**Chapter 19**

**Corporate Formation, Reorganization, and Liquidation**

**SOLUTIONS MANUAL**

**Discussion Questions**

1. [LO 1] Discuss the difference between gain realization and gain recognition in a property transaction.

*Gain realization occurs when a transaction takes place (that is, there has been an exchange of property rights between two persons) and the “amount realized” exceeds the taxpayer’s tax basis in the property sold or exchanged. Recognition is the recording of the gain realized on a tax return. Before gain or loss is recognized, it first must be realized.*

2. [LO 1] What information must a taxpayer gather to determine the *amount realized* in a property transaction?

*A taxpayer must determine the cash and fair market value of property received in the exchange. In addition, a taxpayer must determine if a liability will be assumed on the property received in the exchange or transferred in the exchange. Finally, a taxpayer must determine if selling expenses were incurred in the transaction. The amount realized is the cash plus the fair market value of property received plus any liability assumed by the transferee of property less any liability assumed on property received by the transferor less selling expenses.*

3. [LO 1] Distinguish between exclusion and deferral as it relates to a property transaction.

*Gain or loss that is excluded (exempt) from taxation will never be recognized on a tax return. Gain or loss that is deferred may be recognized on a future tax return if circumstances trigger recognition of the gain or loss deferred in the current year.*

4. [LO 1] Contrast how a taxpayer’s tax basis in property received in a property transaction will be affected if the transaction results in gain exclusion versus gain deferral.

*In an exclusion transaction, the taxpayer’s tax basis in the property received will be its fair market value. In a deferral transaction, the taxpayer’s tax basis in the property received will be its fair market value less the gain deferred.*

5. [LO 1] What information must a taxpayer gather to determine the *adjusted basis* of property exchanged in a property transaction?

*A taxpayer must determine the acquisition basis of the property. In a purchase, this will be cost, but it could be fair market value if received as a bequest or carryover basis if received as a gift. A taxpayer also must determine if depreciation or amortization has been subtracted from the acquisition basis or if capital improvements have been added to the acquisition basis.*

6. [LO 2] Why does Congress allow tax deferral on the formation of a corporation?

*Congress enacted the tax laws allowing deferral of property transfers to a corporation in the Revenue Act of 1921 to remove tax consequences as an impediment to forming a corporation and to provide taxpayers with flexibility in choosing their preferred form of doing business.*

7. [LO 2] List the key statutory requirements that must be met before a corporate formation is tax-deferred under §351.

*Tax deferral only applies to transfers of property to a corporation.*

*The persons transferring property to a corporation must receive “solely” stock in the corporation in return.*

*The persons transferring property to a corporation must collectively control the corporation after the transaction.*

8. [LO 2] What is the definition of *control* for purposes of §351? Why does Congress require the shareholders to control a corporation to receive tax deferral?

*The tax law defines control as ownership of 80-percent-or-more of the corporation’s voting stock and 80-percent-or-more of each class of nonvoting stock for purposes of §351. Congress requires shareholders to own a significant percentage of stock after the transaction to distinguish corporate reorganizations of ownership from a sale of assets to the corporation.*

9. [LO 2] What is a *substituted basis* as it relates to stock received in exchange for property in a §351 transaction? What is the purpose of attaching a substituted basis to stock received in a §351 transaction?

*Under the substituted basis rule, the stock received in a §351 transfer equals the tax basis of the property transferred to the corporation. The formula to compute the stock’s substituted basis is (see Exhibit 19-4):*

*+ Cash contributed  
 + Tax basis of other property contributed  
 − Liabilities assumed by the corporation on property contributed  
 Substituted tax basis of stock received*

*The substituted basis rule preserves the gain or loss deferred in the transfer. If the shareholder sells the stock received at fair market value in a taxable transaction, the gain or loss recognized will equal the gain or loss deferred.*

10. [LO 2] Explain whether the receipt of boot by the shareholder in a §351 transaction causes the transaction to be fully taxable.

*Boot taints an otherwise tax-deferred transaction under §351. A shareholder who receives boot in the transferee corporation recognizes gain (but not loss) in an amount not to exceed the lesser of 1) gain realized or 2) the fair market value of the boot received.*

11. [LO 2] Explain whether a corporation’s assumption of shareholder liabilities will always constitute boot in a §351 transaction.

*Under the general rule, the corporation’s assumption of a shareholder’s liability attached to property transferred (for example, a mortgage attached to the building and land) is not treated as boot received by the shareholder. Congress created two exceptions in which liability assumption by the corporation is treated as boot. Under the first exception, if any of the liabilities assumed by the corporation are assumed with the purpose of avoiding the federal income tax or if there is no corporate business purpose for the assumption, all of the liabilities assumed are treated as boot to the shareholder. Under the second exception, if a shareholder’s liabilities assumed are in excess of the aggregate tax basis of the properties transferred by the shareholder, gain is recognized to the extent of the excess. Liabilities, the payment of which would give rise to a deduction, are not treated as liabilities in making this determination.*

12. [LO 2] How does the tax treatment differ in cases where liabilities are assumed with a tax avoidance purpose versus where liabilities assumed exceed basis? When would this distinction cause a difference in the tax consequences of the transactions?

*Where liabilities are assumed with a tax avoidance purpose, the tax law treats all liabilities assumed as boot received by the transferor. The transferor would recognize gain in an amount equal to the lesser of gain realized or the fair market value of the boot received. Where liabilities assumed exceed basis, the excess is treated as gain recognized by the transferor.*

13. [LO 2] What is a *carryover basis* as it relates to property received by a corporation in a §351 transaction? What is the purpose of attaching a carryover basis to property received in a §351 transaction?

*Under the carryover basis rule, the tax basis of property received by the corporation in a §351 exchange equals the property’s tax basis in the transferor’s hands (that is, the corporation carries over the shareholder’s basis in the property). The carryover basis rule prevents the recipient of the property from getting a basis equal to fair market value in a nontaxable transaction.*

14. [LO 2] Under what circumstances does property received by a corporation in a §351 transaction not receive a carryover basis? What is the reason for this rule?

*When a shareholder recognizes gain as the result of receiving boot in a §351 transaction, the corporation adds the gain recognized by the transferor to the basis it carries over on the property transferred. This rule prevents gain recognized by the shareholder on the transfer to be recognized a second time if the corporation subsequently disposes of the property in an otherwise taxable transaction.*

15. [LO 2] How does a corporation depreciate an asset received in a §351 transaction in which no gain or loss is recognized by the transferor of the property?

*To the extent tax basis carries over from the shareholder, the corporation “steps into the shoes” of the shareholder and continues to depreciate the carryover basis portion of the property’s tax basis using the shareholder’s depreciation schedule. Any additional basis (from recognition of gain due to boot received) is treated as a newly acquired separate asset and is subject to a separate depreciation election (that is, this one physical asset is treated as two tax assets).*

16. [LO 2] Are the tax consequences the same whether a shareholder contributes property to a corporation in a §351 transaction or as a capital contribution?

*A contribution of capital is always non-taxable to the transferor under §118 (that is, gain or loss realized on the transfer is exempt from taxation). A §351 transfer may be taxable to the transferor if boot is received.*

17. [LO 2] Why might a corporation prefer to characterize an instrument as debt rather than equity for tax purposes? Are the holders of the instrument indifferent as to its characterization for tax purposes?

*Payments on debt are treated as interest and are tax-deductible by the corporation issuing the debt. Payments on equity are treated as dividends and are not deductible by the corporation issuing the equity. Holders of the instrument are not indifferent as to its characterization. Dividends receive preferential tax treatment, either a reduced tax rate (individuals) or a dividends received deduction (corporations). Interest is treated as ordinary income and is taxed at the recipient’s marginal tax rate.*

18. [LO 2] Under what conditions is it advantageous for a shareholder to hold §1244 stock? Why did Congress bestow these tax benefits on holders of such stock?

*Section 1244 allows a shareholder to treat a loss on the sale or exchange of stock that qualifies as §1244 stock as an ordinary loss. Section 1244 applies only to individual shareholders who are the original recipients of the stock. The maximum amount of loss that can be treated as an ordinary loss under §1244 is $50,000 per year ($100,000 in the case of married, filing jointly shareholders). To qualify for this tax benefit, the corporation from which the stock was received must be a small business corporation when the stock was issued. The Code defines a small business corporation as one in which the aggregate amount of money and other property received in return for the stock or as a contribution to capital did not exceed $1 million. There is an additional requirement that for the five taxable years preceding the year in which the stock was sold, the corporation must have derived more than 50% of its aggregate gross receipts from an active trade or business. Congress enacted §1244 to provide a tax benefit to entrepreneurs who create a risky start-up company that ultimately fails rather than succeeds.*

19. [LO 3] Why does the acquiring corporation usually prefer to buy the target corporation’s assets directly in an acquisition?

*By acquiring assets, the acquiring corporation usually receives a step-up in the tax basis of assets to fair market value (assuming the assets have appreciated in value). If the asset is depreciable or amortizable, the acquiring corporation receives an increased tax deduction because of the higher basis. In a stock purchase, the acquiring corporation usually carries over the historic cost of the assets.*

20. [LO 3] Why do the shareholders of the target corporation usually prefer to sell the stock of the target corporation to the acquiring corporation?

