. in exchange for $700 of P Co. voting stock and assumption of $200 of T Co.’s liabilities. T holds back its $300 of non-operating assets. T then liquidates and distributes all of its property (including the P shares that T received in the exchange) to its shareholders.

***Answer:***

* Substantially All:
  + Means 90% of the FMV of T’s net assets and 70% of the FMV of T’s gross assets.
  + T’s gross assets = $1,200
  + T’s net assets = $1,200 - $200 = $1,000
  + T transferred 75% ($900 / $1,200) of gross assets
  + T transferred 70% [($900-$200) / $1,000] of net assets. <-This seems odd to me.
  + Therefore, the substantially all requirement is not met.

(c) T sells 1/3 of its operating assets for cash. T then transfers all of its assets for $1,000 of P Co. voting stock. P Co. assumes T Co’s liabilities. T Co. then liquidates and distributes all of its property (consisting of the P Co. shares received in the exchange to its shareholders.)

***Answer:***

* T Co may sell a significant portion of its historic assets immediately before or after the reorganization as part of an overall plan without threatening the tax-free status of the reorganization. Rev. Rul. 88-48.
* The substantially all requirement is met.

# Unit 8 – Stock Acquisitions - “B” Reorganizations

## Part 1 – “B” Reorganization Basics

### Readings

* E&E: Chapter 11 – Introduction to Basic Corporate Reorganization Principles
* E&E: Chapter 12 – Acquisitive Reorganizations
* Code: §§ 351(a), (b), (g); 358; 362; 368(a)(1)(B); 1001(c);

### Problem Set

T Corporation is a closely held corporation with 100 shares of voting common stock outstanding, owned 50 shares by A (basis $200), 30 by B (basis $400), and 20 by C (basis $150). T has the following assets:

|  |  |  |
| --- | --- | --- |
|  | **Basis** | **Value** |
| Nonoperating Assets | $200 | $300 |
| Operating Assets | $700 | $900 |
| **Total** | **$900** | **$1,200** |

T has outstanding liabilities of $200 (in the form of 20-year registered bonds owned by L Corporation), and accumulated earnings of $400. P Corporation is a publicly held corporation whose stock is listed on the New York Stock Exchange.

What are the tax consequences to T. Co., A, B, C and P Co. of the following transactions?

1. On January 2 of the current year, P acquires all of the T’s 100 common stock from A, B, and C solely in exchange for “straight” voting preferred stock of P (not section 351(g) preferred stock.) T has liabilities and they are bonds.

***Answer:***

* Shareholder A:
  + §354:
    - Will receive $500 of P Corp shares on the exchange.
    - Gain Realized = $300 ($500-$200)
    - Does not recognize gain on the exchange
  + §358:
    - Takes a basis of the amount of the exchanged basis ($200) decreased by the amount of boot received ($0), increased by the amount of gain recognized ($0) = $200
  + §1223(1): Holding period in the P Corp shares is the same as in the T Corp shares
* Shareholder B:
  + §354:
    - Will receive $300 of P Corp shares on the exchange
    - Loss Realized = ($100) ($300-$400)
    - Does not recognize loss on the exchange
  + §358:
    - Takes a basis of the amount of the exchanged basis ($400) decreased by the amount of boot received ($0), increased by the amount of gain recognized ($0) = $400
  + §1223(1): Holding period in the P Corp shares is the same as in the T Corp shares
* Shareholder C:
  + §354:
    - Will receive $200 of P Corp shares on the liquidation of T Corp.
    - Gain Realized = $50 ($200-$150)
    - Does not recognize gain on the exchange
  + §358:
    - Takes a basis of the amount of the exchanged basis ($150) decreased by the amount of boot received ($0), increased by the amount of gain recognized ($0) = $150
  + §1223(1): Holding period in the P Corp shares is the same as in the T Corp shares
* Debt Holders:
  + There has been no assignment/reissuance of debt.
  + Therefore there are no tax consequences to the debt holders.
* Target
  + There are no tax consequences to Target as a result of the reorganization.
* Acquiring
  + §1032: Does not recognize gain or loss on the issuance of its own stock.
  + §362(b): Takes a basis in the T Corp. shares the same as the old T Corp shareholders had in their T Corp. shares.
  + §1223(2): Holding period in the assets is the same as in the hands of T Corp.

(a) Suppose, in addition, that P exchanges its own 15-year registered bonds for the T bonds held by L. See Rev. Rul. 98-10.

***Answer:***

* This is an ancillary debt-for-debt exchange. It does not affect the B reorganization because the shareholders are still only receiving solely voting stock.
* §354(a)(1): The exchange of the T bonds for P bonds is a tax-free exchange for the Debt Holders (L), P Corp and the target.

