

WRITE YOUR EXAM NUMBER HERE: _____

**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.

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.

At the end of the three hours, you must turn in this set of questions in the original envelope in which this set came. If you are using a computer, you must submit your answers using Exemplify. If you are writing answers by hand, you must write them in the authorized exam booklet(s) you have been provided, and return the booklet(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 your exam booklet(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.

Unless otherwise instructed, assume that:

- all shareholders described in the question are individuals;
- all entities described in the questions are organized and operated exclusively in the United States;
- all parties described in the questions use the calendar year as their taxable year for federal income tax purposes; and
- all parties described in the questions report their income using the cash method of accounting for such purposes.

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

QUESTION 1
(One hour)

Redco is a C corporation, the single class of stock of which is owned as follows as of April 30, 2022:

Shareholder	Number of shares
Fred, an individual	50
PSP, a partnership for federal tax purposes	25
Sally, an individual	25
Total	100

The partners in PSP are Rae, an individual, and Sally (the same Sally listed above). Rae owns 60 percent of PSP's capital and profits, and Sally owns 40 percent of PSP's capital and profits.

Fred is Rae's father. Sally is not a member of Fred's or Rae's family.

Sally is the president of Redco. Fred and Rae are retired and not involved in the management or operation of Redco. Redco has accumulated earnings and profits of \$200,000, which is a reasonable amount, and earnings and profits for 2022 of \$20,000. Redco and its shareholders have been discussing the possible redemption of some of its stock in stages over the next several years.

On May 1, 2022, Redco redeems all 25 of the shares owned by PSP in exchange for \$120,000 cash. Immediately before the redemption, PSP's adjusted basis in the 25 shares of Redco stock is \$50,000.

What are the federal income tax consequences to PSP, Fred, Sally, and Redco 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.

Discuss.

(End of Question 1)

QUESTION 2
(One hour)

Ava and Ben form a corporation, Corp. As part of the consideration they receive from Corp in the formation transaction, Ava and Ben each receive 100 shares of Corp's voting common stock, which is the corporation's only class of stock. Each share of stock has a fair market value at the time it is issued of \$1,000.

In exchange for her shares, Ava transfers to Corp two items: (a) Blackacre, a parcel of real estate that Ava has been holding for investment, and (b) Ava's unsecured promissory note with a face amount and fair market value of \$30,000. Blackacre has a fair market value of \$150,000, but it is subject to a mortgage with an outstanding principal balance of \$80,000. Immediately before the transaction with Corp, Ava's adjusted basis in Blackacre is \$50,000. Ava took out the mortgage several years ago to provide the funds to purchase Blackacre. Corp agrees to pay the mortgage loan when due. The promissory note that Ava transfers to Corp calls for Ava to make payments of \$10,000 of principal to Corp each year for three years, along with interest on the unpaid balance at a market rate.

In exchange for Ben's shares, Ben transfers to Corp a nonmanaging membership interest in a limited liability company, LLCo. LLCo invests in startup companies with the goal of seeking long-term capital gains; Ben has been holding the LLCo interest for investment. Membership interests in LLCo are not publicly traded. The LLCo interest that Ben transfers to Corp has a fair market value at the time of the transfer of \$150,000. Ben's adjusted basis in the transferred LLCo interest immediately before the exchange is \$125,000. As part of the exchange, in addition to the 100 shares of its stock, Corp transfers to Ben Corp's unsecured debenture with a face amount and fair market value of \$50,000. The debenture, which is debt and not equity for tax purposes, calls for Corp to make payments of \$5,000 of principal to Ben each year for 10 years, along with interest on the unpaid balance at a market rate.

Ava and Corp make all the payments on the promissory note, the debenture, and the mortgage loan as they become due.

What are the federal income tax consequences to Ava, Ben, and Corp 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 3
(One hour)

Acme, a C corporation, has two unrelated shareholders, Mai and Ned. Mai owns 75 percent of Acme's only class of outstanding stock, and Ned owns the other 25 percent. Mai's adjusted basis in Mai's stock is \$30,000; Ned's adjusted basis in Ned's stock is \$10,000. Acme has substantial, but reasonable, accumulated earnings and profits.

In May 2022, Acme adopts a plan of complete liquidation and begins winding up its operations and paying off its debts. In July 2022, Acme makes initial cash distributions to the shareholders as follows: \$12,000 to Mai, and \$4,000 to Ned.

The winding up of Acme's affairs is completed in December 2023. After selling most of its assets at a gain and paying off all of its debts, Acme holds \$20,000 cash; some business supplies, the cost of which Acme previously deducted, with a fair market value of \$4,000; and stock in a publicly traded company, Flyer. Acme bought the Flyer stock on the open market in 2018. As its second and final liquidating distribution to its shareholders, Acme distributes the cash and the supplies to Mai, and the Flyer stock to Ned. Immediately before the distribution, the Flyer stock has a fair market value of \$8,000 and an adjusted basis in Acme's hands of \$13,000.

What are the federal income tax consequences to Acme, Mai, and Ned 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.

Discuss.

(End of examination)