#### Fordham Law School

#### Taxation of Business Entities

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#### Instructions

1. The only permitted materials for the exam are: (1) The Kwall casebook, (2) Any printed version of the IRC, (3) your Class Notes and Slides; and (4) a calculator. You are **not** permitted to access the internet or use any commercial outline, whether in printed form or stored on your computer, **although you can access your notes on your laptop.**
2. Answer all questions only on these exam pages and NOT in a bluebook.
3. The suggested time and relative weighting for grading each question is indicated in brackets at the beginning of each question. The suggested time for the first 2 questions is 5 minutes each. The suggested time for the remaining 7 questions ranges from 10 to 45 minutes. Note, the questions are arranged in order of suggested time.
4. For any true-false question, circle the correct response and provide a brief reason for your choice; a citation to the appropriate section of the Code or regulations is fine.
5. When asked to describe the tax consequences, give the amount and character of the relevant income, deductions, gains, or losses. Unless specifically requested, do NOT compute tax liability. If necessary, assume that the marginal tax rate for individuals and corporations is 35%, but 15% for the long-term capital gains/qualified dividends of individuals.
6. Write neatly. Illegible answers will not be graded.
7. Don’t waste time paraphrasing the Code; an accurate citation is sufficient. Common abbreviations, e.g., FMV, AB, AR, are fine.
8. Assume that all taxpayers are U.S. persons and calendar year taxpayers.
9. Print your student ID number on the top right corner of the first page only of the exam.
10. The exam has 8 pages. Make sure you have them all.

**GOOD LUCK!**

1. [5] What is the **main tax** difference between operating a business as a partnership/LLC or a C corporation? (Two or three accurate sentences should be sufficient.) Why is that difference generally less relevant for closely held businesses? (One or two accurate sentences should be sufficient.)
2. [5] IBM forms a wholly owned Delaware LLC. If IBM makes no elections with respect to the LLC’s tax status, the LLC will be a C corporation.

True False

Reason:

1. [10] X, a C corporation, owns (and has owned since formation) all of the stock of Y, a C corporation. X’s basis in Y is $1 million, and Y owns $1 million cash and a building. Y has $1 million of E&Ps. A, an individual, offers to buy all of the stock of Y for either $5 million after Y has distributed the cash or $6 million with no prior distribution. Briefly describe which option **X** should prefer, why, and note any potential tax risks.
2. [15] SCo has been an S Corporation since its inception. It has 3 equal shareholders, Larry, Mike, and Nick. Each shareholder has an AB in its SCo shares of $50,000 and a FMV of $200,000. On March 1, 2007, SCo borrows $250,000 from Bank of America. On July 1, 2007, SCo distributes in a nonliquidating distribution to its shareholders a vacant lot in Iowa (they take title as tenants in common). The lot has been held for 10 years. The lot has an AB of $100,000 and a FMV of $240,000. For 2007, SCo earns $85,000 of gross income from its Iowa farming operations and incurs $15,000 of expenses related to the farming operations.

What are the tax consequences to Larry, Mike, Nick, **and** SCo for 2007?

1. [15] C corporation has been owned for 5 years by two unrelated individuals, A and B. A owns 60 shares of C common stock (FMV = $1200; AB = $600). B owns 40 shares of C common stock (FMV= $800; AB = $600). C’s E&Ps are $500 **before** either of the transactions below.
   1. If A sells **30** shares back to C corporation for $600, what are the tax consequences to A (amount and character of any income/loss) and the effect on C corporation’s E&Ps?
   2. Same as above, except that A sells **10** shares back to C corporation for property with a FMV of $200 and an AB of $100. What are the tax consequences to A and C (amount and character of any income/loss and basis in the property received) and the effect on C corporation’s E&Ps?
2. [20] X, a C corporation, is owned 85% by C, a C corporation, and 15% by A, an individual. (A doesn’t own any stock of C corporation.) C’s basis in its X stock is $85,000 and A’s basis is $40,000. X owns 2 parcels of land, Blackacre and Whiteacre. Blackacre has basis of $50,000, a FMV of $180,000, and is subject to a liability of $10,000; Whiteacre has a basis of $60,000, a FMV of $40,000, and is subject to a liability of $10,000.

X makes a liquidating distribution to C and A of the properties: X distributes Blackacre to C and Whiteacre to A, both subject to the liabilities. (The ratio of the FMV of each property to the total FMV of all properties is 85/100 and 15/100, the same as the relative shareholder interests, so the distribution is proportional to the ownership interests. Both properties were purchased by X for cash.)