*Target corporation shareholders usually prefer to sell stock because it results in one level of taxation at the seller’s level and any gain recognized on the sale usually qualifies for preferential capital gain treatment if the seller is an individual.*

21. [LO 3] What is the congressional purpose for allowing tax deferral on transactions that meet the definition of a corporate reorganization?

*Congress allows tax deferral in transactions that meet the definition of a corporate reorganization to allow individuals and entities to restructure their entity holdings without interference by the tax laws. Similar to a §351 transaction, tax deferral in corporate reorganizations is predicated on the transferor receiving a continuing ownership interest in the assets transferred through the receipt of equity in the acquiring corporation.*

22. [LO 3] Why do publicly-traded corporations use a triangular form of Type A reorganization in acquiring other corporations?

*A triangular merger isolates the acquired company’s assets and liabilities in a separate subsidiary without having to retitle the assets (if a reverse triangular merger). Reverse triangular Type A mergers are desirable because the transaction preserves the target corporation’s existence. This type of merger is a common vehicle for effecting mergers when the parent corporation stock is publicly traded or the parent corporation is a holding company.*

23. [LO 3] What are the key differences in the tax law requirements that apply to forward versus reverse triangular mergers?

*For a forward triangular merger to be effective, the transaction must satisfy the requirements to be a straight Type A merger and the acquisition subsidiary must acquire “substantially all” of target company’s “properties” in the exchange. Three additional requirements must be met to satisfy the requirements in a reverse triangular merger. First, the acquired company must hold “substantially all” of its properties and the properties of the acquisition subsidiary. Second, the acquired company’s shareholders must transfer in the exchange an amount of stock in the acquired company that constitutes control of the acquired company (80-percent-or-more of the stock). Finally, the shareholders of the acquired company must receive voting stock of the parent company in return for their stock that constitutes control of the acquired company in the exchange.*

24. [LO 3] What are the key differences in the tax law requirements that apply to a Type A stock-for-assets acquisition versus a Type B stock-for-stock acquisition?

*The requirements for a Type A stock-for-assets acquisition are much more flexible than the requirements that apply to a Type B stock-for-stock acquisition. A Type A acquisition allows up to 60 percent of the consideration paid to be in cash or other property, while a Type B acquisition does not allow any cash to be used other than to pay shareholders for fractional shares. Both types of acquisitions require the acquiring company to meet the continuity of business enterprise and business purpose tests.*

25. [LO 4] How does the form of a regular §338 election compare and contrast to a §338(h)(10) election?

*In a regular §338 election, the buyer of the stock of a corporation makes the election to treat the transaction as an acquisition of the corporation’s assets. The acquired corporation must pay tax on the deemed sale of its assets prior to its acquisition. In a §338(h)(10) transaction, a corporation purchases the stock of an 80-percent-or-more owned subsidiary and the election must be made jointly by the buyer and parent corporation of the acquired company. In a §338(h)(10) election, the parent corporation treats the transaction as a sale of the subsidiary’s assets to the buyer rather than a sale of stock. The seller reports gain or loss based on the deemed sale of the subsidiary’s assets.*

26. [LO 4] What tax benefits does the buyer hope to obtain by making a §338 or §338(h)(10) election?

*In both a regular §338 and a §338(h)(10) election, the buyer hopes to receive a “stepped-up” tax basis in the assets of the acquired corporation rather than a carryover of the corporation’s historical tax basis. By increasing the tax basis to fair market value, the buyer receives an increase in the deductions related to depreciation or amortization of the stepped-up basis.*

27. [LO 4] In a stock acquisition, why is there a difference between the *tax* *basis of assets* held by an acquired corporation and the *tax* *basis of the shares* held by a corporate acquirer? Why is this difference important?

*The tax basis of the assets and liabilities of the acquired corporation (called “inside tax basis”) differs from the acquired shares because the tax basis of the assets are not affected by the acquisition of shares. This inside tax basis is the basis can only be depreciated by the acquired corporation. The buyer’s tax basis in the stock of the corporation acquired (called “outside tax basis”) cannot be depreciated and is used to determine gain or loss on a subsequent sale of the stock of the acquired corporation. Typically, the acquiring corporation would prefer to have the purchase price reflected in the inside tax basis to claim additional depreciation.*

28. [LO 4] What is the presumption behind the continuity of ownership interest (COI) requirement in a tax-deferred acquisition? How do the target shareholders determine if COI is met in a Type A reorganization?

*Tax deferral in a reorganization is based on the presumption that the shareholders of the acquired corporation retain a continuing ownership (equity) interest in the acquired corporation’s assets or historic business through ownership of stock in the acquiring corporation. According to the regulations, the target shareholders satisfy the COI requirement when they receive, in the aggregate, equity equal to 40 percent or more of the total value of the consideration received.*

29. [LO 4] W Corporation will acquire all of the assets and liabilities of Z Corporation in a Type A merger, after which W Corporation will sell off all of its assets and liabilities and focus solely on Z Corporation’s business. Explain whether the transaction will be taxable because W Corporation fails the *continuity of business enterprise test*.

*For a transaction to qualify as a tax-deferred reorganization, the acquiring corporation must continue the target corporation’s historic business or continue to use a significant portion of the target corporation’s historic business assets. The continuity of business enterprise (COBE) test does not apply to the historic business or assets of the acquiring corporation; the acquiring corporation can sell off its assets after the reorganization without violating the COBE requirement. Therefore, this transaction will not be taxable.*

30. [LO 4] Compare how a shareholder computes her tax basis in stock received from the acquiring corporation in a straight Type A merger versus a Type B merger.

*The shareholder’s tax basis in the stock received in a Type A merger is a substituted basis of the stock transferred plus any gain recognized less boot received. Similarly, the shareholder’s tax basis in the stock received in a Type B acquisition is a substituted basis of the stock transferred. Because of the prohibition of boot in a Type B acquisition, the shareholder in a Type B acquisition will not recognize gain.*

31. [LO 5] Explain whether all shareholders receive the same tax treatment in a complete liquidation of a corporation.

*All individuals and corporations owning less than 80 percent of the liquidating corporation generally recognize gain or loss on the receipt of a liquidating distribution. Corporations owning 80-percent-or-more of the liquidating corporation defer recognition of gain or loss on the receipt of a liquidating distribution.*

32. [LO 5] Explain whether a corporate shareholder recognizes gains and losses on the receipt of distributions of property from the complete liquidation of a subsidiary corporation.

*Corporate shareholders owning 80 percent or more of the stock (voting power and value) of the liquidating corporation do not recognize gain or loss on the receipt of liquidating distributions. This nonrecognition treatment is mandatory, and the tax basis in the property transferred carries from the liquidating corporation to the recipient shareholder. All other corporate shareholders recognize gain, but potentially not all losses, in a complete liquidation.*

33. [LO 5] Under what circumstances does a corporate shareholder receive tax deferral in a complete liquidation?

*Corporate shareholders owning 80 percent or more of the stock (voting power and value) of the liquidating corporation do not recognize gain or loss on the receipt of liquidating distributions. This nonrecognition treatment is mandatory.*

34. [LO 5] Under what circumstances will a liquidating corporation be allowed to recognize loss in a non-pro rata distribution?

*A liquidating corporation in a taxable transaction recognizes loss in a non-pro rata distribution if the property is distributed to a non-related person. A related person generally is defined as a shareholder who owns more than 50 percent of the stock of the liquidating corporation.*

35. [LO 5] Compare and contrast the built-in loss duplication rule as it relates to §351 with the built-in loss disallowance rule as it applies to a complete liquidation.

*The tax law limits the ability of a shareholder to transfer a “built-in loss” to a corporation in a §351 transaction. In particular, if the aggregate adjusted tax basis of property transferred to a corporation by a shareholder in a §351 transfer exceeds the aggregate fair market value of the assets, the aggregate tax basis of the assets in the hands of the transferee corporation cannot exceed their aggregate fair market value. The aggregate reduction in tax basis is allocated among the assets transferred in proportion to their respective built-in losses immediately before the transfer.*

*In the case of a complete liquidation, a loss disallowance rule applies to built-in loss that arises with respect to property acquired in a §351 transaction or as a contribution to capital. A loss on the complete liquidation of such property is not recognized if the property distributed was acquired in a §351 transaction or as a contribution to capital, and a principal purpose of the contribution was to recognize a loss by the liquidating corporation. This prohibited tax avoidance purpose is presumed if the property transfer occurs within two years of the liquidation. This presumption can be overcome if the corporation can show that there was a corporate business purpose for contributing the property to the corporation. The loss disallowance rule that relates to liquidating distributions of built-in loss property received in a §351 transaction would apply to those assets that retained their built-in loss when contributed to the corporation.*

**Problems**

36. [LO 2] Ramon incorporated his sole proprietorship by transferring inventory, a building, and land to the corporation in return for 100 percent of the corporation’s stock. The property transferred to the corporation had the following fair market value and adjusted bases:

FMV Adjusted Basis

Inventory $ 10,000 $ 4,000

Building 50,000 30,000

Land 100,000 50,000

Total $ 160,000 $ 84,000

The fair market value of the corporation’s stock received in the exchange equaled the fair market value of the assets transferred to the corporation by Ramon.

a. What amount of gain or loss does Ramon *realize* on the transfer of the property to his corporation?