(b) Same as (1)(a) except that P purchases the $200 of outstanding T bonds from L, the holder, for cash. See Rev. Rul. 98-10.

***Answer:***

* This does not ruin the B reorganization.
* However, the ancillary debt-for-cash exchange is a taxable exchange.
* The debt holders will recognize gain to the extent the consideration exceeds their basis in the bonds.

2. “Solely” for Voting Stock. On January 2 of the current year, P acquires all of the T common stock from A, B and C for $200 cash and $800 worth of P voting stock, the consideration being allocated ratably among A, B and C in proportion to their holdings of T.

***Answer:***

* The exchange will fail to meet the “solely for voting stock” requirement of a Type B reorganization.
* Therefore, the exchange will be treated as a taxable exchange.

(a) Suppose instead that A’s and B’s T stock was acquired solely for voting common stock of P, while C’s T stock was acquired for cash.

***Answer:***

* Under Helvering, this exchange will fail to meet the “solely for voting stock” requirement of a Type B reorganization.
* See also Rev. Rul. 85-139.
* Therefore, the exchange will be treated as a taxable exchange.

(b) Suppose instead that A’s and C’s T stock was acquired solely for voting common stock of P, while B’s stock was acquired for $300 worth of a new issue of P voting, cumulative 8% preferred stock that P is required to redeem in 10 years. See § 351(b), (g); 354(a)(2)(C)(i); 356(c), (e).

***Answer:***

* The preferred stock is voting stock for purposes of §368(a)(1)(b). Therefore, this is a Type B reorganization.
* Shareholder B:
  + The preferred stock does not qualify for non-recognition treatment under §354(a)(2)(C).
  + Shareholder B is therefore treated as receiving $300 of boot on the exchange.
  + §356(c):
    - Loss Realized = ($100) ($300-$400)
    - Does not recognize loss on the exchange. §356(c).
  + §358:
    - Takes a basis of the amount of the exchanged basis ($400) decreased by the amount of boot received ($300), increased by the amount of gain recognized ($0) = $100
  + §1223(1): Holding period in the P Corp shares is the same as in the T Corp shares.

3. “Creeping” B. On January 2 of the current year, P acquires all of B’s T common stock for cash. On July 1 of the current year, P acquires all of C’s common stock solely for P voting stock. On December 1 of the current year, P acquires all of A’s T common stock solely for P voting stock.

***Answer:***

* Under Chapman, all three exchanges will likely be treated as an integrated plan.
* The regulations provides that exchanges occurring with 12 months of each other are integrated. §1.368-2(c).
* Because P Corp purchased B’s stock for cash, the exchange will fail to meet the “solely for voting stock” requirement of a Type B reorganization.
* Therefore, the exchange will be treated as a taxable exchange.

4. B Reorganizations with Prior Redemptions of Minority Target Shareholders. Instead of the basic transaction, on January 2 of the current year, T redeems B’s and C’s T stock for cash. Then P acquires all of A’s T common stock (amounting at this point to 100%) solely in exchange for P voting stock worth $500 (a price that seems appropriate because the value of the Target has been diminished by the cash redemptions). See Rev. Rul. 68-285 and Rev. Rul. 75-360.

***Answer:***

* The issue is whether a pre-reorganization redemption or distribution will be considered as part of the reorganization.
* If the pre-reorganization redemption or distribution was directly or indirectly funded by P Corp, the cash paid for the shares will be treated as boot. §1.368-1(e)(1)(ii)
* If the pre-reorganization redemption or distribution was completely funded by T Corp, it should not affect continuity of interest. §1.368-1(e)(8) ex. 9.

(a) Suppose instead that A’s and C’s T stock is redeemed by T (using exclusively its own funds), and P then acquires B’s T common stock solely in exchange for P voting stock worth $300.

***Answer:***

* See above.
* §1.368-1(e)(8), ex. 9: pre-reorganization redemption does not affect continuity.

## Part 2 – Miscellaneous Issues

### Readings

* E&E: Chapter 11 – Introduction to Basic Corporate Reorganization Principles
* E&E: Chapter 12 – Acquisitive Reorganizations

### Problem Set

On January 2 of the current year, P acquires all of the T common stock from A, B, and C solely in exchange for 100 voting preferred shares of P. The transaction qualifies as a basic “(B)” reorganization. What are the tax consequences to T, A, B, C and P of the following additional transactional facts?

1. B Reorganization with Infusion of Cash by P into T. As part of the transaction, P advances $100 in cash to T. Would you be more comfortable with the transaction if, instead of making a cash advance, P buys $100 worth unissued stock? See Rev. Rul. 72-522.

