Business Entities Tax classnotes, Spring 2006. John Miller.

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<u>Tuesday, January 10</u>

Introduction

- Course outline: we will walk through the life cycle of:
    1. Parnerships (most of our attention will be here)
        - §§ 701 – 761
        - This is the main entity for business, nowadays
        - These are tax conduits: partners are taxed on income even if it is not distributed to them. Thus, we need a mechanism to avoid double taxation—this mechanism is basis.
        - A partnership can be liquidate without any gain recognition.
    2. C corporations
        - §§ 301 – 381
        - Historically, this has been the main entity for business. It is still the main entity for publicly-traded entities.
        - These are separate tax entities—they pay their own income taxes. Distributions create a second tax, and this is why most entities don't operate as C corporations.
            - However, at least temporarily, dividends are taxed at 15%, which is the same as the capital gains rate.
        - Liquidation of a C corporation is a taxable event (it is a sale or exchange between the corporation and its shareholders).
    3. S corporations
        - §§ 1361 – 1374
        - This is a hybrid entity.
        - These are tax conduits, like partnerships, but in a simplified form. They still, though, have many features of C corporations (including liquidation as a gain recognition event).
- For each entity, we will look at:
    - Formation
    - Operation
    - Shutdown

    All from a tax perspective.

Review of major tax concepts

- Basis: your tax investment in something that has already been taxed.
    - § 1012: basis is cost.
    - § 1015: donees take their donor's basis, but there is no transfer of unrealized loss (in that case, the donee takes an FMV basis).
    - § 1041: transfers between spouses—the transferee always take the transferor's basis.
    - § 1016(a): adjustments to basis

        - (1): upward adjustment for additional capital contributions
        - (2): downward adjustment for depreciation deductions
- Realization and recognition
    - § 1001: GR = AR – AB; LR = AB – AR
        - (c): gains realized must be recognized, unless this provision is overridden by another section (e.g. § 1031 for like-kind exchanges, and formation exchanges of property for an equity interest in an entity).
- Capital gains versus ordinary income
- Depreciation recapture
    - § 1250: the only depreciation recaptured, as OI, is depreciation in excess of straightline (which can't be done with real property under current law).
- Installment sales
- Cash versus accrual accounting
- The *Crane* principle: if property is transferred subject to a mortgage, AR includes the amount of debt transferred away.
- Discharge of indebtedness: if a debt is forgiven, there's income in that amount (but it is *not* AR, as with *Crane* situations).
- At-risk and passive activity loss limitations
    - These apply with partnerships. See § 469.

<u>Wednesday, January 11</u>

PARTNERSHIPS

Basics

- Check-the-box regulations: R 301.7701-3: you can pick your entity form for tax purposes, unless you're a true, legal corporation.
- Parnerships types
    - General partnership
    - Limited partnership (LP)
    - Limited liability partnership (LLP)
    - Limited liability limited partnership (LLLP)
    - Limited liability company (LLC)
        - Note that LLCs can have a single owner, and if so they can elect to be treated as a disregarded entity. If they do not so elect, they will be treated as a corporation for tax purposes, R 301.7701-2.
- Entity choice
    - GP/LP/LLP versus LLC
        - Partnership law is more well-developed than LLC law
        - Estate planning: GP interests are converted to assignee interests under most state law, and this affects the value (down) of the underlying interest (because there's no control over the entity anymore).
    - Idaho
        - LLC Act: IC §§ 53-601 to 672

    - LP Act: IC §§ 53-201 to 268
    - UPA: IC §§ 53-301 et seq.
- What *is* a partnership for tax purposes?
  - A conduit (pass-through entity): the "aggregate" theory of partnership tax
  - But there's also an entity aspect to them—the partnership as an entity:
    - Selects a tax year
    - Selects an accounting method
    - Selects a depreciation method
    - Characterizes gain (i.e., to determine whether it is OI or CG, look to the *partnership*'s relationship to the asset)
- What's the difference between a partnership and mere co-ownership?
  - An intention to share profits (and often losses, too) makes something look like a partnership. See *Allison*.
  - Active management also makes something look more like a partnership.

  What if you have two owners of property who hire a manager? If the agent is actively conducting a business, then this might be a partnership. This is borderline, Miller says. See RR 75-374 and R 301.7701-1(a)(2).

  - Joint ventures: these are usually for a single undertaking. They are treated as partnerships for tax purposes. § 761.
  - Whether something is a partnership for tax purposes is a question solely of federal law, which will look to state law to define the rights of the parties. But this is not a significant issue now, because of the check-the-box regulations.
- N.b., trusts: see R 301.7701-4(b) and (c). Trusts get a deduction for the amount of earnings they distribute.

<u>Thursday, January 12</u>

Formation

- Subchapter K: §§ 701 – 771
- Forming a business
  - Generally, this is a sale or exchange—a transfer of assets for an ownership interest.
  - Focus: §§ 721 – 723
- Contribution
  - No gain or loss recognized. § 721.
    - This includes any § 1245 gain—see § 1245(b)(3), which says that you don't have to recognize any gain that you wouldn't recognize anyway (under § 721 and the other sections mentioned there). (Recall that you must look for all exceptions to § 1245 only in § 1245 itself.)
    - § 721(b): this is a very limited exception to the no-recognition rule. We are not responsible for this for exam purposes.
    - There are three ways that a partner *could* recognize gain on formation:

        1. Contribution of services. § 83.
        2. If the transfer is actually a sale to the partnership. § 707(a).
        3. If the partnership distributes cash to the partner in excess of the partner's basis. §§ 752 et al.
  - Basis
    - Partnership's basis (IB): same as the property contributed in the hands of the contributing partner. This is a "transferred basis," § 7701(a)(43).
    - Partner's basis (OB): same as the basis of the property contributed. This is an "exchanged basis," § 7701(a)(44).
    - Generally, IB = OB. But sometimes not.
  - Holding period
    - Partners: get tacking under § 1223(1).
    - Partnership: gets tacking under § 1223(2).
  - § 704(c): this provision protects against assignments of income. It also helps put OB in line with the partner's equity interest (his cap account).
  - Character (§ 724): the character of gain and loss with respect to contributed property will be the same in the hands of the partnership as in the hands of the contributing partner.
  - RR 99-5 (p38): different forms of formation can have substantially different tax consequences.