*Ramon realizes a net gain of $76,000 on this transfer, computed as follows:*

*Fair market value of stock received $160,000  
– Adjusted basis of the property transferred 84,000  
Gain realized $ 76,000*

b. What amount of gain or loss does Ramon *recognize* on the transfer of the property to his corporation?

*Ramon does not recognize any gain or loss on the transfer because the requirements of §351 are met and no boot is received in the exchange.*

c. What is Ramon’s basis in the stock he receives in his corporation?

*$84,000. Ramon’s tax basis in the stock received is a substituted basis of the assets transferred.*

37. [LO 2] {Planning} Carla incorporated her sole proprietorship by transferring inventory, a building, and land to the corporation in return for 100 percent of the corporation’s stock. The property transferred to the corporation had the following fair market value and adjusted basis.

FMV Adjusted Basis

Inventory $ 20,000 $ 10,000  
 Building 150,000 100,000  
 Land 250,000 300,000  
 Total $ 420,000 $ 410,000

The corporation also assumed a mortgage of $120,000 attached to the building and land. The fair market value of the corporation’s stock received in the exchange was $300,000.

a. What amount of gain or loss does Carla *realize* on the transfer of the property to the corporation?

*Carla realizes a net gain of $10,000 on this transfer, computed as follows:*

*Fair market value of stock received $ 300,000  
+ Mortgage assumed by corporation 120,000  
 Amount realized $ 420,000  
– Adjusted basis of the property transferred 410,000  
 Gain realized $ 10,000*

b. What amount of gain or loss does Carla *recognize* on the transfer of the property to her corporation?

*Carla does not recognize any gain or loss on the transfer because the requirements of §351 are met and no boot is received in the exchange.*

c. What is Carla’s basis in the stock she receives in his corporation?

*$290,000. Carla’s tax basis in the stock received is a substituted basis of the assets transferred less the mortgage assumed by the corporation.*

d. Would you advise Carla to transfer the building and land to the corporation? What tax benefits might she and the corporation receive if she kept the building and land and leased it to the corporation?

*By keeping the building and land outside the corporation, Carla could lease the assets to her corporation and reduce future taxable income by the rental payments to Carla. This arrangement allows Carla to withdraw earnings from the corporation in a manner that is tax deductible to the corporation.*

38. [LO 2] Ivan incorporated his sole proprietorship by transferring inventory, a building, and land to the corporation in return for 100 percent of the corporation’s stock. The property transferred to the corporation had the following fair market value and adjusted basis.

FMV Adjusted Basis

Inventory $ 10,000 $ 15,000  
 Building 50,000 40,000  
 Land 60,000 30,000  
 Total $ 120,000 $ 85,000

The fair market value of the corporation’s stock received in the exchange equaled the fair market value of the assets transferred to the corporation by Ivan. The transaction met the requirements to be tax-deferred under §351.

a. What amount of gain or loss does Ivan *realize* on the transfer of the property to his corporation?

*Ivan realizes a net gain of $35,000 on this transfer, computed as follows:*

*Fair market value of stock received $120,000  
– Adjusted basis of the property transferred 85,000  
Gain realized $ 35,000*

b. What amount of gain or loss does Ivan *recognize* on the transfer of the property to her corporation?

*Ivan does not recognize any gain or loss on the transfer because the requirements of §351 are met and no boot is received in the exchange.*

c. What is Ivan’s basis in the stock he receives in his corporation?

*$85,000. Ivan’s tax basis in the stock received is a substituted basis of the assets transferred.*

d. What is the corporation’s adjusted basis in each of the assets received in the exchange?

*The corporation receives a carryover basis in the assets received from Ivan.*

*Inventory $15,000  
Building 40,000  
Land 30,000  
 Total $85,000*

e. Would the stock held by Ivan qualify as §1244 stock? Why would this fact be important if he sold his stock at a loss at some future date?

*Yes, the corporation is a “qualifying small business corporation” (capitalized for less than $1 million) and Ivan is the original holder of the stock. The corporation must meet the active trade or business requirement for 5 years before the stock meets the §1244 requirements. If the §1244 requirements are met, Ivan can recognize up to $50,000 per year of loss ($100,000 in the case of married, filing jointly shareholders) on subsequent sale of the stock as an ordinary, rather than a capital, loss.*

39. [LO 2] Zhang incorporated her sole proprietorship by transferring inventory, a building, and land to the corporation in return for 100 percent of the corporation’s stock. The property transferred to the corporation had the following fair market value and adjusted basis.

FMV Adjusted Basis

Inventory $ 20,000 $ 10,000  
 Building 150,000 100,000  
 Land 230,000 300,000  
 Total $ 400,000 $ 410,000

The corporation also assumed a mortgage of $100,000 attached to the building and land. The fair market value of the corporation’s stock received in the exchange was $300,000. The transaction met the requirements to be tax-deferred under §351.

a. What amount of gain or loss does Zhang *realize* on the transfer of the property to her corporation?

*Zhang realizes a net loss of $10,000 on this transfer, computed as follows:*

*Fair market value of stock received $ 300,000   
Plus: Mortgage assumed by corporation + 100,000   
Amount realized $400,000   
Less: Adjusted basis of the property transferred – 410,000   
Loss realized $ (10,000)*

b. What amount of gain or loss does Zhang *recognize* on the transfer of the property to her corporation?

*Zhang does not recognize any loss on the transfer because the requirements of §351 are met.*

c. What is Zhang’s tax basis in the stock she receives in the exchange?

*$310,000. Zhang’s tax basis in the stock received is a substituted basis of the assets transferred less the mortgage assumed by the corporation.*

d. What is the corporation’s adjusted basis in each of the assets received in the exchange?

*The corporation receives a carryover basis in the assets received from Zhang, reduced by the aggregate net built-in loss on the assets transferred, which is allocated to the land.*

*Inventory $ 10,000  
Building 100,000  
Land ($300,000 – $10,000) 290,000  
 Total $400,000*

*If the aggregate adjusted tax basis of property transferred to a corporation by a shareholder in a §351 transfer exceeds the aggregate fair market value of the assets, the aggregate tax basis of the assets in the hands of the transferee corporation cannot exceed their aggregate fair market value. The aggregate reduction in tax basis is allocated among the assets transferred in proportion to their respective built-in losses immediately before the transfer. As an alternative, the Zhang can elect to reduce her stock basis to fair market value ($300,000).*

Assume the corporation assumed a mortgage of $500,000 attached to the building and land. Assume the fair market value of the building is now $250,000 and the fair market value of the land is $530,000. The fair market value of the stock remains $300,000.

e. How much, if any, gain or loss does Zhang recognize on the exchange assuming the revised facts?

*Zhang realizes a gain of $390,000 on the exchange ($300,000 FMV of stock + $500,000 mortgage assumed – $410,000 aggregate tax basis). The liability assumed by the corporation exceeds the total adjusted basis of the property Zhang transferred to the corporation by $90,000 ($500,000 – $410,000). Zhang recognizes gain of $90,000 on this transfer.*

f. What is Zhang’s basis in the stock she receives in the exchange?

*Adjusted basis of property contributed $410,000   
+ Gain recognized on the exchange 90,000   
– Mortgage assumed by corporation (500,000)  
 Tax basis of stock received $ 0*

*Zhang defers recognition of $300,000 of gain realized. If she sells her stock for its fair market value of $300,000, she will recognize gain of $300,000, equal to the amount deferred.*

g. What is the corporation’s adjusted basis in each of the assets received in the exchange?

*The gain recognized must be allocated to the tax basis of the assets received by the corporation in proportion to the assets’ relative fair market values, as follows:*

*Inventory [$10,000 + ($20,000/$800,000) × $90,000] $ 12,250  
Building [$100,000 + ($250,000/$800,000) × $90,000] 128,125  
Land [$300,000 + ($530,000/$800,000) × $90,000] 359,625  
 Total $500,000*

*The total tax basis of the three assets equals their carryover basis ($410,000) plus the gain recognized by Zhang on the exchange.*

40. [LO 2] {Planning} Sam and Devon agree to go into business together selling college-licensed clothing. According to the agreement, Sam will contribute inventory valued at $100,000 in return for 80 percent of the stock in the corporation. Sam’s tax basis in the inventory is $60,000. Devon will receive 20 percent of the stock in return for providing accounting services to the corporation (these qualified as organizational expenditures). The accounting services are valued at $25,000.

a. What amount of gain or loss does Sam *realize* on the formation of the corporation? What amount, if any, does he *recognize*?

*Sam realizes a gain of $40,000 on this transfer, computed as follows:*

*Fair market value of stock received $100,000  
– Adjusted basis of inventory transferred 60,000  
 Gain realized $ 40,000*

*Sam is entitled to tax deferral under §351 (he transfers property to the corporation and controls the corporation immediately after the exchange).*

b. What is Sam’s tax basis in the stock he receives in return for his contribution of property to the corporation?

*$60,000, a substituted basis equal to the basis of the inventory transferred.*

c. What amount of income, gain, or loss does Devon *realize* on the formation of the corporation? What amount, if any, does he *recognize*?