***Answer:***

* As long as the cash does not constitute consideration to T shareholders for their stock, the cash infusion under either alternative will not cause exchange to fail to meet the solely for voting stock requirement.

2. B Reorganization with Cash Changing Hands for One Thing or Another. As part of the transaction, alternatively:

(a) T distributes $400 (all of its E&P) to A, B and C as a dividend. See Rev. Ruls. 68-435, 69-443 and 70-172.

***Answer:***

* Money paid as a dividend is not viewed as part of the reorganization.
* The dividend will not cause the exchange to fail to meet the solely for voting stock requirement.

(b) P agrees to pay the costs of registering its common stock when A, B and C wish to sell it. See Rev. Rul. 67-275.

***Answer:***

* Payment of these costs is not viewed as part of the reorganization.
* The cost payments will not cause the exchange to fail to meet the solely for voting stock requirement.

(c) P agrees to pay any transfer taxes arising from the exchange. See Rev. Rul. 73-54.

***Answer:***

* Payment of these transfer taxes is not viewed as part of the reorganization, if taxes of T Corp. If taxes of the shareholder, then there is a problem.
* The cost payments will not cause the exchange to fail to meet the solely for voting stock requirement.

(d) P agrees to pay all legal and accounting feels attributable to the exchange. See Rev. Rul. 73-54.

***Answer:***

* Payment of these costs is not viewed as part of the reorganization, if costs of T Corp. If costs of the shareholder, then there is a problem.
* The cost payments will not cause the exchange to fail to meet the solely for voting stock requirement.

# Unit 9 – Triangular Reorganizations

## Part 1 – Triangular Reorganizations

### Readings

* Code: §§ 368(a)(1)(B) & (C), 368(a)(2)(C), (D) & (E); 368(b) flush language, 358(e)
* Regs: §§1.368-1(d), -2(b)(2), -2(c), -2(f); -2(j), -2(k); 1.381(a)-1(b)(2); 1.358-6; 1.1032-2,
* Materials on NYU Classes:
  + Rev. Rul. 67-448, 2001-25, 2001-26,
* E&E: Chapter 11 – Introduction to Basic Corporate Reorganization Principles
* E&E: Chapter 12 – Acquisitive Reorganizations

### Problem Set

T Corp is owned 100% by A, an individual. T Corp has assets with a gross value of $1,200 and an adjusted basis of $900. T Corp has liabilities of $200 and earnings and profits of $300. A’s basis in his T Corp stock is $650. P Corp is a publicly held corporation whose stock is listed on a national exchange. S Corp is a wholly-owned subsidiary of P Corp. P Corp’s basis in the S Corp stock is $100. All of the following alternative transactions occur on January 2 of the current year in pursuance of a plan of reorganization. In each case, what are the tax consequences to each of the parties?

(1) C Reorganizations. In each of the following parts, assume that, following the exchange with P Corp (or S Corp, as the case may be), T Corp liquidates and distributes all of its properties to its shareholder, A.

(a) C Reorganizations with “Drop-down”. In a transaction that is not effected as a merger under local law, T Corp transfers all its assets to P Corp solely for P Corp voting stock worth $1,000 and P Corp’s assumption of T Corp’s $200 of liabilities. P Corp then promptly transfers the T Corp assets to S Corp (subject to liabilities) for additional S Corp stock.