<u>Friday, January 13</u>

Partnership accounting

- How do we keep track of partners' equity interests as the partnership's value changes over time? With cap accounts.
  - These are separate from the tax books.
  - The rules for keeping cap accounts are at R 1.704-1(b)(2)(iv), especially (iv)(b).
    - The basic rules:
      - Start with cash plus FMV of property contributed.
      - ADD income and gain allocated to the partner.
      - SUBTRACT cash distributed to the partner.
      - SUBTRACT FMV of property distributed to the partner.
      - SUBTRACT losses allowed to the partner.
      - And that's your ending balance.
    - Adjusting OB: this is the same as adjusting cap accounts, except that:
      - Start with cash plus *basis* of property contributed.
      - SUBTRACT *basis* of property distributed, rather than FMV.
  - Borrowing money
    - Owner's equity doesn't change, and so neither do the cap accounts.
    - But OB *does* change—borrowing can increase OB, because you take a cost basis under *Crane*. Thus, the bigger a partner's share of liabilities, the bigger his OB (and so the more income he can absorb).

- New partners
  - When a new partner joins the partnership, restate and revalue the old partners' cap accounts. Do not restate the tax accounts.
  - Also, the new partner won't want to pay for any gain on the appreciated property inside the partnership, so he will want a § 704(b) adjustment on § 704(c) principles. This way, only the gain after his arrival will be allocated to him.

<u>Tuesday, January 17</u>

Liabilities

- § 752 governs these, and it is connected with §§ 722, 723 (and also 731 and 733).
- Partners care a lot about OB:
  - Cash distributions are not taxed to the a partner unless they exceed his OB—that is, they are generally governed by § 731. They are normally CG under § 741.
  - § 704(d) says that a partner can't take losses and deduct them against other income *to the extent* that the losses exceed his OB.

  Thus, partners like having a high OB. This makes partnerships attractive, because borrowing affects OB, under § 752.

<u>Wednesday, January 18</u>

- How we allocate liabilities to partners is not covered by the code itself—we must look to the regulations under § 752.
  - There's a difference in the treatment for recourse and nonrecourse liabilities.
    - How do we distinguish between the two?
      - (Some nonrecourse liabilities can be treated as recourse, e.g. if a partner pledges property to the bank or pledges to indemnify the other partners.)
      - R 1.752-1(a)(1) & (2): ask—who, under actual circumstances, will bear the economic loss if the liability must be repaid?
        - R 1.752-2(a) says to employ *constructive liquidation* to determine whether a particular partner bears the economic loss.
          - R 1.752-2(b) tells us how to do a constructive liquidation: assume a liquidation where all the partnership's assets are worthless.
            - If nobody would have to pay, then the liability is nonrecourse.
            - If someone would have to pay, then it's recourse—ask who would pay.
          - Note that with LPs, limited partners can agree (in

the partnership agreement) to contribute to the partnership in certain circumstances, and this may mean that they're bearing some of the economic risk of loss. See R 1.752-2(b)(1) & (3)(ii).

- Nonrecourse liabilities: 1.752-3(a)(1), (2), & (3)
  - Allocation schemes:
    1. Share of "partnership minimum gain"
    2. Share of § 704(c) gain: this is where a partner contributes property that is already subject to a liability.
       - Cap account: increased by the *net* value contributed (and this is only one of two times where liabilities will affect cap accounts at all (the other is in the distribution of encumbered property)).
       - OB: theoretically, (1) reduced by the amount of liabilities that the partner is relieved of, then (2) increased by the partner's share of the liabilities. But only the *net* actually affects the contributing partner's OB, so that there's no unnecessary gain recognition.

         That is:

         $OB_{New} = OB_{Old}$ – (debt relief – debt assumption)

       * -3(a)(2): says to first allocate to the contributing partner the amount of gain he would have if he walked away from the partnership, which is (debt relief) – AB.
    3. In accordance with the partner's share of profits

<u>Thursday, January 19</u>

- A hypo:
  - A and B contribute $50K
  - C contributes an asset:
    - AB = 40K
    - FMV = 110K
    - Lb. = 60K
  - If this is a recourse liability:
    - OB for A and B = 50 + 20 = 70.

        - OB for C = 40 + (60 – 20) = 0.
        - If C's AB was 25K:
            - OB for A and B still = 50 + 20 = 70.
            - OB for C = 25 + (60 – 20) = 0, and 15K gain (under § 731, usually CG under § 741).
            - This means that IB = 50 + 50 + 25 = 125, but OB = 70 + 70 + 0 = 140!!!
                - This is a distrotion, because the gain to C doesn't automatically increase IB.
                    - If we had a § 754 election in place, then we could adjust IB under § 734(b) (otherwise, the gain will be taxed twice).
                - How could we prevent this distortion on the front end?
                    - C could contribute extra cash.
                    - C could indemnify A and B.
                    - C could pay down part of the liability before contribution.
    - If this is a nonrecourse liability:
        - First allocate all the gain that would be recognized by walking away from the property (the *Crane* gain) to the contributing partner. Which, here, is 60 (liabilities) – 40 (AB) = 20 allocated to C.
            - OB for C = 40 – (60 – 20 (-3(a)(2)) – 1/3(40) (-3(a)(3))) = 13,333
            - OB for A and B = 50 + 1/3(40) = 63,333.

            There's no distortion here.

- Accounts receivable and payable
    - Definitions
        - "Accounts payable": debts incurred with a local merchant, usually. These are still liabilities. The difference between them and ordinary liabilities is that A/P usually get a deduction as they are paid off.
        - "Accounts receivable": money owed *to* you for goods or services sold or provided in the ordinary course of business.
            - Note that under the cash method, AB for services A/R is 0.
    - The legislative history of §§ 751 & 752 tell us that we should *ignore* A/P liabilities for OB purposes—because the partnership will be getting a deduction.
    - What will the cap account look like? See R 1.704-1(b)(2)(iv)(c): net A/R and A/P (thus A/P *is* treated as a liability here).