*Devon has compensation income of $25,000. Devon is not entitled to tax deferral under §351 because services are not considered property.*

d. What is Devon’s tax basis in the stock he receives in return for his contribution of services to the corporation?

*Devon’s tax basis in the stock he receives is $25,000, equal to the income recognized on the receipt of the stock in exchange for services.*

Assume Devon received 25 percent of the stock in the corporation in return for his services.

e. What amount of gain or loss does Sam *recognize* on the formation of the corporation?

*Sam is no longer entitled to tax deferral under §351 because he does not control the corporation immediately after his transfer of property (he must own 80 percent or more). As a result, he recognizes gain of $40,000 on his transfer of property.*

f. What is Sam’s tax basis in the stock he receives in return for his contribution of property to the corporation?

*$100,000, equal to the fair market value of the inventory transferred.*

g. What amount of income, gain, or loss does Devon *recognize* on the formation of the corporation?

*Devon has compensation income of $33,333. If Sam receives 75 percent of the stock in exchange for inventory worth $100,000, Devon’s services must be worth $33,333 ($100,000/.75 – $100,000). Devon is not entitled to tax deferral under §351 because services are not considered property.*

h. What is Devon’s tax basis in the stock he receives in return for his contribution of services to the corporation?

*Devon’s tax basis in the stock he receives is $33,333, equal to the income recognized on the receipt of the stock in exchange for services.*

i. What tax advice could you give Sam and Devon to change the tax consequences?

*If Devon could contribute property equal to 10-percent-or-more of the services he renders to the corporation, his stock could be counted in the control test. As a result, Sam would be eligible for tax deferral on the transfer of his inventory to the company.*

41. [LO 2] {Tax Forms} {Research} Jekyll and Hyde formed a corporation (Halloween Inc.) on October 31 to develop a drug to address split personalities. Jekyll will contribute a patented formula valued at $200,000 in return for 50 percent of the stock in the corporation. Hyde will contribute an experimental formula worth $120,000 and medical services in exchange for the remaining stock. Jekyll’s tax basis in the patented formula is $125,000, whereas Hyde has a basis of $15,000 in his experimental formula.

a. Describe the tax consequences of the transaction.

*Jekyll realizes a gain of $75,000 (fair market value of $200,000 less his basis of $125,000). Hyde realizes a gain of $105,000 (fair market value of $120,000 less his basis of $15,000) and compensation of $80,000 (the remaining value of the Halloween stock). Neither Jekyll nor Hyde recognizes their gains because the formation of the corporation qualifies for deferral under §351 (both transfer property to the corporation and together the transferors control the corporation immediately after the exchange). However, Hyde will recognize $80,000 of compensation (which will be deductible by the corporation). Jekyll and Hyde will have a basis in their Halloween stock of $125,000 and $95,000, respectively. Hyde’s basis is the carryover basis of $15,000 plus of income of $80,000 recognized on the transfer.*

b. Prepare the §351statement that must be included with the return.

***Halloween Inc. (Transferee Corporation) Statement Pursuant to Reg. §1.351-3(b)*** *1. The name and identification of every significant transferor:  
 (1) Dr. Jekyll  
 (2) Mr. Hyde  
2. Dates of the transfer:  
 October 31  
3. The aggregate fair market value and basis of all property received in the exchange:  
 (1) FMV of $200,000 basis of $125,000  
 (2) FMV of $200,000 basis of $15,000  
4. The date and number of any private letter rulings issued in conjunction with the transaction:  
 none*

42. [LO 2] Ron and Hermione formed Wizard Corporation on January 2. Ron contributed cash of $200,000 in return for 50 percent of the corporation’s stock. Hermione contributed a building and land with the following fair market value and adjusted basis in return for 50 percent of the corporation’s stock.

FMV Adjusted Basis

Building $ 75,000 $ 20,000  
 Land 175,000 80,000  
 Total $ 250,000 $ 100,000

To equalize the exchange, Wizard Corporation paid Hermione $50,000 in addition to her stock.

a. What amount of gain or loss does Ron *realize* on the formation of the corporation? What amount, if any, does he *recognize*?

*Ron does not realize gain on this transfer because only cash is transferred. As a result, no gain is recognized.*

b. What is Ron’s tax basis in the stock he receives in return for his contribution of property to the corporation?

*$200,000, equal to the cash transferred to the corporation.*

c. What amount of gain or loss does Hermione *realize* on the formation of the corporation? What amount, if any, does she *recognize*?

*Hermione realizes a gain of $150,000 on this transfer, computed as follows:*

*Fair market value of stock received $200,000  
+ Cash received 50,000  
Amount realized $250,000  
– Adjusted basis of assets transferred 100,000  
Gain realized $ 150,000*

*Hermione recognizes gain of $50,000, equal to the lesser of gain realized ($150,000) or boot received ($50,000).*

d. What is Hermione’s tax basis in the stock she receives in return for her contribution of property to the corporation?

*Adjusted basis of property contributed $100,000   
+ Gain recognized on the exchange 50,000   
– Cash (boot) received (50,000)  
Tax basis of stock received $100,000*

e. What adjusted basis does Wizard Corporation take in the land and building received from Hermione?

*Wizard Corporation increases the tax basis of the building and land to reflect the gain recognized by Hermione. The gain is allocated to the assets based on their relative fair market values:*

*Building: $75,000 / $250,000 × $50,000 = $15,000  
Land: $175,000 / $250,000 × $50,000 = $35,000  
The building’s tax basis = $20,000 + $15,000 = $35,000  
The land’s tax basis = $80,000 + $35,000 = $115,000*

Assume Hermione’s adjusted basis in the land was $200,000.

f. What amount of gain or loss does Hermione *realize* on the formation of the corporation? What amount, if any, does she *recognize*?

*Hermione realizes a gain of $30,000 on this transfer, computed as follows:*

*Fair market value of stock received $200,000  
+ Cash received 50,000  
Amount realized $250,000  
– Adjusted basis of assets transferred 220,000  
Gain realized $ 30,000*

*The boot (cash) received is allocated to the land and building based on their relative fair market values, as before.*

*Building: $75,000 / $250,000 × $50,000 = $15,000  
Land: $175,000 / $250,000 × $50,000 = $35,000*

*Hermione recognizes a gain of $15,000 on the contribution of the building, which is the lesser of the gain realized on the transfer of $55,000 or the amount of boot allocated to the building.*

g. What adjusted basis does Wizard Corporation take in the land and building received from Hermione?

*Wizard Corporation only increases the tax basis of the building because the land contributed by Hermione has a built-in loss. The boot allocated to the building remains $15,000 (see the answer to (e) above). The amount added to the building is the lesser of the gain realized on its exchange ($55,000) or the amount of boot allocated to the building ($15,000). The building’s tax basis is $35,000. The land’s tax basis remains a carryover basis of $200,000.*

Assume Hermione’s adjusted basis in the land was $250,000.

h. What amount of gain or loss does Hermione *realize* on the formation of the corporation? What amount, if any, does she *recognize*?

*Hermione realizes a loss of $(20,000) on this transfer, computed as follows:*

*Fair market value of stock received $200,000   
+ Cash received 50,000   
Amount realized $250,000   
– Adjusted tax basis of assets transferred 270,000   
Loss realized $( 20,000)*

*Hermione does not recognize the loss (boot received does not allow the transferor to recognize loss, only gain).*

i. What adjusted basis does Wizard Corporation take in the land and building received from Hermione?

*The corporation receives a carryover basis in the assets received from Hermione, reduced by the aggregate net built-in loss on the assets transferred, which is allocated to the land.*

*Building 20,000  
Land ($250,000 – 20,000) 230,000  
 Total (equal to the assets’ fair market value) $250,000*

*If the aggregate adjusted tax basis of property transferred to a corporation by a shareholder in a §351 transfer exceeds the aggregate fair market value of the assets, the aggregate tax basis of the assets in the hands of the transferee corporation cannot exceed their aggregate fair market value. The aggregate reduction in tax basis is allocated among the assets transferred in proportion to their respective built-in losses immediately before the transfer.*

j. What election can Hermione and Wizard Corporation make to allow Wizard Corporation to take a carryover basis in the land?

*As an alternative, the Hermione and Wizard can elect to reduce her stock basis to fair market value ($200,000) to eliminate the duplication of loss on the transfer.*

43. [LO 2] {Planning} This year Jack O. Lantern incurred a $60,000 loss on the worthlessness of his stock in the Creepy Corporation (CC). The stock, which Jack purchased in 2005, met all of the §1244 stock requirements at the time of issue. Jack’s wife, Jill, also incurred a $75,000 loss on the sale of Eerie Corporation (EC) stock that she purchased in July 2005 and which also satisfied all of the §1244 stock requirements at the time of issue. Both corporations are operating companies.

a. How much of the losses incurred on the two stock sales can Jack and Jill deduct this year, assuming they do not have capital gains in the current or prior years?

*Total deduction of $103,000. §1244 limits the ordinary loss deduction for a married couple filing jointly to $100,000. In this case, the total loss incurred on the §1244 stock is $135,000 ($60,000 + $75,000). The remaining $35,000 loss is treated as a capital loss, which can offset other capital gains plus $3,000 of ordinary income.*

b. Assuming they did not engage in any other property transactions this year, how much of a net capital loss will carryover to next year for Jack and Jill?