***Answer:***

* A transaction otherwise qualifying as a C reorganization will not be disqualified if the assets acquired are dropped down to a C reorganization. §368(a)(2)(C).
* C Reorganization
  + Target
    - The Target receives $1000 of P Corp shares on the exchange of its assets.
    - P’s assumption of T’s liabilities is not considered boot for purposes of §361. §357(a).
    - The remaining $1000 of P Corp shares are distributed to the shareholders in liquidation.
    - §361:
      * §361(a): The exchange of assets for P Corp shares is tax-free
      * §361(c)(1): The distribution of P Corp shares to the shareholders is tax-free
    - There are no tax consequences to Target as a result of the reorganization.
  + Shareholder A:
    - §354:
      * Will receive $1000 of P Corp shares on the liquidation of T Corp.
      * Gain Realized = $350 ($1000-$650)
      * Does not recognize gain on the exchange
    - §358:
      * Takes a basis of the amount of the exchanged basis ($650) decreased by the amount of boot received ($0), increased by the amount of gain recognized ($0) = $650
    - §1223(1): Holding period in the P Corp shares is the same as in the T Corp shares
  + P Corp
    - §1032: Does not recognize gain or loss on the issuance of its own stock.
    - §362(b): Takes a carry-over basis in the assets
    - §1223(2): Holding period in the assets is the same as in the hands of T Corp
* §351 Contribution
  + Assets:
    - FMV = $1200
    - Liabilities = $200
    - Basis = $900
  + P Corp:
    - §351:
      * P Corp realizes $300 of gain, but recognizes $0 of gain under §351
      * Under §357(a), the assumption of the $200 mortgage is not treated as boot.
    - §358:
      * P Corp takes a basis in the S Corp shares received of the amount of the exchanged basis ($900) decreased by the amount of boot received ($200), increased by the amount of gain recognized ($0) = $700
      * Added to the existing basis of $100, the total basis is $800
      * §358(d)(1) provides that the assumption of the $200 of liabilities is treated as money received by the taxpayer on the exchange.
    - §1223(1): P Corp’s holding period in X Corp stock is tacked (i.e., equal to holding period in real property) because real property is §1231 property.
  + S Corp
  + §1032: S Corp recognizes no gain or loss on the issuance of its stock.
  + §362(a):
    - S Corp takes a basis in the assets the same as it would be in the hands of P Corp ($900), increased in the amount of gain recognized to the transferor on such transfer ($0) = $900.
  + §1223(2): S Corp’s holding period in the assets is tacked, because it is always tacked.
* The tax attributes of the target are inherited by P Corp, not S Corp. §1.381(a)-1(b)(2)

(b) Triangular C Reorganizations. In a transaction not effected as a merger under local law, T Corp transfers all its assets to S Corp and S Corp assumes all of T Corp’s liabilities. S Corp pays for the T Corp assets by transferring to T Corp $1,000 worth of P Corp voting stock (which stock had previously been contributed by P Corp to S Corp to be used for this purpose).

***Answer:***

* See §1.358-6(b)(2)(ii) ex. 1
* Not a §368(a)(2)(D) reorganization.
* Can treat the transaction which gets S Corp to P Corp as a §351 transaction.
* Note S Corp gets the tax attributes of T Corp.
* Target
  + The Target receives $1000 of P Corp shares on the exchange of its assets.
  + P’s assumption of T’s liabilities is not considered boot for purposes of §361. §357(a).
  + The $1000 of P Corp shares are distributed to the shareholders in liquidation.
  + §361:
    - §361(a): The exchange of assets for P Corp shares is tax-free
    - §361(c)(1): The distribution of P Corp shares to the shareholders is tax-free
  + There are no tax consequences to Target as a result of the reorganization.
* Shareholder A:
  + §354:
    - Will receive $1000 of P Corp shares on the liquidation of T Corp.
    - Gain Realized = $350 ($1000-$650)
    - Does not recognize gain on the exchange
  + §358:
    - Takes a basis of the amount of the exchanged basis ($650) decreased by the amount of boot received ($0), increased by the amount of gain recognized ($0) = $200
  + §1223(1): Holding period in the P Corp shares is the same as in the T Corp shares
* S Corp
  + §1032: Does not recognize gain or loss on the issuance of P Corp stock. §1.1032-2(b)
  + §362(b): Takes a carry-over basis in the assets
  + §1223(2): Holding period in the assets is the same as in the hands of T Corp
* P Corp
  + Under the “over-the-top” method adopted by the regulations, P corp adjusts it basis in the S Corp stock as if it first received the assets in a direct Type C asset acquisition and then transferred the assets to its subsidiary in a §351 transaction. §1.358-6(c)(1).
  + In other words, P would increase its previous basis in its S shares by the basis in the T assets acquired in the transaction.
  + The basis would be a carry over basis under §362(b). But see §362(e)(2).
  + P Corp takes a basis in the S Corp shares received of the amount of the exchanged basis ($900) decreased by the amount of boot received ($200), increased by the amount of gain recognized ($0) = $700
  + Added to the existing basis of $100, the total basis is $800
  + §358(d)(1) provides that the assumption of the $200 of liabilities is treated as money received by the taxpayer on the exchange
  + Note, this is the same result as Question 1(a).

(2) Forward Subsidiary Merger. In a transaction which qualifies as a statutory merger under applicable local law, S Corp acquires all the assets of T Corp (and assumes all its liabilities) solely in exchange for $1,000 of P Corp non-voting preferred stock (which previously had been contributed by P Corp to S Corp for this purpose). What result to the parties?

***Answer:***

* A forward type A triangular merger is authorized under §368(a)(2)(D).
* The tax consequences are the same as Question 1(b).

(a) Forward Subsidiary Merger with Boot. Suppose instead that S Corp issues $400 of 20-year debentures (and exchanges only $600 of P Corp stock) in the transaction?