Friday, January 20

Contributions of Services

- Capital interests versus profits interests
    - Capital interests: have a cap account value equal to the FMV of any contributed assets.
    - Profits interests: have a cap account value of 0 at formation. But with profitable operation, without distributions, the cap account will rise. See R 1.704-1(b)(iv)(b).
- No § 721 nonrecognition for a contribution of services. So, a services contribution is a taxable event—it will result in OI under § 61.
    - The timing of this income is governed by § 83: there will be OI when the interest:
        1. Is fully vested
        2. and has a value determinable.

        This is § 83(a).
    - A partner can *elect* to have a services interest treated as a nonforfeitable (vested) interest, and so have his OI immediately. This is § 83(b).
        - Why would you make this election?
            - If there will be no further income later (until the partnership sells its assets and distributes the profit), meaning deferral for the partner.
            - If you wait, you'll have larger income later if the partnership assets appreciate.

            Thus, you would make the election if you're an optimist.
        - However, if you elect and end up forfeiting your interest, you don't get to take the deduction.
    - When your interest does vest, you take a cost basis in your partnership interest.
    - A partner isn't a real partner until his interest has vested (or he makes an § 83(b) election).
- When a partner takes a services interest, the other partners are treated as selling part of their interest to the new partner. That is, *McDougal* is still good law, but is now limited just to formations.

<u>Tuesday, January 24</u>

- *McDougal* (TC 1974) (p61)
    - The owners' original basis: 10K (approximately).
        - They promised a half interest for a cure for the horse.
        - At transfer, the horse had a 60K FMV.
            - The IRS argued that GR = 30K (AR) – 5K (AB) = 25K
            - The court says yes, the owner had to recognize this 25K gain. The trainer has 30K income and takes a 30K OB. Thus, the partnership's IB = 5K (owners') + 30K (trainer's) = 35K.
            - The payment to the trainer generates a § 162 deduction for ther owners.

    - The proposed regulations *do nothing* to change *McDougal*.
- The proposed regulations
    1. They do not distinguish between receipt of capital and profits interests.
        - We still, though, end up with a 0 basis in most profits interests because of the safe harbor election.
    2. If electing the safe harbor, then you value the interest by reference to its liquidation value. Thus, a profit interest in future profits, e.g., is worth 0 at contribution.
    3. A partner who receives an interest for services that is substantially vested has *immediate income* (but, for a pure profits interest, the amount of this income would be 0).
    4. The safe harbor election will be a given for the purposes of this course.
    5. The service partner's cap account will be the amount of income that the partner must recognize upon entry (plus any money or property contributed).
    6. If an ongoing, existing partnership transfers an interest to a service partner, there is no gain or loss recognized by the partnership. R 1.721-1(b)(2).
        - This is a divergence between *McDougal* and the proposed regulations.
    7. But, if the transfer of a capital interest occurs during *formation*, then there will be gain recognized by the partners. Thus, *McDougal* is limited to its facts.
    8. Normally, even though there will be no gain (see #6), a transfer still should create a § 162 deduction (*unless* the services are capital expenditures, such as a lawyer's services in acquiring real estate).

We will ignore the proposed regulations' treatment of "forfeiture allocations" in this course, in part because the rules are likely to change here.

<u>Wednesday, January 25</u>

- More on the proposed regulations: Miller doesn't expect us to have the ability to cite these regulations as well as for other regulations. Just know the major points:
    - Assume no difference between capital and profits interests.
    - But, if in the safe harbor (which we can assume), then value the interest by reference to the liquidation value.
    - If a service partner does receive his interest on contribution, then the partner's cap account = the income he reports.
    - An exception to *McDougal*: there is no gain recognition *except* at the time of formation. Thus, there will be no gain recognition if the partnership is an ongoing one (there is no authority for this besides § 721 generally).

<u>Thursday, January 26</u>

Entity aspects of partnerships

- Entity aspects: a partnership is an entity for purposes of:
  - Filing an information return. §§ 6031 & 6698.
    - A partner will receive Form 1065 Schedule K-1 from his partnership.
  - Tax proceedings. §§ 6221 to 6233.
  - Computing the partnership's taxable income. § 703.
  - Determining the tax year and accounting method. § 706(b).
    - Tax year: a partner reports his share of partnership income in the partner's tax year in which the partnership's tax year ended. § 706(a).
  - Characterization. § 702(b).
  - Tax elections. § 703(b).

Partnership operations

- § 701: partners pay tax—not the partnership.
- § 702(a) tells us how each partner knows how much partnership income and loss to report—his "distributive share."
  - The partnership agreement determines what the "distributive share" is. § 704(a). *But*, there's a major caveat in § 704(b): the partnership agreement must have "substantial economic effect" if it is to be honored by the IRS. Those words have spawned the sprawling § 704(b) regulations.
- § 702(a) also requires a bunch of things to be separately stated.
  - This is because these items can have a *variable effect* depending on the rest of each partner's tax picture. Thus, we call these "variable effect" items. E.g., § 1231 gain.
  - You can net, however, things like LTCG and LTCL, because they have no variable effect on the partner.
- § 702(b): the initial character of items is determined at the partnership level.
- § 703(a) tells us how to compute the partnership's taxable income.
  - Why do we need to do this? Miller doesn't know, exactly, except that it gets you to § 705, where we compute a partner's OB.
- § 705: computing the effect of partnership operations on OBs:
  - Start with the old OB (from § 722, if this is a new partnership or partner).
  - ADD the partnership's taxable income (most separately stated items can be aggregated for this purpose). § 705(a)(1)(A).
  - ADD tax exempt income. § 705(a)(1)(B).
    - We include this so that it won't end up getting taxed later (see § 731)).
  - SUBTRACT § 733 distributions. § 705(a)(2).
  - SUBTRACT losses. § 705(a)(2)(A).
    - These "losses" include certain separately stated deductions.
  - SUBTRACT disallowed deductions. § 705(a)(2)(B).
    - We exclude this for the same kind of reason that we include tax exempt income—so that they won't end up allowed later on.

