Corporate Taxation
Bogdanski **Spring 2019**

FINAL EXAMINATION

(Three hours)

INSTRUCTIONS

This examination consists of three essay questions, each of which will be given equal weight in determining grades. Three hours will be permitted for this examination.

At the end of the three hours, you must turn in this set of essay questions in the original envelope in which this set came. If you are using a computer, then unless you have been otherwise expressly authorized by the law school, you must submit your answers using Examplify. If you are writing answers by hand, you must write them all in the bluebook(s) you have been provided, and return the bluebook(s) along with this set of questions in the envelope.

No credit will be given for anything written on this set of questions. Only your electronic answer file or bluebook(s) will be graded.

Pay close attention to the final portion, or "call," of each question. Failure to respond to the matters called for will result in a low score for the question. On the other hand, discussion of matters outside the scope of the call of the question will not receive credit.

Be sure to explain as thoroughly as possible your answers to the questions posed. Your reasoning, discussion, and analysis are often as important as any particular conclusion you reach.

The suggested time limit for each question is one hour. Experience has shown that failure to budget one's time according to this limit can result in a drastic lowering of one's overall grade on this examination.

Unless otherwise instructed, assume that:

- all shareholders described in the questions are individuals;
- all shareholders and corporations described in the questions use the *calendar year* as their taxable year for federal income tax purposes;
- all *shareholders* report their income on the *cash* method for such purposes; and
- all *corporations* report their income on the *accrual* method for such purposes.

Any references to "the Code" are to the Internal Revenue Code of 1986, as amended.

QUESTION ONE

(One hour)

Subb is a domestic corporation with one class of stock outstanding. The shares are held as follows: 15 percent by Iris, an individual; and 85 percent by Parr, another domestic corporation. Iris has an aggregate adjusted basis in her Subb shares of $200,000. Parr has an aggregate adjusted basis in its Subb shares of $1,800,000. Subb has substantial, but reasonable, accumulated earnings and profits (as does Parr).

In 2019, the directors and shareholders of Subb adopt a plan of complete liquidation of Subb. Around the same time, Subb distributes $150,000 in cash to Iris, and Subb distributes Factory, an industrial facility, to Parr. Factory has a fair market value of $850,000. Immediately before the distribution, Factory has an adjusted basis in Subb's hands of $1,000,000. There are no mortgages or other encumbrances on Factory.

In 2021, after winding up its business, selling off its assets, and paying off debts, Subb makes additional distributions to its shareholders. Subb distributes $1,700,000 cash to Parr. To Iris, Subb distributes shares of stock in XYZ, a corporation in which Subb had previously invested. The stock represents a small minority stake in XYZ. Immediately before the distribution, the XYZ stock has a fair market value of $450,000, and an adjusted basis in Subb's hands of $200,000.

The XYZ stock is subject to a security interest (that is, a mortgage) securing a debt that Subb owes to a lender. Iris assumes this liability as part of taking ownership of the XYZ stock. At the time the XYZ stock is distributed, the outstanding balance on this debt is $150,000.

Except as just described, Subb makes no distributions to its shareholders in 2019 or thereafter.

Answer *all* of the following questions:

A. **(80 percent of question grade)** What are the federal income tax consequences to Subb, Parr, *and* Iris of *each* of the transactions just described, with *and* without all available elections? Be sure to discuss the amount, timing, and character (capital or ordinary) of any income, gain, loss, or deduction realized or recognized by each party; each party's basis in the stock or assets that party holds, at each stage of the transactions; and the effects of Subb's earnings and profits.

B. **(20 percent of question grade)** Could Subb have elected to be an S corporation? Why or why not? Does the answer depend on whether Parr is an S corporation?

Discuss.

(End of Question 1)

QUESTION TWO
(One hour)

Two unrelated individuals, Luke and Monique, form Newco, a corporation under state law, to conduct a real estate development business. On January 2, 2019, Luke transfers to Newco (a) Luke's promissory note for $10,000 (the "Luke Note"), and (b) Blackacre, a parcel of undeveloped real estate. In exchange for these contributions, Luke receives from Newco 50 shares of Newco voting common stock and 50 shares of Newco nonvoting preferred stock.