***Answer:***

* The T shareholders are receiving 60% of the consideration in an asset constituting a proprietary interest in P Corp.
* Therefore, the COSI requirements are met. §1.368-1(e)(2)(v), ex. 1
* For COSI requirements, long-term debt is stock.
* For tax consequences, all debt is boot.
* Boot is allowed in a Forward Subsidiary Merger. §1.368-2(b)(2).
* Target
  + §361(a): The exchange of assets for P Corp stock and debentures is tax free, because they are all securities.
  + §957(a) insulates assumption of liabilities.
  + §361(c)(1): The distribution of P Corp stock and debentures is not taxable to Target because it is qualified property. Both stock and debentures are securities.
* Shareholder A:
  + §356(a)(1):
    - Realized Gain: $350 ($1,000 - $650)
    - Receives $400 of boot.
    - Recognizes boot to the extent of gain.
    - Therefore, recognizes the full $350 of gain.
    - §356(a)(2) will not apply, because the reorganization does not change the respective ownership of the shareholders.
  + §358:
    - Takes a basis of the amount of the exchanged basis ($650) decreased by the amount of boot received ($400), increased by the amount of gain recognized ($350) = $600
  + §1223(1): Holding period in the P Corp shares is the same as in the T Corp shares
* S Corp
  + §1032: Does not recognize gain or loss on the issuance of its own stock.
  + §362(b): Takes a carry-over basis in the assets
  + §1223(2): Holding period in the assets is the same as in the hands of T Corp
* P Corp
  + Under the “over-the-top” method adopted by the regulations, P corp adjusts it basis in the S Corp stock as if it first received the assets in a direct Type A acquisition and then transferred the assets to its subsidiary in a §351 transaction.
  + In other words, P would increase its previous basis in its S shares by the basis in the T assets acquired in the transaction.
  + P Corp takes a basis in the S Corp shares received of the amount of the exchanged basis less liabilities shed ($900-$200) decreased by the amount of boot provided by S Corp ($400) = $300. §1.358-6(d).
  + Added to the existing basis of $100, the total basis is $400

(b) Forward Subsidiary Merger with Use of Parent Voting Stock and Subsidiary Nonvoting Stock. Suppose instead that S Corp exchanges $40 worth of its nonvoting stock and $960 worth of P Corp’s voting stock in the transaction.

***Answer:***

* This transaction does not qualify as a Forward Triangular A Reorganization because no stock of S Corp may be used in the transaction. §368(a)(2)(D)

(3) Reverse Subsidiary Merger. Assume that A owns 80% of T Corp, and B, an individual, owns 20%. P Corp transfers $850 of its voting stock and $150 in cash to S Corp (newly formed) solely for stock of S Corp. Immediately thereafter, S Corp (whose only assets are the P Corp stock and $150 in cash) merges into T Corp under applicable state law. Under the plan of merger, and by operation of state law; (i) the S Corp stock owned by P Corp is exchanged for $1,000 of T Corp stock; (ii) all of S’s assets (and liabilities, if any -- here there are none) are transferred to T; (iii) S dissolves; and (iv) the T Corp stock held by its shareholders, A and B, is exchanged, pro-rata, for the $850 of P Corp stock and $150 in cash received by T Corp on the merger of S Corp into T Corp. As a result, P Corp owns 100% of T Corp after the transaction. What result to the parties?