  Cap accounts are adjusted in the same way, except that we use FMV, not basis, for contributions and distributions. R 1.704-1(b)(2)(iv)(b).

Note § 163(d), which prevents "tax arbitraging."

Friday, January 27

- Separate statement of variable effect items: see R 1.702-1(a)(8)(ii), the catchall for all unenumerated but nevertheless variable effect items.
- RR 68-79: holding period is determined at the *partnership* level (just like character, under § 702(b)).
- R 1.704-1(d)(2): all separately stated (unallowed) deductions end up being treated as losses.
- Draws: under R 1.731-1(a)(ii), a distribution called a "draw" is treated as a distribution made on the last day of the tax year.
    - "Draws"are distributions where, by the partnership agreement, the partner receiving it must refund any portion of the draw that exceeds his OB.
    - This last-day-of-the-year rule lets us not worry about the timing of events during the year (and thus the possible accidental triggering of gain).
    - Under R 1.704-1(d)(2), distributions are subtracted from OB next to last—just before losses. See also § 705.
- Basis is determined at the end of the year. R 1.705-1(a)(1).
    - There are some exceptions to this, such as a sale of a partnership interest during the year.
- Remember that these adjustments are largely mirrored in the cap account adjustments.

Loss limitations

- § 704(d) says that a partners can't deduct partnership losses in excess of OB. So, this is a loss limitation rule.
    - Losses than can't be deducted are carried forward.
        - Carryforward is in proportion to character.
        - Can donees take suspended losses? The logic of § 1015 would say no. But McKee on Partnership Tax says it should carryover because otherwise distortions would result.

Tuesday, January 31

- § 704(d): see also R 1.704-1(d)(2).
- End-of-year basis adjustments
    - Start with old OB (§§ 722, 733, 705)
    - ADD income
    - ADD tax exempt income
    - SUBTRACT disallowed deductions
    - SUBTRACT distributions

    This is your basis before losses.

        - Now SUBTRACT losses

        This is your new OB. It can't be below 0.
- Carryover losses
    - These don't transfer on the sale of the partnership interest.
    - McKee on Partnership Tax, at ¶ 10.05[2][c] says that losses *should* carryover to a donee. Miller, though, says that the law probably doesn't work here.
    - McKee also says that, because of the way that § 704(d) and R 1.704-1(d)(2) are written, charitable contributions are *not* subject to the § 704(d) limit. See ¶ 10.05[1][b].
- At-risk and passive loss limitations
    - At-risk rules: you can't deduct losses in an amount exceeding the amount "at risk."
        - You're "at risk" to the extent of:
            - Cash contributed.
            - Basis of property contributed.
            - Debts of the business activity that you're personally liable for.

            So, your at-risk amount could be different than your OB.
    - Passive loss rules: you can't deduct "passive activity losses" except against "passive activity gains."
        - Limited partners are usually passive participants.
- Order of application:
    1. § 704(d)
    2. § 465 (at-risk rules)
    3. § 469 (passive losses)

    For this course, we are only responsible for knowing § 704(d).

Special allocations

- § 704(b)
    - PIP—the "partner's interest in the partnership."
        - This is the default rule. It applies when:
            - The partnership agreement is silent.
            - Or the partnership agreement does not have "substantial economic effect."

            I.e., § 704(b) will trumpt § 704(a) in these two situations.
- *Orrisch* (1970) (p122)
    - The regulations have gone way beyond itc., but itc. is still the foundation of this area.
    - Itc. says that an allocation must have an actual effect on the dollars of income and loss, beyond the mere tax consequences, in order to have SEE.

- The regulations: these split SEE into:
  - The economic effect test. R 1.704-1(b)(2)(ii)(a).
  - The substantiality test: R 1.704-1(b)(2)(iii)(a). This looks for allocations that have economic effect in isolation, but only tax effect when viewed in context.
- The economic effect test: R 1.704-1(b)(2)(ii)(b) (p1331)
  - This has three requirements:
    1. Keep cap accounts under the regulations.
       - The basic rules here:
         1. Increase for cash contributions. R 1.704-1(b)(2)(iv)(b).
         2. Increase for FMV of contributed property. -1 (b)(2)(iv)(c).
         3. Increase for partnership gain and income allocated to a partner, including tax exempt distributions.
         4. Decrease for cash distributed to a partner.
         5. Decrease for FMV of property distributed to a partner. -1(b)(2)(iv)(e)(2).
         6. Decrease for nondeductible expenditures of the partnership.
         7. Decrease for losses and deductions of the partnership.

         Note the similarity of this to the OB adjustment rules.

         Also note that liabilities don't affect the cap accounts (see R 1.704-1(b)(2)(iv)(c)), except that when adjusting for the value of property contributed or distributed, liabilities passing with the property will be subtracted from the property's FMV.
    2. Liquidate according to positive cap account balances.
    3. If there's a deficit in the cap account, it must be contributed back upon liquidation.
- The alternate economic effect test: this is provided because limited partners don't normally have to make up for their cap account deficits upon liquidation (and so could not meet #3. -1(b)(2)(ii)(d).
  - The AEET says that you do *not* have to meet #3 of the EET if:
    1. You have a “qualified income offset.” -1(b)(2)(ii)(d)(6).
       - This QIO is a provision in the partnership agreement that specially allocates income to restore accidental, too-large deficits.
       - See n5p144 for language for a typical QIO.
    2. And allocations don't create or increase a cap account deficit.
    3. And we reduce cap accounts for any forseeable events.

See -1(b)(5) ex. 1(iv), (v), & (vi).

What the AEET does is, in effect, *prevent* any deficits larger than a partner's ability to restore.

