QUESTION ONE
(One hour)

Xco, a corporation under state law and a C corporation for tax purposes, has only one class of stock outstanding, namely, voting common stock. Ana owns 75 shares of the voting common stock. Ana's adjusted basis in her Xco stock is $300,000. Xco has accumulated earnings and profits of $1,500,000. Xco's stock is owned by the following shareholders in the following amounts:

Shareholder	*Number of Shares*	*Percentage of Outstanding Shares*
Ana	75	50.0%
Dylan, Ana's Daughter	25	16.7%
Trust No. 2, a trust	50	33.3%
Total	**150**	**100**

Trust No. 2 was established by the will of Ana's friend Gina, who died several years ago. Gina had helped co-found Xco with Ana. The sole beneficiary of Trust No. 2 is Gina's son, Som. Som is married to Dylan. The trustee of the trust is a bank.

Ana also owns a demand note issued by Xco. The face amount of the demand note is $600,000; that amount is also Ana's adjusted basis in the note. The note represents Xco's obligation to repay Ana for various "advances" that Ana has made to the corporation over the years. The note is freely transferable, has no maturity date or monthly payment schedule, and bears a fixed interest rate of 6 percent per year. The note by its terms is subordinated to a bank debt of Xco. Over the years, payments of principal on the note have been made on demand based on Ana's need for cash. Payments of interest on the note have been made, without fail, at the end of each month.

On the first day of its taxable year, Xco redeems 50 shares of its common stock held by Ana, in exchange for $700,000 cash. On the same day, Xco pays off the demand note in full, by transferring to Ana $600,000 of additional cash.

Immediately after the redemption, Xco's stock is owned as follows:

Shareholder	*Number of Shares*	*Percentage of Outstanding Shares*
Ana	25	25.0%
Dylan	25	25.0%
Trust No. 2	50	50.0%
Total	**100**	**100.0%**

What are the federal income tax consequences to Ana, Dylan, Trust No. 2, *and* Xco of *each* of the transactions just described, with *and* without all available elections (but assuming that Xco does not elect to be an S corporation)? 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 Xco's earnings and profits.

Discuss.

QUESTION TWO
(One hour)

Targ is a C corporation with accumulated earnings and profits. Targ has two equal shareholders, Leon and Meghan. Each shareholder has a basis in that shareholder's Targ stock of $200,000. Targ's balance sheet shows the following assets:

Asset	Adjusted Basis	Fair market value
Investments	$500,000	$400,000
Patents	300,000	700,000
Equipment	-0-	100,000
Inventory	100,000	200,000
Total	**$-900,000**	**$1,400,000**

Targ also owns self-created goodwill, going concern value, and workforce in place. These intangibles have a fair market value of $500,000. Targ properly deducted all the costs of these three intangible assets when Targ was developing them.

Targ owes $400,000 to bondholders, which is Targ's only outstanding debt.

Targ is approached by a competitor, Purco, which offers to buy the business of Targ. Two alternative formats for the takeover are proposed:

A. Leon and Meghan transfer their Targ stock to Purco in exchange for a total of $900,000 cash and three-year Purco promissory notes for a total of $600,000. That is, each shareholder receives from Purco $450,000 cash and a three-year Purco promissory note for another $300,000.

B. Targ sells all of its assets to Purco, which assumes Targ's $400,000 liabilities on its bonds. Purco pays Targ $900,000 cash and issues to Targ a three-year Purco promissory note for an additional $600,000. Targ then liquidates, distributing the Purco note, and all of Targ's cash, one half each to Leon and Meghan.

What would the federal income tax consequences be to Targ, Leon, *and* Meghan of *each* of the alternative transactions just described, with *and* without all available elections (but assuming that Targ does not elect to be an S corporation)? 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 Targ's earnings and profits.

Explain.

QUESTION THREE
(One hour)

Company is a C corporation with one class of stock outstanding. The stock is held by two shareholders, Regina and Sasha. Regina owns 70 shares, and Sasha owns 30 shares. The two shareholders are not related to each other. Both are employees of Company as well as shareholders.

Company, which has a deficit in accumulated earnings and profits, needs additional capital, which Regina is willing to provide. Regina transfers $500,000 cash and real estate to Company in exchange for additional stock of Company. The real estate consists of Blackacre, which Company uses in its business. Blackacre has a fair market value of $500,000. Immediately before the exchange, Regina's adjusted basis in Blackacre is $650,000. In exchange for the cash and Blackacre, Regina receives 50 shares of Company stock, bringing her shareholdings to 120 shares total.

Two months later, Company presents a stock bonus to Sasha. In recognition of exemplary service as a Company executive, Sasha is awarded 10 additional shares of Company stock, with a fair market value of $185,000. This brings Sasha's stock holdings to 40 shares total. Company transfers the 10 new shares to Sasha at a ceremonial dinner.

What are the federal income tax consequences to Company, Regina, *and* Sasha of *each* of the transactions just described, with *and* without all available elections (but assuming that Company does not elect to be an S corporation)? 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; and the effects of the transactions on Company's earnings and profits.

Discuss.