***Answer:***

* Without the boot, this could potentially be treated as a Type B Reorganization.
* Reverse Subsidiary Mergers are permitted under §368(a)(2)(E).
* However, there are a few additional requirements, in addition to the normal A reorganization requirements:
  + The Target must hold substantially all of the assets of both the T Corp and S Corp after the reorganization. §1.368-2(j)(3)(iii)
  + Control-For-Voting Stock Requirement: A and B must exchange 80% of the stock of T Corp for stock of P Corp. §1.368-2(j)(3)(i)
  + Voting Stock Requirement: The P stock used in the exchange must be voting stock.
* Each of these requirements is met in the current exchange.
* Formation of S Corp
  + P Corp
    - §351:
      * P Corp realizes $0 of gain and recognizes $0 of gain under §351
    - §358:
      * P Corp takes a basis in the S Corp shares received of the amount of the exchanged basis = $150 (has zero basis in own stock)
  + S Corp
  + §1032: S Corp recognizes no gain or loss on the issuance of its stock.
* Forward Triangular Stock Acquisition
  + S Corp:
    - Exchanges the P Corp stock and cash to Shareholders A and B for the T Corp stock
    - §1032: Does not recognize gain or loss on the issuance of its P Corp stock.
    - §362(b): Takes a basis in the T Corp. shares the same as the old T Corp shareholders had in their T Corp. shares.
    - §1223(2): Holding period in the T Corp shares is the same as in the hands of T Corp.
  + Shareholder A:
    - §356(a)(1):
      * Receives $680 of P Corp stock (80% \* $850)
      * Receives $120 of cash (80% \* $150)
      * Assume basis of $400
      * Realized Gain: $400 ($800 - $400)
      * Recognizes boot to the extent of gain = $120.
      * §356(a)(2) will not apply, because the reorganization does not change the respective ownership of the shareholders.
    - §358:
      * Takes a basis of the amount of the exchanged basis ($400) decreased by the amount of boot received ($120), increased by the amount of gain recognized ($120) = $400
    - §1223(1): Holding period in the P Corp shares is the same as in the T Corp shares
  + Shareholder B:
    - §356(a)(1):
      * Receives $170 of P Corp stock (20% \* $850)
      * Receives $30 of cash (20% \* $150)
      * Assume basis of $100
      * Realized Gain: $100 ($200 - $100)
      * Recognizes boot to the extent of gain = $30.
      * §356(a)(2) will not apply, because the reorganization does not change the respective ownership of the shareholders.
    - §358:
      * Takes a basis of the amount of the exchanged basis ($100) decreased by the amount of boot received ($30), increased by the amount of gain recognized ($30) = $100
    - §1223(1): Holding period in the P Corp shares is the same as in the T Corp shares
  + Target
    - There are no tax consequences to Target as a result of the stock acquisition.
  + P Corp
    - There are no tax consequences to Target as a result of the stock acquisition.
* Merger of S Corp into T Corp
  + T Corp
    - When S merges into T Corp, there are no tax consequences.
  + S Corp
    - When S merges into T Corp, there are no tax consequences.
  + P Corp
    - §1032: The exchange S Corp stock for T Corp stock as part of the merger is tax-free.
    - §1.358-6(c)(2)(i): P’s basis in the T stock is determined using the “over-the-top” method. P is viewed as first acquiring the assets of T Corp directly, and then contributing them to T Corp in a §351 transaction.
    - P Corp takes a basis in the S Corp shares received of the amount of the exchanged basis ($900) decreased by the amount of boot received ($200), increased by the amount of gain recognized ($0) = $700
    - Added to the existing basis of $150, the total basis is $850
    - If this a B reorganization, then basis can be calculated using either the “over-the-top” method, or the normal method.

(a) Reverse Subsidiary Merger; Cash-out Dissenter. Assume the T shares are owned 75% by A and 25% by B. B dissents to the merger and T pays him $250 in cash for his T shares, using T’s own money. A exchanges his T stock for $750 of P voting stock.

***Answer:***

* Control-For-Voting Stock Requirement
  + The former surviving corporation shareholders must exchange 80% of the stock of T Corp for stock of P Corp.
  + The issue is whether B is part of the control group.
  + The answer is no. The pre-reorganization redemption is not factored into the reorganization. §1.368-2(j)(1)(i).
  + Therefore, Shareholder A exchanges 100% of the stock of T Corp for stock of P Corp.
* Substantially-All-Requirements
  + The surviving corporation must hold substantially all of its own properties after the reorganization. §368(a)(2)(E)(i).
  + The substantially all test is the same as the test under §368(a)(1)(C). Rev. Rul. 2001-25.
  + The issue is whether the assets redeemed are considered for purposes of the substantially all test.
  + The answer is yes. The pre-reorganization redemption is factored into the test. §1.368-2(j)(3)(iii).
  + Means 90% of the FMV of T’s net assets and 70% of the FMV of T’s gross assets.
  + T’s gross asset = $1,200
  + T’s net assets = $1,000
  + T transferred 79% ($1200 - $250 / $1,200) of gross assets
  + T transferred 75% ($1000 - $250 / $1,000) of net assets
  + Therefore, the substantially all requirement is not met.
* Because the exchange does not meet the substantially all requirements, this is a failed reverse subsidiary merger.

(b) Creeping Reverse Subsidiary Merger. Assume A and B receive only P voting stock (and no cash). Could this transaction be effected as a §368(a)(2)(E) merger if P Corp already owned 25% of T Corp?

***Answer:***

* §368(a)(2)(E)(ii) requirement that control be transferred “in the transaction” suggests the impossibility of a qualified creeping reverse triangular merger where the acquiring corporation already owns more than 20% “old and cold stock” in the target.
* Because P corp already owned 25% of T Corp, this is a failed reverse subsidiary merger.
* However, this could potentially be treated as a Type B Reorganization.