<u>Wednesday, February 1</u>

- Why are these regulations so complicated? Because partnerships are flexible with allocations, and so the tax regulations must have an elaborate scheme to try to maintain symmetry between the economic and tax effects of transactions.
- Recall:
  - The EET:
    1. Maintain cap accounts under the regulations.
    2. Liquidate per cap account balances.
    3. Restore deficits on liquidation.
       - But limited partners don't usually have to do this, so we have the AEET:
         1. Limit deficits to the partner's obligations.
         2. Have a QIO provision: unexpected losses causing excess deficits must immediately be covered by the partnership (by allocation partnership taxable income to make up for the deficit).
- RR 97-38 (p139)
  - The partnership agreement here didn't have a restoration of deficits clause, but under state law GPs were liable to their lenders for debt. So, does the state law give the GP an obligation to restore that satisfies EET #3?
    - This RR says yes, but the IRS will assume that the value of the property is always equal to book value. So, the IRS will determine the limit of the GPs obligation by the book value of the property.
  - So:

The opening BS:

Bldg.	1000	1000			800
			GP	900	100
			LP	100	100
	1000	1000		1000	1000

The GP's OB is due to a recourse loan, which is only included in the GP's OB.

Y1 BS

Bldg.	800	800			800 (only servicing this debt)
			GP	800	0

|LP 0 0

Here, we've allocated 100 of tax depreciation on the building to each partner, using PIP. This is because the real economic consequence of depreciation is mirroring the tax consequences (because here, the LP is bearing 1/2 of the depreciation loss).

Y2 BS

Bldg.	600	600			800
			GP	600	(200)
			LP	0	0

The GP's cap account is allowed a deficit because he's obliged to restore under state law. Thus, the GP alone is on the hook for Y2's depreciation loss.

What would happen if the partnership sold the building for 1200 (this isn't in the RR)?

If the debt is unpaid:

Cash	1200	1200			800
			GP	1000	200
			LP	200	200

How to allocate the gain?

1. Put the partners back where they were.
2. Then allocate by PIP.

Thus, 400 to the GP (200 for Y1 and 200 for Y2); 200 to the LP (200 for Y1).

This is because the partnership agreement has a "gain chargeback" provision.

- (Why doesn't this trigger insubstantiality? After all, this gives the GP two offsetting allocations, which could have a tax benefit to the GP. The only reason this is substantial, actually, is because the rules say it's okay. This is a gift, Miller says, to the real estate industry.)

If the debt is paid:

Cash	400	400			0
			GP	200	200
			LP	200	200

Here, the GP loses 800 OB because the liability is paid and is now gone.

- Economic effect equivalency: R 1.704-1(b)(ii)(l).
  - This is the ultimate fallback.
  - See -1(b)(5) ex. 4(ii) & (iii).
  - The PIP test: -1(b)(1)(i) and -1(b)(3)(ii).

- Substantiality
  - This is more a judgment call than a mechanical test (as the EET is).
  - "Shifting" and "transitory" allocations:
    - These are distinguished by the timing.
    - See -1(b)(2)(iii)(a) – (c).
  - The *presumption* here: depreciations are presumed to be real. Thus, if property is later sold for a gain, that gain was *not* forseeable. Thus, gain chargeback provisions in partnership agreements are forseeable.

<u>Thursday, February 2</u>

§ 704(c)

- § 704(c)(1)(A): a partner that contributes an asset with built-in gain or loss will recognize that gain or loss when it's realized by the partnership. Partners will share any additional gain or loss.
  - This prevents assignments of income (including changes in character by assigning income).
- What if there was no § 704(c)?
  - Let's say A contributes \$20K and B contributes property with 20K FMV and 10K AB. Then the property is sold for 20K.
    - Without § 704(c), both partners get 5K OI.
    - With § 704(c), B gets all 10K of OI.
- But, it's more complex than just this.
  - Depreciation
    - Apply the same method to cap and tax accounts (but use book value for the cap account and AB for the tax account).
    - Always try to keep tax depreciation and book depreciation equal.

<u>Friday, February 3</u>

<u>Tuesday, February 7</u>

- Nonrecourse allocations (not on the exam)
    - Depreciation deductions from property financed with nonrecourse debt are called "nonrecourse deductions." These have no SEE by their nature, so the regulations control the allocation of these.
        - 1.704-2(b)(1): allocate per PIP.
        - To be allocable, the partnership agreement must have a minimum chargeback provision. (See the sample partnership agreement on the course website.)
            - "Partnership minimum gain": gain that would be allocated by the partnership if it walked way from its nonrecourse liabilities.
                - See 1.704-2(e), (b)(2), and (d)(1).
                - The MGC must provide allocation to partners' income and gain equal to any net decrease in PMG (-2(f)(1)).
- Reverse § 704(c) allocations: these are § 704(b) allocations on § 704(c) principles. These come up when a new partner joins an existing partnership.
    - There are several ways to do this:
        - A revaluation under 1.704-1(b)(2)(iv)(f).
        - Or, don't revalue, but put a footnote in the books to indicate that built-in gain is attributable to the existing partners.
- Some loophole closers
    - § 704(c)(1)(B) & (C): these are designed to prevent games with built-in gains and losses.
        - (c)(1)(B): if an asset is contributed with built-in gain and then distributed within seven years, the *gain is recognized*. These are called "mixing bowl" or "churning" transactions.
        - (c)(1)(C): if an asset is contributed with built-in loss, a successor partner to a former partner *would*, without this provision, take your basis, thus taking your loss. But this provision says that everyone except a contributing partner takes a date-of-contribution FMV basis, so a successor will *not* get any loss the former partner contributed.

<u>Wednesday, February 8</u>

[book problems only]

<u>Thursday, February 9</u>

Allocations where partner interests vary

- §§ 706(c)(2)(B) and 706(d)
- Interim closing of the books approach: try to actually trace the income and deductions to particular times during the year.
- Proration approach: allocate partners' shares based on the percentage of the year for a particular interest.

Both of these methods are permitted under the regulations. See 1.706-1(c)(2)ii). But, these methods can be manipulated. Thus, § 706(d)(2) was enacted to put partnerships on an accrual method for certain items.