*They have a capital loss carryforward to next year of $32,000 ($35,000 – $3,000 deducted against ordinary income).*

c. What would be the tax treatment for the losses if Jack and Jill reported only $60,000 of taxable income this year excluding the securities transactions?

*The $100,000 ordinary loss deduction would create a net operating loss deduction of $40,000. As a result, none of the $35,000 capital loss could be used to offset additional ordinary income. The capital loss carryover would be $35,000.*

d. What tax planning suggestions can you offer the Lanterns to increase the tax benefits of these losses?

*To get the maximum tax benefit from the sales of §1244 stock, they should limit their total loss to $100,000, if possible. By recognizing the excess $35,000 this year, they could treat the entire loss as ordinary.*

44. [LO 2] Breslin, Inc. made a capital contribution of investment property to its 100 percent-owned subsidiary, Crisler Company. The investment property had a fair market value of $3,000,000 and a tax basis to Breslin of $2,225,000.

a. What are the tax consequences to Breslin, Inc. on the contribution of the investment property to Crisler Company?

*Breslin does not recognize gain or loss on the transfer.*

b. What is the tax basis of the investment property to Crisler Company after the contribution to capital?

*$2,225,000. Crisler’s tax basis is a carryover basis from Breslin.*

45. [LO 3] {Research} On February 4, 2013, Verint Systems Inc. acquired Comverse Technology Inc. in a tax-deferred acquisition. The Form 8-K for Comverse (ticker CMVT, cik 803014) describes the transaction and was filed with the SEC on August 13, 2012. You can access the Form 8-K at the SEC’s Investor website (http://www.sec.gov/edgar/searchedgar/webusers.htm). Read “Item 1.01, Entry into a Material Definitive Agreement” and determine which form of merger was used to affect the acquisition.

*This is a forward A (upstream) triangular reorganization. Note the distribution of assets by the target prior to the merger – Comverse is required to distribute all assets except Verint stock (41% of outstanding Verint shares) prior to the merger into a Verint sub. The only assets in the target at the time of the merger are shares of the acquirer! Apparently, despite the distribution, the merger meets the substantially all requirement in the IRC.*

46. [LO 3] {Research} On March 1, 2013, Leucadia National Corporation acquired Jefferies Group LLC, in a tax-deferred acquisition. The Form 8-K for Jefferies (ticker JEF, cik 1084580) describes the transaction and was filed with the SEC on November 13, 2012. You can access the Form 8-K at the SEC’s Investor website (http://www.sec.gov/edgar/searchedgar/webusers.htm). Read “Item 1.01, Entry into a Material Definitive Agreement” and determine which form of merger was used to affect the acquisition.

*This is a two-stage merger. In the first stage, the target (Jefferies) and the target’s subsidiaries merge with merger sub one in a downstream A (reverse triangle). In this merger, the target shareholders receive stock in Jefferies Holdings (a sub of the acquirer). Next, the target (“New” Jefferies) is converted into an LLC and merges into merger sub two in an upstream (forward triangle) with the result that merger sub two is a subsidiary of Jefferies Holdings, a subsidiary of the ultimate acquirer (Leucadia). In this second merger, shareholders owning stock in Jefferies Holdings will receive stock in Leucadia.*

47. [LO 4] Amy and Brian were investigating the acquisition of a tax accounting business, Bottom Line, Inc. (BLI). As part of their discussions with the sole shareholder of the corporation, Ernesto Young, they examined the company’s tax accounting balance sheet. The relevant information is summarized as follows:

FMV Adjusted Basis Appreciation

Cash $ 10,000 $ 10,000

Receivables 15,000 15,000

Building 100,000 50,000 50,000

Land 225,000 75,000 150,000

Total $ 350,000 $ 150,000 $ 200,000

Payables $ 18,000 $ 18,000

Mortgage\* 112,000 112,000

Total $ 130,000 $ 130,000

\* The mortgage is attached to the building and land.

Ernesto was asking for $400,000 for the company. His tax basis in the BLI stock was $100,000. Included in the sales price was an unrecognized customer list valued at $100,000. The unallocated portion of the purchase price ($80,000) will be recorded as goodwill.

a. What amount of gain or loss does BLI recognize if the transaction is structured as a direct asset sale to Amy and Brian? What amount of corporate-level tax does BLI pay as a result of the transaction, assuming a tax rate of 34 percent?

*BLI has an “amount realized” from the sale of $530,000, the $400,000 paid by Brian and Amy plus the liabilities assumed of $130,000. BLI recognizes a net gain of $380,000 on the sale of its assets to Amy and Brian ($530,000 – $150,000 aggregate basis in the assets sold). BLI would owe a corporate-level tax of $129,200 on the sale ($380,000 × 34 percent).*

b. What amount of gain or loss does Ernesto recognize if the transaction is structured as a direct asset sale to Amy and Brian, and BLI distributes the after-tax proceeds (computed in question a) to Ernesto in liquidation of his stock?

*Ernesto receives net cash of $270,800 ($400,000 – $129,200 taxes paid). Ernesto recognizes capital gain of $170,800 on the distribution ($270,800 – $100,000 stock basis).*

c. What are the tax benefits, if any, to Amy and Brian as a result of structuring the acquisition as a direct asset purchase?

*Amy and Brian receive a tax basis in the assets received equal to the assets’ fair market value.*

*Cash $ 10,000  
 Accounts receivable 15,000  
 Building 100,000  
 Land 225,000  
 Customer list 100,000  
 Goodwill 80,000  
 Total $530,000*

48. [LO 4] Using the same facts in problem 47, assume Ernesto agrees to sell his stock in BLI to Amy and Brian for $400,000.

a. What amount of gain or loss does BLI recognize if the transaction is structured as a stock sale to Amy and Brian? What amount of corporate-level tax does BLI pay as a result of the transaction, assuming a tax rate of 34 percent?

*$0. BLI does not recognize any gain or loss because it does not sell its assets to Brian and Amy.*

b. What amount of gain or loss does Ernesto recognize if the transaction is structured as a stock sale to Amy and Brian?

*$300,000 capital gain ($400,000 – $100,000 tax basis).*

c. What are the tax benefits, if any, to Amy and Brian as a result of structuring the acquisition as a stock sale?

*Amy and Brian do not get to write-up the tax basis of the assets to fair market value. The only potential tax benefits they could receive would be to preserve any beneficial tax attributes of BLI, such as a net operating loss or net capital loss carryover.*

49. [LO 4] Rather than purchase BLI directly (as in problems 47 and 48), Amy and Brian will have their corporation, Spartan Tax Services (STS), acquire the business from Ernesto in a tax-deferred Type A merger. Amy and Brian would like Ernesto to continue to run BLI, which he agreed to do if he could obtain an equity interest in STS. As part of the agreement, Amy and Brian propose to pay Ernesto $200,000 plus voting stock in STS worth $200,000. Ernesto will become a 10 percent shareholder in STS after the transaction.

a. Will the continuity of ownership interest (COI) requirements for a straight Type A merger be met? Explain.

*Yes. Ernesto receives equity in STS equal to 50 percent of the total consideration received ($200,000 / $400,000). For COI purposes, the equity must be at least 40 percent of the consideration received.*

b. What amount of gain or loss does BLI recognize if the transaction is structured as a Type A merger? What amount of corporate-level tax does BLI pay as a result of the transaction, assuming a tax rate of 34 percent?

*BLI does not recognize any gain or loss on the transfer of its assets in a Type A merger.*

c. What amount of gain or loss does Ernesto recognize if the transaction is structured as a Type A merger?

*Ernesto realizes gain of $300,000 in the exchange ($200,000 + $200,000 – $100,000). He must recognize $200,000, equal to the lesser of the gain realized or the cash (boot) received.*

d. What is Ernesto’s tax basis in the STS stock he receives in the exchange?

*Ernesto has a tax basis in his STS stock of $100,000, computed as:*

*Adjusted basis of stock exchanged $100,000   
+ Gain recognized on the exchange 200,000   
– Cash (boot) received (200,000)  
 Tax basis of stock received $100,000*

e. What are the tax bases of the BLI assets held by STS after the merger?

*STS takes a carryover basis plus any gain recognized by BLI on its transfer of assets. Gain recognized by Ernesto does not increase the basis of the BLI assets received by STS. As a result, STS takes a carryover basis in the assets.*

50. [LO 4] Robert and Sylvia propose to have their corporation, Wolverine Universal (WU), acquire another corporation, EMU, Inc., in a tax-deferred triangular Type A merger using an acquisition subsidiary of WU. The sole shareholder of EMU, Edie Eagle, will receive $250,000 plus $150,000 of WU voting stock in the transaction.

a. Can the transaction be structured as a forward triangular Type A merger? Explain why or why not.

*Probably not. In a forward triangular Type A merger, the continuity of interest (COI) requirement of a Type A merger must be met. In this transaction, COI is not met under the regulations because the value of the equity transferred is 37.5% of the total consideration received by Edie ($150,000/$400,000). The regulations seem to require a 40% equity interest.*

b. Can the transaction be structured as a reverse triangular Type A merger? Explain why or why not.