Blackacre has a fair market value of $105,000, but it is encumbered by a mortgage of $40,000 that Luke owes to a bank. The mortgage secures a recourse loan from the bank to Luke, on which the outstanding balance is $40,000. Immediately before the transfer, Luke's adjusted basis in Blackacre is $30,000. Newco assumes Luke's liability to the bank.

The Luke Note calls for two principal repayments of $5,000 each, the first to be made by Luke in 2020 and the second in 2021. The Luke Note also provides that Luke will pay Newco interest at a market rate every quarter on the unpaid balance.

Also on January 2, 2019, Monique transfers to Newco Whiteacre, another parcel of undeveloped real property, with a fair market value of $76,000. Monique owns Whiteacre free and clear of any encumbrances. Monique's adjusted basis in Whiteacre immediately prior to the transfer is $90,000. In exchange for Whiteacre, Monique receives from Newco 50 shares of the Newco voting common stock and 50 shares of the Newco nonvoting preferred stock. Newco also agrees to pay a $1,000 liability that Monique owes to a vendor for supplies that Monique previously consumed in Monique's business.

Immediately after the foregoing transactions, Newco's voting common stock has a fair market value of $100,000, or $1,000 per share. At the same time, Newco's nonvoting preferred stock has a fair market value of $50,000, or $500 per share. The shares issued to Luke and Monique are Newco's only outstanding shares. The preferred stock is *not* "nonqualified preferred stock" within the meaning of section 351(g)(2) of the Code.

On February 5, 2019, Luke transfers his 50 shares of Newco preferred stock to a buyer, Cayla, in exchange for $20,000 cash. Cayla is a business associate of Luke and Monique in the property development industry. The three have previously discussed owning a company together. Luke retains his shares of Newco common stock.

What are the federal income tax consequences to Newco, Luke, *and* Monique of *each* of the transactions just described, with *and* without all available elections? Be sure to discuss the amount, timing, and character (capital or ordinary) of any income, gain, loss, or deduction realized or recognized by each party; and each party's basis in the stock or assets that party holds, at each stage of the transactions.

Explain.

(End of Question 2)

QUESTION THREE
(One hour)

Corp is a C corporation with one class of stock, voting common stock, outstanding. Immediately before the transactions discussed in this question, the shares of Corp are owned as follows:

Shareholder	Number of Shares	Adjusted Basis of Shareholder's Entire Block of Stock	Fair Market Value of Shareholder's Entire Block of Stock
Abby	50	$ 300,000	$ 600,000
Stephen, Abby's son	25	150,000	300,000
Blake, Abby's brother	25	150,000	300,000
Total	*100*	*$ 600,000*	*$ 1,200,000*

In its taxable year 2019, Corp has current earnings and profits of $120,000. At the start of 2019, Corp's accumulated earnings and profits were zero.

On December 31, 2019, Corp issues a stock dividend. For each share of common stock that a shareholder owns, he or she receives one share of Corp's new nonvoting, nonparticipating preferred stock.

The issuance of the preferred stock to the shareholders dilutes the values of their common stock holdings. This results in the following fair market values immediately after the stock dividend:

Shareholder	Fair Market Value of Shareholder's Preferred Stock	Fair Market Value of Shareholder's Common Stock After Dividend
Abby	$ 120,000	$ 480,000
Stephen, Abby's son	60,000	240,000
Blake, Abby's brother	60,000	240,000
Total	*$ 240,000*	*$ 960,000*

On April 12, 2020, in an arm's-length transaction, Blake sells all of his Corp preferred stock to an unrelated investor, Dave, for $58,000 cash. Blake retains his shares of Corp common stock.

On September 1, 2020, in a transaction unrelated to Blake's transaction, Corp redeems all of Abby's shares of Corp common stock. Abby retains her shares of Corp preferred stock. In the redemption, Corp transfers to Abby $480,000 cash.

What are the federal income tax consequences to Abby, Blake, *and* Corp of *each* of the transactions just described? Be sure to discuss the amount, timing, and character (capital or ordinary) of any income, gain, loss, or deduction realized or recognized by each party; each party's basis in the stock or assets that party holds at each stage of the transactions; and the effects of the transactions on Corp's earnings and profits. Assume that at no time does Corp elect to be an S corporation.

Discuss.

(End of examination)