Family partnership rules

- § 704(e)
- Families use partnerships to transmit wealth from one generation to the next. § 704(e) manages transfer of partnership interests to protect against improper assignments of income.
  - You can transfer partnership interests among family members, and these transfers will normally be respected.
    - They will always be respected if capital is a material income generator for the partnership (i.e., the partnership is the tree and the fruit).
      - However, even where capital is a material income generator, the interest transferred must be proportional to the tax consequences. E.g., you can't transfer a 25% interest and have the transferee taxed on 50%.
    - But, if the partnership has substantial service income, the partners who perform the services must be adequately compensated, so that the income will be taxed to them.
    - See 1.704-1(e) on gifts: they must be complete gifts to be honored.

<u>Friday, February 10</u>

Transfers between partners and their partnerships

- § 707(a)(1) & (a)(2)(A); 1.707-1(a).
- *Pratt* (1975) (p213)
  - If a transfer is inside the scope of a partner's duties, then the transaction is between the partner and the partnership.
  - If it's outside the scope, though, then it's a transfer between the partnership and a third party.

  To determine this, look at what's called for by the partnership agreement. Thus, the parties have some control over treatment—but it's not complete control because of 1.707-1(a), which says that we look at the economic substance of the transaction, not its form.

- Why does this matter?
    - If a partner is acting as a partner, then allocations will affect his OB and cap account. Even so, most of the time it won't make a difference, because partnerships are pass-through entities.
    - It affects exclusions from income.
        - *Armstong* (1968) (p214), about the § 119 exclusion for food and lodging provided by an employer to the employee for the employer's benefit. Itc. says that a partner can be both a partner and an employee. Usually, though, a partner in this situation will be a partner and an independent contractor.
    - A partner is taxed on his share of income, without regard to distribution; whereas a nonpartner is taxed at the time of receipt. So, there can be *timing* differences.

    Some hypos:
        - A lawyer is a partner, but the partnership's purpose is to acquire real estate and hold it for investment. The partnership gets some property but needs to litigate title. The lawyer litigates it and wins, retaining the property.
            - The lawyer is *not* acting as a partner in the litigation, because the purpose of the partnership is not the practice of law.
        - Same facts, but the partnership is a law practice that gets into a dispute over the title of the firm's building.
            - This looks more like a partner-as-partner, especially if the partner got credit for billable hours for the litigation.

        Note that in both examples, the partnership expenses are capital expenditures, because they are related to a capital asset.
- Even if a partner is not acting as a partner when the partnership is entitled to a deduction for a payment to him, the partnership cannot take the deduction until the partner includes the payment in his gross income. § 267(a)(2) & (e).
- What happens if the partnership tries to make a transaction look like a partnership-partner transaction, but it's really a partnership-third party transaction?
    - Then § 707(a)(2)(A) will apply § 707(a)(1) to these "disguised transactions."
        - Why? To prevent the partnership from taking a deduction for an expenditure that's really a capital expenditure.

Note that this are is not likely to be tested on the exam.

<u>Tuesday, February 14</u>

Guaranteed payments

- Review: payments to partners:

1. Distributive share: § 704(a) & (b). This share comes out tax-free, up to OB.
2. Partner as a third party transactions: § 707(a)(1).
3. Guaranteed payments: § 707(c).

- What are guaranteed payments?
  - Payments to a partner—in his capacity as a partner (unlike § 707(a)(1)--for performance of services or use of property, determined without reference to partnership profits.
  - There are two kinds (see 1.707-1(c) exs. 1 & 2):
    - The easy kind: a fixed amount over and above a partner's distributive share.
    - The hard kind: a fixed percentage, but not less than a fixed amount.
- What happens with them?
  - The pass *outside* of cap accounts and OB—they are not part of the distributive share.
    - According to McKee at ¶ 13.03[1][b], guaranteed payments do not affect cap accounts.
    - However, *Gaines* says that guaranteed payments increase OB.
  - The partnership's perspective: they are normally deductible under § 162.
  - The partner's perspective: they are OI.
  - Timing: the partner has income when the *partnership's* accounting method gives it a deduction. 1.707-1(c).
    - Note that this is the opposite of § 707(a)(1).
- An example of the hard kind:
  - A and B have a 50/50 partnership. A is guaranteed the greater of 50% or 100K.
    - What if the partnership has 200K of income? Then the guaranteed payment is 0, because A is just getting his regular 50%.
    - What if it has 180K of income?
      - Then A gets a 10K guaranteed payment—A's distributive share is 90K, and he gets the excess 10K (to make 100K total) as a guaranteed payment. See 1.707-1(c) ex. 2.
      - This 10K payment reduces partnership income to 170K. A is allocated 90K of this, and B 80K (he is making the payment to A, in effect).
- Capital gains: you can't deduct a guaranteed payment against capital gains.
  - Take the hypo from above: assume the partnership's income is 140K OI and 40K LTCG.
  - How do we share the capital gains?
    - It can't be 50%, because that would leave 140K – 10K = 130K OI. Half of that to A is 65K, and then half of the 40K CG is 20K, leaving A with only 85K—5K short!
    - So, instead we keep the ratio:
      - 90K/170K = 9/17 of the OI, or 68.8K, goes to A.

        - And 9/17 of the CG, or 21.2, goes to A.
        - See RR 69-180.

<u>Wednesday, February 15</u>

- Hypo: what if the partnership has 180K of income—140K LTCG and 40K OI?
    - Miller says that if the guaranteed payment creates a deduction that makes it impossible to satisfy the guaranteed payment, then flip back to the fixed guaranteed payment style calculation.
        - Thus, 40K OI – 100K guaranteed payment = 60K OL to the partnership.
        - 30K OL goes to the partner, along with 100K OI (the guaranteed payment) and 70K LTCG.

        This seems to be the result suggested by McKee at ¶ 13.03[3]. You have to do something like this to avoid a distortion.