*No. In a reverse triangular merger, Edie must receive voting stock in WU equal to the fair market value of 80 percent of the EMU stock transferred. In this transaction, the WU equity received is only 37.5% of the fair market value of the EMU stock transferred.*

51. [LO 4] Robert and Sylvia propose to have their corporation, Wolverine Universal (WU), acquire another corporation, EMU, Inc., in a stock-for-stock Type B acquisition. The sole shareholder of EMU, Edie Eagle, will receive $400,000 of WU voting stock in the transaction. Edie’s tax basis in her EMU stock is $100,000.

a. What amount of gain or loss does Edie recognize if the transaction is structured as a stock-for-stock Type B acquisition?

*Edie realizes a $300,000 gain ($400,000 – $100,000) on the exchange. Because the transaction qualifies as a Type B reorganization, she does not recognize (defers) the gain.*

b. What is Edie’s tax basis in the WU stock she receives in the exchange?

*$100,000. Edie substitutes her stock basis in EMU for her new basis in WU.*

c. What is the tax basis of the EMU stock held by WU after the exchange?

*$100,000. WU carries over Edie’s stock basis in EMU as its tax basis.*

52. [LO 5] Shauna and Danielle decided to liquidate their jointly owned corporation, Woodward Fashions, Inc. (WFI). After liquidating its remaining inventory and paying off its remaining liabilities, WFI had the following tax accounting balance sheet.

FMV Adjusted Basis Appreciation

Cash $ 200,000 $ 200,000

Building 50,000 10,000 40,000

Land 150,000 90,000 60,000

Total $ 400,000 $ 300,000 $ 100,000

Under the terms of the agreement, Shauna will receive the $200,000 cash in exchange for her 50 percent interest in WFI. Shauna’s tax basis in her WFI stock is $50,000. Danielle will receive the building and land in exchange for her 50 percent interest in WFI. Danielle’s tax basis in her WFI stock is $100,000. Assume for purposes of this problem that the cash available to distribute to the shareholders has been reduced by any tax paid by the corporation on gain recognized as a result of the liquidation.

a. What amount of gain or loss does WFI recognize in the complete liquidation?

*WFI has a taxable transaction and recognizes gain of $40,000 on the transfer of the building and gain of $60,000 on the transfer of the land.*

b. What amount of gain or loss does Shauna recognize in the complete liquidation?

*Shauna recognizes gain of $150,000 on the transfer of her stock to WFI ($200,000 – $50,000) in complete liquidation of WFI.*

c. What amount of gain or loss does Danielle recognize in the complete liquidation?

*Danielle recognizes gain of $100,000 on the transfer of her stock to WFI ($200,000 – $100,000) in complete liquidation of WFI.*

d. What is Danielle’s tax basis in the building and land after the complete liquidation?

*Danielle’s tax basis equals the fair market value of the assets she receives (building: $50,000, land: $150,000).*

53. [LO 5] Tiffany and Carlos decided to liquidate their jointly owned corporation, Royal Oak Furniture (ROF). After liquidating its remaining inventory and paying off its remaining liabilities, ROF had the following tax accounting balance sheet.

FMV Adjusted Basis Appreciation (Depreciation)

Cash $ 200,000 $ 200,000

Building 50,000 10,000 40,000

Land 150,000 200,000 (50,000)

Total $ 400,000 $ 410,000 $ (10,000)

Under the terms of the agreement, Tiffany will receive the $200,000 cash in exchange for her 50 percent interest in ROF. Tiffany’s tax basis in her ROF stock is $50,000. Carlos will receive the building and land in exchange for his 50 percent interest in ROF. His tax basis in the ROF stock is $100,000. Assume for purposes of this problem that the cash available to distribute to the shareholders has been reduced by any tax paid by the corporation on gain recognized as a result of the liquidation.

a. What amount of gain or loss does ROF recognize in the complete liquidation?

*ROF recognizes gain of $40,000 on the transfer of the building and recognizes a $50,000 loss on the transfer of the land. Although this distribution is non-pro rata, Carlos is not a related person because he does not own more than 50 percent of ROF stock.*

b. What amount of gain or loss does Tiffany recognize in the complete liquidation?

*Tiffany recognizes gain of $150,000 on the transfer of her stock to ROF ($200,000 – $50,000).*

c. What amount of gain or loss does Carlos recognize in the complete liquidation?

*Carlos recognizes gain of $100,000 on the transfer of his stock to ROF ($200,000 – $100,000).*

d. What is Carlos’s tax basis in the building and land after the complete liquidation?

*Carlos receives a tax basis equal to the fair market value of the assets he receives (building: $50,000, land: $150,000).*

Assume Tiffany owns 40 percent of the ROF stock and Carlos owns 60 percent. Tiffany will receive $160,000 in the liquidation and Carlos will receive the land and building plus $40,000.

e. What amount of gain or loss does ROF recognize in the complete liquidation?

*ROF recognizes gain of $40,000 on the transfer of the building, but cannot recognize loss of $50,000 on the transfer of the land. This distribution is non-pro rata and the recipient, Carlos, is a related person because he owns more than 50 percent of ROF stock.*

f. What amount of gain or loss does Tiffany recognize in the complete liquidation?

*Tiffany recognizes gain of $110,000 on the transfer of her stock to ROF ($160,000 – $50,000).*

g. What amount of gain or loss does Carlos recognize in the complete liquidation?

*Carlos recognizes gain of $140,000 on the transfer of his stock to ROF ($240,000 – $100,000).*

h. What is Carlos’s tax basis in the building and land after the complete liquidation?

*Carlos receives a tax basis equal to the fair market value of the assets he receives (building: $50,000, land: $150,000). If Carlos later sells the land for more than $150,000 but less than $200,000, he will recognize neither gain nor loss on the sale.*

54. [LO 5] Jefferson Millinery, Inc. (JMI) decided to liquidate its wholly-owned subsidiary, 8 Miles High, Inc. (8MH). 8MH had the following tax accounting balance sheet.

FMV Adjusted Basis Appreciation

Cash $ 200,000 $ 200,000

Building 50,000 10,000 40,000

Land 150,000 90,000 60,000

Total $ 400,000 $ 300,000 $ 100,000

a. What amount of gain or loss does 8MH recognize in the complete liquidation?

*8MH does not recognize gain or loss on the liquidation because the liquidating distribution is to a corporation that owns 80-percent-or-more of 8MH.*

b. What amount of gain or loss does JMI recognize in the complete liquidation?

*JMI does not recognize gain or loss on the receipt of the liquidating distribution because it owns 80-percent-or-more of 8MH.*

c. What is JMI’s tax basis in the building and land after the complete liquidation?

*JMI takes a carryover tax basis in each of 8MH’s assets received in the liquidation.*

55. [LO 5] Jones Mills, Inc. (JMI) decided to liquidate its wholly owned subsidiary, Most Help, Inc. (MH). MH had the following tax accounting balance sheet.

FMV Adjusted Basis Appreciation

Cash $ 200,000 $ 200,000

Building 50,000 10,000 40,000

Land 150,000 200,000 (50,000)

Total $ 400,000 $ 410,000 $ (10,000)

a. What amount of gain or loss does MH recognize in the complete liquidation?

*MH does not recognize gain or loss on the liquidation because the liquidating distribution is to a corporation that owns 80-percent or more of MH.*

b. What amount of gain or loss does JMI recognize in the complete liquidation?

*JMI does not recognize gain or loss on the receipt of the liquidating distribution because it owns 80-percent-or-more of MH.*

c. What is JMI’s tax basis in the building and land after the complete liquidation?

*JMI takes a carryover tax basis in each of MH’s assets received in the liquidation.*

**Comprehensive Problems**

56. Several years ago, your client, Brooks Robinson, started an office cleaning service. His business was very successful, owing much to his legacy as the greatest defensive third baseman in major league history and his nickname, “The Human Vacuum Cleaner.” Brooks operated his business as a sole proprietorship and used the cash-basis method of accounting. Brooks was advised by his attorney that it is too risky to operate his business as a sole proprietorship and that he should incorporate to limit his liability. Brooks has come to you for advice on the tax implications of incorporation. His balance sheet is presented below. Under the terms of the incorporation, Brooks would transfer the assets to the corporation in return for 100 percent of the company’s common stock. The corporation would also assume the company’s liabilities (payables and mortgage).

# Balance Sheet

Adjusted Basis FMV

Accounts receivable 0 5,000  
 Cleaning equipment (net) 25,000 20,000  
 Building 50,000 75,000  
 Land 25,000 50,000  
 Total assets $100,000 $150,000  
 Accounts payable 0 10,000  
 Salaries payable 0 5,000  
 Mortgage on land and building 35,000 35,000  
 Total liabilities $35,000 $50,000

a. How much gain or loss does Brooks *realize* on the transfer of each asset to the corporation?

*Fair market value of stock received\* $100,000  
+ Liabilities assumed by corporation 50,000  
Amount realized $150,000*

*\* $150,000 (FMV of assets) – $50,000 (liabilities assumed)*

*Brooks allocates the amount realized to each of the assets transferred (by relative fair market value) and subtracts the asset’s adjusted basis to compute gain or loss realized on each asset:*

*Accts Rec Equipment Building Land Total*

*FMV $5,000 $20,000 $75,000 $50,000 $150,000  
AB 0 25,000 50,000 25,000 100,000  
Gain/loss $5,000 $(5,000) $25,000 $25,000 $ 50,000*

b. How much, if any, gain or loss (on a per asset basis) does Brooks *recognize*?