What are the tax consequences to C, A, and X? Be sure to address any gain or loss recognized by any party plus the AB of the property in the hands of the shareholders. (Assume that X has $Z (where Z is “exactly enough” dollars) on hand to pay any corporate tax liabilities. In other words, don’t worry about it!)

1. [30] A and B each contribute $100,000 to a newly formed general partnership, AB, which purchases a building for $200,000. Assume that the building has a 10-year life and is depreciated on a straight-line basis. The PSH agreement allocates all income and loss 50-50, except for depreciation, which is allocated to B.
   1. If apart from depreciation, AB’s rental income exactly equals operating expenses, what are the partners’s capital account balances at the end of year 1 if the allocation of depreciation to B has economic effect?
   2. If AB sells the building at the beginning of year 2 and liquidates, how do the proceeds have to be distributed if the allocation is to have economic effect and the building is sold for $180,000? For $200,000?
   3. Assume the PSH agreement provides that gain on the disposition of the building is allocated to B to the extent of prior depreciation allocated to B. What are the consequences if AB sells the building for $200,000 on January 1 of year 2 (how much gain/loss does AB, A, or B recognize and what is the effect on the partners’s capital accounts)?
   4. Assume the original facts in 7.a. above, except that now that AB is a limited PSH and B a limited partner with no obligation to restore any deficit in his capital account. The PSH agreement includes a “qualified income offset.”
      1. What are the results to A and B in Year 1?
      2. Year 6? [Assume that no changes are made to the allocation section of the PSH agreement.]
2. [30] A, B, and C are equal partners in the ABC general partnership. At formation of the ABC partnership, A, B, and C contributed cash, which ABC used to purchase Blueacre, a vacant lot of land held solely for investment purposes. The basis of the land has not been adjusted since it was contributed (as a reminder, land is **not** depreciable). ABC’s balance sheet as of 1/1/07 is as follows:

ABC has no debt.

In 2007, ABC makes a liquidating distribution to C of $12,000. Assume that AB has no income or deductions for 2007.

* 1. What are the tax consequences to A, B, C, ***and*** ABC, if ABC does **not** make a 754 election?
  2. What are the tax consequences if ABC makes a 754 election?
  3. Would you recommend that ABC make a 754 election? Why or why not?

1. [45] On January 1, 2007, Able, Becky, Carl, and David formed a new corporation (Newco) to produce and sell fake iPhones. Newco was authorized to issue a single class of common stock. Able transferred $100,000 in cash to Newco as working capital for 100 Newco shares. Becky transferred an iPhone maker with an AB in her hands of $250,000, a FMV of $450,000, subject to a liability of $300,000, in exchange for $50,000 in cash and 100 Newco shares. (Newco assumes the liability.) Carl transferred to Newco a building in which to house the iPhone maker. The building had an AB in Carl’s hands of $1,200,000 and a FMV of $600,000. Carl received 600 Newco shares. David was named marketing director. In exchange for his promise to render future services to Newco and his personal collection of hundreds of Audrey Hepburn DVDs (FMV = 50; AB = 50,000), he received 100 Newco shares. He believes that if the employees watch the DVDs they will be inspired to design “fabulously fashionable” iPhones. All shares are freely transferable upon receipt.

The new venture proved so profitable that their friend Eric wanted to join in the action as a 50% shareholder. To accomplish this, on July 1, 2007, he transferred a machine for etching images of NASCAR drivers on the iPhones to Newco in exchange for 700 Newco shares and $100,000. The machine had an AB in his hands of $300,000, a FMV of $900,000, and was subject to a liability of $100,000, which Newco assumed.

With regard to Able, Becky, Carl, David, Eric, **and** Newco, determine only (1) the amount of recognized gain or loss, (2) the amount of any income or deduction, and (3) the basis that each (both the shareholders and Newco) takes in the stock or property received.

Because I’m a nice guy, here’s a table summarizing the contributions:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Person** | **AB** | **FMV** | **Liability** | **Consideration** |
| Able | 100,000 | 100,000 | 0 | 100 shares |
| Becky | 250,000 | 450,000 | 300,000 | 100 shares plus 50,000 |
| Carl | 1,200,000 | 600,000 | 0 | 600 shares |
| David | 50,000 | 50 | 0 | 100 shares |
| Eric | 300,000 | 900,000 | 100,000 | 700 shares plus 100,000 |