Sales of partnership interests

- The code straddles the aggregate/entity line here. The aggregate part looks like an individual holding many assets. The entity part looks like a shareholder.
    - Look at both the capital and other assets inside the partnership—divide them into just two categories.
- The buyer's perspective—this is very complex:
    - § 754 election: the selling partner is recognizing existing gain, but the new partner could be taxed on this, too, at disposition. A § 754 election eliminated preexisting gains and losses, preventing double taxation across time.
- The seller's perspective
    - The staring point is § 741: gain is capital by default, but § 751 trumps (just like § 1245 trumps § 1231).
    - Then, there's § 1001: AR – AB = GR. This is just a net number, and so it can be deceiving—but we'll still do it.
        - Use OB for AB.
            - Note that a sale will usually occur during the tax year. At sale, the tax year of the selling partner ends (§ 706(c)(2)(A)), and so we must so all OB adjustments and make all allocations at that time. See 1.705-1(a)(1).
        - AR includes any given-up liabilities (see *Crane*). § 752(d) and 1.752-1(h).
    - Allocating gain and loss between § 741 and § 751 property
        - What's § 751 property? "Unrealized receivables" and "inventory items." § 751(c) & (d).
            - What are "inventory items"?
                - Inventory.
                - *And* nearly everything else that would generate OI—

including unrealized receivables.
        - What are "unrealized receivables"??

        So, these definitions overlap. The same stuff won't be counted twice, though.
    - What's § 741 property? Everything else.
    - How do we calculate § 751 gain and loss?
        - 1.751-1(a)(2).
        - Note that any § 704(c) gain must be allocated to the selling partner at this time.
    - How do we calculate § 741 gain and loss?
        - The easy way:
            - Hypo: 10K § 1001 gain.
                - If 5K § 751 gain, then we know that 5K is § 741 gain.
                - But if 15K is § 751 gain, then we know that we have 5K § 741 loss.
            - See 1.751-1(a)(2).
        - The harder way:
            - See 1.741-1(a).
            - Figure out how much AR and AB are left after your § 751 calculation, then use AR and AB to get GR.

<u>Thursday, February 16</u>

- The buyer's perspective
    - The default rule is that the new partner takes the old partner's cap account and a cost OB (§ 742), plus his share of liabilities assumed (§ 752).
        - Note that there is no revaluation of the old partner's cap account. This is because the cap accounts are still in the right proportion because the new partner is not joining by contribution.
    - Because there is a new OB, the aggregate of the OBs will no longer match the partnership's IB!
        - New partner entry does not automatically change IB. § 743(a). It will only change if there is a § 754 election.
    - § 754 elections: this gives a new partner a special IB.
        - Why isn't this election mandatory?
            - Because gains will be recognized twice if the election isn't made (however, the same loss could be recognized twice, too).
            - The election is very complicated (and you end up with a new IB just for one partner), and so it's costly to pay accountants to do it.
        - The *partnership* makes the election.
        - The election applies in these circumstances and in § 734 circumstances.

- How to make the IB adjustment:
    - What is the adjustment amount (AA)?
        - AA = (OB of the new partner) – (the new partner's share of IB). § 743(b).
        - The shorthand method of this is: AA = $OB_{New} - OB_{Old}$
            - This won't always be right—look for:
                - Special allocations
                - § 704(c) gain
    - What is the new partner's share of IB, then?
        - IB sh. = (previously taxed capital) + (share of liabilities). 1.743-1(d)(1).
    - Well, then what's previously taxed capital?
        - PTC = (what we'd receive in cash from a buyer, over and above any liabilities assumed) + (losses allocable in assets) – (gains allocable in assets). 1.743-1(d)(1)(i), (ii) & (iii).

So:

1. PTC = $ + losses – gains
2. IB sh. = PTC + Lb. sh.
3. AA = OB – IB sh.

The adjustment has no affect on the existing partners.

- Once you determine the adjustment amount, you must then allocate it among the individual partnership assets. Use § 755 (because § 743(c) says to use § 755).
    - § 755(b)(1) & (2): split the assets into two classes:
        - OI property
        - CG and quasi-CG property
    - Then allocate based on a hypothetical sale, allocating to the new partner his potential share.

<u>Friday, February 17</u>

[missed class]

<u>Tuesday, February 21</u>

- Recall: the § 754 election—lets you make a § 743(b) adjustment to IB, giving the new partner a unique IB, to avoid sticking him with built-in gain upon buying a partnership interest.

<u>Wednesday, February 22</u>

Operating distributions

- Because OB is being adjusted upon partnership income and loss, no distribution should be taxed—it has already been taxed. § 731 accepts this analysis.
  - Cash distributions up to OB—no gain recognition. § 731(a)(1).
  - Cash distributions in excess of OB—gain recognition to the extent of the excess.
    - Usually, this gain will be capital, because it is treated as gain on a sale/exchange of a partnership interest (which is capital, under § 741). See also § 731(d).
  - All cash distributions reduce OB. § 733.
- Note the operation of § 752: if a liability passes out of the partnership as part of a distribution, then we must adjust OB to reflect this change in the liability structure.
- Draws
  - 1.731-1(a)(1)(ii): distributions are treated as occurring on the last day of the tax year.
  - Draws will always be considered cash distributions *if* the partnership agreement provides that a partner must refund any amount exceeding the partner's distributive share. See McKee ¶ 19.03[2].
    - Note that OB is adjusted at the end of the year, too, under § 705.
  - Note that a loan by a partnership to a partner is not considered a distribution. 1.731-1(c)(2).
- Noncash distributions: §§ 731 & 732.
  - The nonrecognition rule of § 731 has several exceptions for noncash distributions (§ 704, etc.), but we won't worry about these right now—they're merely loophole closers.
  - Otherwise, nonrecognition applies categorically—even when FMV exceeds OB.
    - However, the partner will recognize excess gains at *his* disposition of the property, through the basis mechanism. § 732(a).
  - The partner takes the partnership's basis in the property—except that he can't take a basis in excess of his OB.
  - OB is reduced by any basis that the partner takes in the property distributed.

  So, this is deferral.
- Distributions of both cash and property
  - Do the cash first (i.e., adjust OB for the amount of cash distributed).
    - This is taxpayer favorable, because it increases the possibility that no gain will be recognized.
  - § 741 and § 751 property
    - § 751 assets come out first. § 732(c)(1)(A). This is also taxpayer favorable.
  - What if the partner's OB is less than the partnership's IB? I.e., what if two assets come out—how do we know how to allocate basis?
    - Do the § 751 assets first. § 732(c)(1)(A).