(4) Triangular B Reorganization. Revert to the basic model in which A owns 100% of T’s stock with a basis of $650. S Corp acquires all of A’s T Corp stock solely in exchange for the transfer by P Corp of its voting stock to A.

***Answer:***

* Transfer of P Corp Stock to S Corp
  + P Corp
    - §351:
      * P Corp realizes $0 of gain and recognizes $0 of gain under §351
    - §358:
      * P Corp takes a basis in the S Corp shares received of the amount of the exchanged basis = $0 (has zero basis in own stock)
  + S Corp
  + §1032: S Corp recognizes no gain or loss on the issuance of its stock.
* Forward Triangular Stock Acquisition
  + S Corp:
    - Exchanges the P Corp stock to Shareholders A for the T Corp stock
    - §1032: Does not recognize gain or loss on the issuance of its P Corp stock.
    - §362(b): Takes a basis in the T Corp. shares the same as the old T Corp shareholders had in their T Corp. shares.
    - §1223(2): Holding period in the T Corp shares is the same as in the hands of T Corp.
  + Shareholder A:
    - §354:
      * Receives $1,000 of P Corp stock
      * Realized gain: $350 ($1,000 - $650)
      * Recognizes $0 of gain.
      * §356(a)(2) will not apply, because the reorganization does not change the respective ownership of the shareholders.
    - §358:
      * Takes a basis of the amount of the exchanged basis ($650) decreased by the amount of boot received ($0), increased by the amount of gain recognized ($0) = $650
    - §1223(1): Holding period in the P Corp shares is the same as in the T Corp shares
  + Target
    - There are no tax consequences to Target as a result of the stock acquisition.
  + P Corp
    - Under the “over-the-top” method adopted by the regulations, P corp adjusts it basis in the S Corp stock as if it first received the assets in a direct Type C asset acquisition and then transferred the assets to its subsidiary in a §351 transaction. §1.358-6(c)(1).
    - In other words, P would increase its previous basis in its S shares by the basis in the T assets acquired in the transaction.
    - The basis would be a carry over basis under §362(b). But see §362(e)(2).
    - P Corp takes a basis in the S Corp shares received of the amount of the exchanged basis ($900) decreased by the amount of boot received ($200), increased by the amount of gain recognized ($0) = $700
    - Added to the existing basis of $100, the total basis is $800
    - §358(d)(1) provides that the assumption of the $200 of liabilities is treated as money received by the taxpayer on the exchange
    - Note, this is the same result as Question 1(a).

(a) Triangular B with Use of Stock of Both Parent and Subsidiary. Suppose instead that P Corp gave its voting stock worth $800 and S Corp gave its voting stock worth $200 in exchange for S Corp’s acquisition of the T Corp stock from A.

***Answer:***

* This is a failed B reorganization
* The regulations provide that a transaction will not be a B reorganization “if stock is acquired in exchange for voting stock both of the acquiring corporation and of a corporation which is in control of the acquiring corporation.” §1.368-2(c).

# Unit 10 – D Reorganizations and Section 355

## Part 1 – Acquisitive D Reorganizations

### Readings

* Code: §§ 304(c)(1); 354(b); 357(a),(c)&(d);368(a)(1)(D); 368(a)(2)(A) & (H); 368(c).
* Regs: §1.354-1(a)(2)
* E&E: Chapter 11 – Introduction to Basic Corporate Reorganization Principles
* E&E: Chapter 12 – Acquisitive Reorganizations

### Problem Set

General Facts. X Corp. is a corporation, the shares of which are owned equally by A and B, both individuals. X Corp.’s assets are worth $1,200 (basis $300); it has liabilities of $200; its shares are worth a total of $1,000. P Corp is a corporation the shares of which trade on the New York Stock Exchange. Which of the following transactions constitutes a reorganization under § 368(a)(1), and of which type?

1. X Corp. transfers all of its assets to P Corp.; P Corp. assumes X Corp.’s liabilities; P Corp.

issues $1,000 of its voting stock (worth 5% of P Corp.) to X Corp.; X Corp. dissolves and distributes the P Corp. stock equally to A and B.

***Answer:***

* A Reorganization:
  + The transaction does not qualify as an A Reorganization because there has not been a statutory merger.
* B Reorganization
  + The transaction does not qualify as a B Reorganization because P Corp has not acquired voting stock. Rather it has acquired assets.
* C Reorganization
  + To qualify as a C reorganization, the exchange must meet the following requirements:
    - COBE requirement;
    - Invest company restriction;
    - Business purposes requirements;
    - Plan or reorganization requirement;
    - Solely-for-voting-stock requirement;
    - Substantially all requirement; and
    - Liquidation requirement.
  + Because each of the requirements is satisfied, the transaction will qualify as a C reorganization.
* D Reorganization
  + The transaction does not qualify as a D Reorganization because A and B are not in control of P Corp after the exchange.