*Brooks does not recognize any gain or loss on this transaction because he satisfies the §351 requirements and he has not received any boot from the corporation.*

c. How much gain or loss, if any, must the corporation recognize on the receipt of the assets of the sole proprietorship in exchange for the corporation’s stock?

*The corporation does not recognize gain or loss when it exchanges its stock for property. Section 1032 states that a corporation does not recognize gain or loss on the distribution of its own stock.*

d. What tax basis does Brooks have in the corporation’s stock?

*The basis in the stock received is computed using the substituted basis rules of §358, as follows:*

*Adjusted basis of property contributed $100,000   
+ Gain recognized on the exchange 0   
– Mortgage assumed by corporation\* (35,000)  
Tax basis of stock received $ 65,000*

*\*§358(d)(1) treats liabilities assumed as money received by the taxpayer for purposes of computing the stock basis. However, §358(d)(2) excludes from the computation any liability excluded under §357(c)(3). Liabilities described in §357(c)(3) are those liabilities the payment of which would give rise to a deduction. Because Brooks is on the cash basis, payment of the accounts and salaries payable would give rise to a deduction; therefore they are not subtracted in computing the stock basis. If Brooks was on the accrual basis, the corporation’s assumption of these liabilities would reduce his stock basis.*

e. What is the corporation’s tax basis in each asset it receives from Brooks?

*The corporation takes a carryover basis in each asset transferred, increased by any gain recognized on the transfer by Brooks (§362). In this case, no gain was recognized by Brooks; therefore the tax basis of each asset carries over to the corporation unchanged.*

*Accounts receivable $ 0  
Equipment 25,000  
Building 50,000  
Land 25,000  
 Total $100,000*

f. How would you answer the question in part (b) if Brooks had taken back a 10-year note worth $25,000 plus stock worth $75,000 plus the liability assumption?

*The 10-year note is considered boot under §351(b). Brooks must allocate the fair market value of the note to each asset transferred and then recognize gain (not loss) equal to the lesser of the*

*• Gain realized on the asset transfer, or  
• The fair market value of the note allocated to the asset.*

*The FMV of the note is allocated to the assets transferred using the relative fair market values of the assets.*

*Accts Rec: 5,000/150,000 × $25,000 = $833  
Equipment: 20,000/150,000 × $25,000 = $3,333  
Building: 75,000/150,000 × $25,000 = $12,500  
Land: 50,000/150,000 × $25,000 = $8,333*

*Gain recognized:   
Accts Rec: lesser of $5,000 or $833  
Equipment: the $5,000 loss is not recognized  
Building: lesser of $25,000 or $12,500  
Land: lesser of $25,000 or $8,333  
Total gain recognized is $21,667.*

*An aside: The tax year(s) in which the gain is recognized depends on whether Brooks accounts for the gain under the installment method (§453) or elects to recognize the entire gain currently. If he does not elect out of the installment method, he will recognize the gain as the principal on the security is collected ($2,167 per year for ten years). Brooks will be subject to interest payments on the deferred tax.*

g. Will Brooks be able to transfer the accounts receivable to the corporation and have the corporation recognize the income when the receivable is collected?

*Yes. The transfer of the cash basis receivables meets the definition of an “assignment of income,” which generally the IRS and courts prohibit. However, the courts have held that a transfer of cash basis receivables to a corporation should not be subject to the assignment of income rules (Hempt Bros., Inc.). The IRS acquiesced to a degree in Rev. Rul. 80-198, in which it allowed the transfer if made for a valid business reason and the transferor did not accumulate the receivables prior to the transfer in anticipation of the transfer (i.e., to shift the income to a lower tax rate bracket).*

h. Brooks was depreciating the equipment (200% declining balance) and building (straight-line) using MACRS when it was held inside the proprietorship. How will the corporation depreciate the equipment and building? Assume Brooks owned the equipment for four years (7 year property) and the building for 6 years.

*§168(i)(7) states that in certain transactions, of which §351 is one, the transferee corporation will be treated as the transferor for purposes of computing the depreciation deduction with “respect to so much of the basis in the hands of the transferee as does not exceed the adjusted basis in the hands of the transferor.” This means that the corporation steps into the shoes of Brooks with respect to the basis that carries over under §362 and continues to use the same depreciation schedule as Brooks was using prior to the transfer.*

*With respect to basis in excess of the carryover basis (the gain portion), the corporation treats this portion as a new asset and is required to elect a new depreciation schedule for this amount. For tax purposes, the single physical asset becomes two depreciable assets.*

i. Will the corporation be able to deduct the liabilities when paid? Will it matter which accounting method (cash or accrual) the corporation uses?

*If Brooks transfers the accounts and salaries payable and there is a business purpose for the transfer, the corporation can deduct the amounts when paid, regardless of the accounting method chosen by the corporation (Rev. Rul. 80-198, 1980-2 C.B. 113). Alternatively, Brooks could retain enough accounts receivable to offset the accounts payable and deduct the expenses when paid.*

j. Would you advise Brooks to transfer the land and building to the corporation? What other tax strategy might you suggest to Brooks with respect to the realty?

*Most tax advisers recommend that taxpayers not transfer realty to their corporation. By keeping the building and land out of the corporation, Brooks could lease the property to the corporation and receive tax deductible rent payments from the corporation. This could alleviate reasonable compensation issues that might arise if Brooks pays himself too much salary. Another reason for keeping property out of the corporation is the negative tax consequences that could arise if Brooks liquidated the corporation and took the property back. Liquidating distributions of appreciated property to the shareholders are taxable to the corporation and the shareholder.*

57. Your client, Midwest Products, Inc. (MPI), is a closely-held, calendar-year, accrual-basis corporation located in Fowlerville, Michigan. MPI has two operating divisions. One division manufactures lawn and garden furniture and decorative objects (furniture division), while the other division manufactures garden tools and hardware (tool division). MPI’s single class of voting common stock is owned as follows:

Shares Tax Basis FMV

Iris Green 300 $2,000,000 $3,000,000  
 Rose Ruby 100 1,200,000 1,000,000  
 Lily White 100 800,000 1,000,000  
 Totals 500 $4,000,000 $5,000,000

The three shareholders are unrelated.

Outdoor Living Company (OLC), a publicly held, calendar-year corporation doing business in several midwestern states, has approached MPI about acquiring its furniture division. OLC has no interest in acquiring the tool division, however. OLC’s management has several strong business reasons for the acquisition, the most important of which is to expand the company’s market into Michigan. Iris, Rose, and Lily are amenable to the acquisition provided it can be accomplished in a tax-deferred manner.

OLC has proposed the following transaction for acquiring MPI’s furniture division. On April 30 of this year OLC will create a 100-percent owned subsidiary, OLC Acquisition, Inc. (OLC-A). OLC will transfer to the subsidiary 60,000 shares of OLC voting common stock and $2,000,000. The current fair market value of the OLC voting stock is $50 per share ($3,000,000 in total). Each of the three MPI shareholders will receive a pro rata amount of OLC stock and cash.

As part of the agreement, MPI will sell the tool division before the acquisition, after which MPI will merge into OLC-A under Michigan and Ohio state laws (a forward triangular Type A merger). Pursuant to the merger agreement, OLC-A will acquire all of MPI’s assets, including 100 percent of the cash received from the sale of the tool division ($2,000,000), and will assume all of MPI’s liabilities. The cash from the sale of the tool division will be used to modernize and upgrade much of the furniture division’s production facilities. OLC’s management is convinced that the cash infusion, coupled with new management, will make MPI’s furniture business profitable. OLC management has no plans to liquidate OLC-A into OLC at any time subsequent to the merger. After the merger, OLC-A will be renamed Michigan Garden Furniture, Inc.

a. Determine whether the proposed transaction meets the requirements to qualify as a tax-deferred forward triangular Type A merger. Consult Rev. Rul. 88-48 and Rev. Rul. 2001-25 in thinking about the premerger sale of the tool division assets.

*It should. The transfer meets the continuity of interest requirement because the three shareholders of MPI receive, in the aggregate, stock in OLC valued at $3,000,000, out of total consideration received of $5,000,000 (60 percent). The transfer meets the continuity of business enterprise requirement. To meet this requirement, OLC must continue MPI’s historic business or continue to use a “significant” portion of its historic business assets. In this transaction, OLC continues to operate MPI’s furniture division, which should satisfy the COBE requirement. The transfer meets the business purpose test. OLC’s primary motivation for acquiring MPI is to expand its market into Michigan, thus satisfying this requirement.*

*OLC-A must acquire substantially all of MPI’s property in the merger. To receive a ruling from the IRS, OLC-A must acquire 90 percent of the fair market value of MPI’s net properties (assets – liabilities), and 70 percent of the fair market value of the MPI’s gross properties (Rev. Rul. 72-576, 1972-2 C.B. 217). MPI has a gross FMV of $6,000,000 and a net FMV of $5,000,000. The furniture division constitutes 66.7% of gross FMV ($4,000,000/$6,000,000) and 60 percent of net FMV ($3,000,000 / $5,000,000). OLC could not get a ruling as to whether the substantially all test is met if only the furniture division is considered.*

*In the proposed transaction, the cash from sale of the tools division will be transferred to OLC-A. In Rev. Rul. 2001-25, the IRS held that transfer of cash from sale of unwanted assets prior to a reverse triangular Type A merger did not violate the substantially all test if the cash was transferred to the acquiring corporation. Applying this principle to this transaction, OLC-A will be treated as acquiring 100 percent of MPI’s assets.*

b. Could the proposed transaction qualify as a reverse triangular Type A merger if OLC-A merged into MPI? If not, how would the transaction have to be restructured to meet the requirements to be a reverse triangular merger?

*No. The MPI shareholders only receive equity equal to 60 percent of the consideration received. To be a tax-deferred reverse triangular Type A merger, the equity must be voting stock equal to 80 percent of the consideration transferred. To rectify the transaction, OLC would have to give the MPI shareholders voting stock worth $4,000,000 (80 percent × $5,000,000) if it wanted to structure the transaction as a reverse triangular Type A merger.*

58. Rex and Felix are the sole shareholders of the Dogs and Cats Corporation (DCC). After several years of operations using the accrual method, they decided to liquidate the corporation and operate the business as a partnership. Rex and Felix hired a lawyer to draw up the legal papers to dissolve the corporation, but they need some tax advice from you, their trusted accountant. They are hoping you will find a way for them to liquidate the corporation while minimizing the total tax liability.

The DCC’s tax accounting balance sheet at the date of liquidation is as follows:

Adjusted Basis FMV

Cash $30,000 $30,000  
Accounts receivable 10,000 10,000  
Inventory 10,000 20,000  
Equipment 30,000 20,000  
Building 15,000 30,000  
Land 5,000 40,000  
 Total assets $100,000 $150,000  
  
Accounts payable $5,000  
Mortgage payable – Building 10,000  
Mortgage payable – Land 10,000  
Total liabilities $25,000  
  
Common stock – Rex (80%) $60,000 $100,000  
Common stock – Felix (20%) 30,000 25,000  
Total shareholders’ equity $90,000 $125,000

a. Compute the gain or loss recognized by Rex, Felix, and DCC on a complete liquidation of the corporation assuming each shareholder receives a pro rata distribution of the corporation’s assets and assumes a pro rata amount of the liabilities.

*DCC:   
Gain recognized:   
Inventory ($20,000 – $10,000) $10,000   
Building ($30,000 – $15,000) 15,000   
Land ($40,000 – $5,000) 35,000   
Total gain recognized $60,000   
  
Loss recognized:   
Equipment ($20,000 – $30,000) $(10,000)   
  
The loss is deductible because the loss property is distributed pro rata to each of the shareholders. Thus, the corporate level tax will be $7,500.*

*Rex:   
FMV of assets received (80% × $150,000) $120,000   
– Liabilities assumed (80% × $25,000) ( 20,000)  
– Corporate tax (80% × $7,500) ( 6,000)  
Amount realized $94,000   
– Tax basis of stock (60,000)  
Gain recognized $24,000*

*Felix:  
FMV of assets received (20% × $150,000) $30,000   
– Liabilities assumed (20% × $25,000) ( 5,000)  
– Corporate tax (20% × $7,500) ( 1,500)  
Amount realized $23,500   
– Tax basis of stock (30,000)  
Loss recognized $( 6,500)*

b. Compute the gain or loss recognized by Rex, Felix, and DCC on a complete liquidation of the corporation assuming Felix receives $25,000 in cash and Rex receives the remainder of the assets and assumes all of the liabilities.

*DCC recognizes the same $60,000 gain as before, but DCC cannot recognize the loss on the distribution of the equipment because the loss property is distributed to a related person (Rex is a more-than-50-percent shareholder) in a non pro rata distribution). Hence, DCC will owe an additional $2,500 in corporate level tax. Felix’s $500 share of this liability will increase his loss to $7,000 while Rex’s $2,000 share of this liability will reduce his gain to $22,000.*

Assume Felix received the accounts receivable and equipment and assumed the accounts payable.

c. Will Felix recognize any income when he collects the accounts receivable?

*Felix will not recognize any income when he collects the accounts receivable because his basis in the accounts receivable will be $10,000, which is equal to the amount to be collected (DCC already recognized income under the accrual method when the receivable was created).*

d. Will Felix be able to take a deduction when he pays the accounts payable?

*Felix will not get a second deduction when he pays the accounts payable because DCC already took this deduction under the accrual method when the liability was created.*

Assume Rex is a corporate shareholder of DCC.

e. Compute the gain or loss recognized by Rex, Felix, and DCC on a complete liquidation of the corporation assuming each shareholder receives a pro rata distribution of the corporation’s assets and assumes a pro rata amount of the liabilities.

*DCC recognizes a gain of $12,000 on the distribution to Felix under §336 (20% × $60,000 = $12,000) and pays $1,800 of corporate tax. DCC does not recognize gain on the distribution to Rex Corporation (§337). DCC does not recognize loss on the distribution to either Rex Corporation or Felix under §336(d)(3) (this is a transaction to which §332 applies; therefore, no loss is allowed on the distribution of any property to any shareholder).*

*Rex Corporation does not recognize any gain on the liquidation because §332 applies to this transaction (Rex Corporation is an 80-percent-or-more corporate shareholder).*

*Felix receives assets and liabilities worth $24,640. Thus, under §331 Felix recognizes a loss of $5,640 ($30,000 less $5,000 less $360).*

f. Compute the gain or loss recognized by Rex, Felix, and DCC on a complete liquidation of the corporation assuming Felix receives $25,000 in cash and Rex receives the remainder of the assets and assumes all of the liabilities.

*In this case, DCC recognizes no gain or loss because §337 applies to the distribution to Rex and no appreciated assets are distributed to Felix. Rex Corporation does not recognize any gain on the liquidation under §332. Felix will recognize a loss of $5,000 ($30,000 less $5,000 less the AB of $30,000).*

Assume the equipment was contributed by Rex to DCC in a §351 transaction two months prior to the liquidation. At the time of the contribution, the property’s fair market value was $25,000.

g. Would the tax result change if the property was contributed one year ago? Two years ago? Three years ago?

*The contribution of loss property to a corporation within two years of a liquidation could cause the loss to be disallowed under §336(d)(2). Under this “anti-stuffing” provision, the “built-in loss” existing at the time of the property’s contribution ($25,000 – $30,000 = -$5,000 in this case) is disallowed unless there is a “clear and substantial relationship between the contributed property and the conduct of the corporation’s current and future business enterprises.” DCC will be able to deduct $5,000 of the $10,000 loss, and may be able to deduct the entire $10,000 if it can show a corporate business purpose for contributing the property.*

59. {Tax Forms} {Research} Cartman Corporation owns 90 shares of SP Corporation. The remaining 10 shares are owned by Kenny (an individual). After several years of operations, Cartman decided to liquidate SP Corporation by distributing the assets to Cartman and Kenny.

SP reported the following balance sheet at the date of liquidation:

Adjusted Basis FMV

Cash $ 12,000 $ 12,000  
Accounts receivable 8,000 8,000  
Stock investment 2,000 10,000  
Land $40,000 70,000  
 Total assets $ 62,000 $100,000  
  
Common stock – Cartman (90%) $ 10,000 $ 90,000  
Common stock - Kenny (10%) 7,000 10,000  
 Total shareholder equity $ 17,000 $100,000

a Compute the gain or loss recognized by SP, Cartman, and Kenny on a complete liquidation of the corporation where SP distributes $10,000 of cash to Kenny and the remaining assets to Cartman.

***SP*** *recognizes no gain or loss under §337 to the extent that the transaction qualifies as the liquidation of a controlled subsidiary under §332. However, the distribution to Kenny would trigger gain recognition under §336 (but not loss - see §336(d)(3)). However, there is zero gain realized on the distribution of cash to Kenny.****Cartman*** *would recognize no gain or loss because the transaction qualifies as the liquidation of a controlled subsidiary under §332. Cartman takes a carryover basis in the assets under §334.****Kenny*** *recognizes a $3,000 gain under §331 ($10,000 cash received minus $7,000 stock basis).*

b. Compute the gain or loss recognized by SP, Cartman, and Kenny on a complete liquidation of the corporation where SP distributes the stock investment to Kenny and the remaining assets to Cartman. Assume that SP’s tax rate is zero.

***SP*** *recognizes a gain of $8,000 under §336 as if stock investment was sold at its fair market value ($10,000 - $2,000). No gain is recognized on the assets it distributes to Cartman.****Cartman*** *would recognize no gain or loss because the transaction qualifies as the liquidation of a controlled subsidiary under §332. Cartman takes a carryover basis in the assets under §334.****Kenny*** *recognizes a $3,000 gain on the distribution under §331($10,000 fmv of stock investment received minus $7,000 basis in SP stock) and has a $10,000 basis in the stock investment.*

c. What form needs to be filed with the liquidation of SP?

*Form 966 needs to be filed within 30 days of the plan of liquidation adoption.*