2. Same as (1), except that the P Corp. voting stock transferred to X Corp.is worth 50% of P Corp.'s total outstanding stock.

***Answer:***

* C Reorganization
  + To qualify as a C reorganization, the exchange must meet the following requirements:
    - COBE requirement;
    - Invest company restriction;
    - Business purposes requirements;
    - Plan or reorganization requirement;
    - Solely-for-voting-stock requirement;
    - Substantially all requirement; and
    - Liquidation requirement.
* D Reorganization
  + To qualify as a D reorganization, the exchange must meet the following requirements:
    - COBE requirement;
    - Invest company restriction;
    - Business purposes requirements;
    - Plan or reorganization requirement;
    - Substantially all requirement;
    - Control requirement; and
    - Distribution requirement.
  + §368(a)(2)(H)(i) provides that for an acquisitive D reorganization, control has the meaning set out in §304(c). §304(c) defines control as “the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of all shares of all classes of stock.”
  + Because each of the requirements is satisfied, the transaction will qualify as a D reorganization.
* Because the transaction meets the requirements of both a C reorganization and a D reorganization, the D reorganization trumps. §368(a)(2)(A).

## Part 2 – Section 355 and Divisive D Reorganizations

### Readings

* E&E: Chapter 13 – Corporate Divisions
* Code: §§ 304(c)(1); 311(b); 312(h); 331; 336(a), (c); 351(c); 354(b); 355(a),(b),(c) 356;358(b)(2),(c),(g); 368(a)(1)(D); 368(a)(2)(A) & (H); 368(c);361(c)(4)
* Regs: §§ 1.355-1, -2, -3, -4; 1.356-2; 1.358-2(a); 1.368-1(b).
* Materials on NYU Classes:
  + excerpt from Rev. Proc 96-30
  + Helvering v. Gregory.

### Problem Set

General Facts. Alden Co. has 2,000 shares of common stock outstanding (worth $1 per share), of which Henry and Benny have each owned 50%, 1,000 shares each, for the last five years. Henry’s basis for his stock is $800 and Benny’s basis is $1,200.

Alden Co. is engaged in two lines of business (and has been so engaged for the last 5 years unless the facts specify otherwise): the manufacture and sale of peanut butter (“Peanut”) and the manufacture and sale of jelly (“Jelly”). The assets of each division are worth $1,000 and have a basis of $500; separate records have been kept for each business; all assets are readily allocable to the respective businesses; no liabilities exist; Alden Co. has E&P of $1,000.

1. On January 2, 2009, the following alternative transactions occur. What are the tax consequences to the parties?

(a) In order to facilitate expanded (and more favorable) bank financing of Peanut's business and to effect cost savings (reduce duplication of employees), Alden Co. transfers all of the Peanut assets to new Peanut Co. for all of its stock and all of the Jelly assets to new Jelly, Inc. for all of its stock. Immediately thereafter, Alden Co. liquidates and distributes the Peanut Co. stock to Henry and the Jelly, Inc. stock to Benny.

***Answer:***

* [Insert]

(b) Henry and Benny no longer see eye to eye. Their co-ownership and co-management produce friction and conflict, and they wish to go their separate ways. To that end, Alden Co. transfers the Peanut assets to Peanut Co. for all its stock. Immediately thereafter, Alden Co. distributes the Peanut Co. stock to Henry in exchange for all of his Alden Co. stock.

***Answer:***

* [Insert]

2. § 355(b) active business requirement. Assume the basic transaction passes muster under § 355 (i.e., business purpose, no device, etc). What would be the effect of the following factual variation? The Peanut and Jelly businesses had been conducted separately by Crunchy Corp. and Grape Corp. for the 4 years ending 12/31/2005. On 1/1/2006, Alden Co. acquired the Jelly business through a state-law merger of Grape Corp (368a1A – no boot). Into Alden Co., in which Alden Co. issued only Alden Co. stock. As part of the plan of reorganization, Alden Co. transferred the Jelly assets to newly-organized Jelly, Inc. in exchange for all of its stock. Six months after that, Alden Co. acquired all of the Crunchy Corp. stock in exchange solely for Alden Co. voting stock, and changed the name of Crunchy Corp. to Peanut Co..Alden Co. has continued to operate both businesses through its Peanut Co. and Jelly, Inc. subsidiaries. In 2009 Alden Co. distributes the Peanut Co. stock (Peanut Co. holds the Peanut business) to Henry in exchange for all of his Alden Co. shares.

***Answer:***

* [Insert]