                - Then do the § 741 assets.
                - Within each category (§ 732(c)(1)(B), (c)(1)(A), (c)(3)(A), (c)(3)(B)):
                    - Reduce each item's IB by its built-in loss (unrealized depreciation) first.
                    - If there's any more OB to allocate, then reduce by the proportion of basis (i.e., (item basis) / (aggregate basis).
        - § 732(d): allows a distribution-receiving partner in a non-§ 754 electing partnership to treat the distribution *as if* there was a § 754 election, for the purposes of that distribution.
        - § 731(c): marketable securities.
- Liabilities
    - RR 79-205; RR 99-4
        - When liabilities come out as part of a distribution, the partner is—in effect—relieving the partnership of a liability. So, under § 752, that's equivalent to the partner contributing the amount of the liability in cash to the partnership. However, the partner is also relieved of his share of the liability as a partner. Thus, we must net the deemed distribution and deemed contribution. Do this netting before determining the effect of the distribution.
            - If there's a net deemed distribution, RR 99-4 says to treat it as a draw.
- Effect of distributions on cap accounts
    - Reduce cap account by the FMV of whatever comes out. 1.704-1(b)(2)(iv)(b)(4) & (5).
    - Liabilities: reduce cap account by FMV – Lb. (i.e., by the net FMV).
- Distribution of an asset with unbooked appreciation or depreciation
    - Here, you must adjust book value before distributing—i.e., do a mini-revaluation. 1.704-1(b)(2)(iv)(e)(1) and 1.704-1(b)(5) ex. 14(v).

<u>Thursday, February 23</u>

- Note that § 751 property is often referred to as "hot assets" ("hot" in the sense that it carries OI).

<u>Friday, February 24</u>

- The partnership's perspective of operating distributions
    - No gain is recognized. § 731(b).
    - But, a partner can't take an AB greater than his OB.
        - If there's no § 754 election in place, then the excess basis will disappear. § 734(a).
        - If there is a § 754 election, then § 734(b) applies, adjusting IB. (This is kind of like § 743(b)'s operation in the sale/exchange context.)
            - Four occasions triggering adjustment:
                - Upward adjustments—operating distributions only:

            - § 734(b)(1)(A): increase from gain recognition.
            - § 734(b)(1)(B): increase from OB insufficient to absorb all AB.
        - Downward adjustments (don't worry about these right now—these are only for liquidating distributions):
            - (b)(2)(A): decrease from loss recognition.
            - (b)(2)(B): decrease from OB greater than IB in the distributed assets.

        Thus, there are no downward adjustments in the operating distribution context.

        Upward (operating distribution) adjustments:
            - (b)(1)(A): increase IB by the amount of gain recognized.
            - (b)(1)(B): increase by the amount that OB is insufficient.

        Allocating upward adjustments among partnership assets:
            - Use § 734(c), which points to § 755 and the regulations under § 755.
            - 1.755-1(a): allocate any increase among § 751 and § 741 property.
                - Allocate to the same class that gave rise to the adjustment (e.g., allocate to other capital assets if the distribution was of a capital asset). 1.755-1(c)(1)(i).
                - If the increase is from gain recognition ((b)(1)(A)), then allocate to capital assets. 1.755-1(c)(1)(ii).

- Who gets the benefit of an adjustment?
    - Typically, we'll make a § 704(b) special allocation of the adjustment to the nondistributee partners.
- If there are no capital assets to adjust, but you have an adjustment for capital assets, carryover the adjustment. 1.755-1(c)(4).
- If the assets to be adjusted are depreciable, then create a new useful life just for the adjustment. 1.755-1(e)(1). The useful life begins at the date of the distribution.
- How to adjust individual assets within a class?
    - 1.755-1(c)(2) sets up a hierarchy:
        - First adjust assets with appreciation, in proportion to each asset's share of aggregate appreciation:

(item appreciation / aggregate appreciation) * adjustment amount = item adjustment amt.

- However, you can't allocate beyond each asset's FMV. So, if you still have AA to allocate, then allocate in proportion to FMV:

  (item FMV / agg. FMV) * AA = item AA
- What about capital assets? If they are appreciated, you have to do a mini-revaluation. 1.704-1(b)(2)(iv)(e)(1) and -1(b)(5) ex. 14(v).

- N.b. § 751(b) (we're not responsible for this)
  - Almost nobody complies with this, and, anyhow, almost nobody knows how to do it. Perhaps not even the IRS.
  - This section will treat non-prorata portions of distributions as a prorata distribution followed by a sale.
    - It does not apply to draws.
    - It does not apply to property distributed that was contributed by the distributee.

<u>Tuesday, March 7</u>

Liquidation of a partnership interest

- This is a variation on operating distributions, mixed up a little with sales of partnership interests.
  - The code treats a liquidating "distribution" as a mix between a distribution and a sale/exchange.
- § 731: the nonrecognition rule.
- § 736: this indirectly adopts § 731.
  - The general rule is § 736(b)(1)--treat liquidation as a distribution (so use § 731).
  - Exceptions:
    - § 736(b)(2): amounts paid *for* unrealized receivables and goodwill are not included in § 736(b)(1) and so are not treated as a § 731 distribution. Rather, they are treated under § 736(a) as either a distributive share (if determined in reference to partnership income) or as a guaranteed payment (if *not* determined in reference to partnership income) (§ 736(a)).
      - § 736(a) payments are almost always OI.
        - The other partners will prefer § 736(a), because then the partnership will get a deduction (if it's a guaranteed payment) or the partners will get a reduction in their shares of partnership taxable income (if it's a distributive share). (Neither of these things will happen if the payments are within § 736(b)(1)).

    - Exceptions to the exceptions:
        - § 736(b)(3): distribution (§ 736(b)(1)) rules apply to payments *for* unrealized receivables or goodwill *if*:
            - Capital is a material income-producing factor.
            - Or the leaving partner is not a general partner.
        - § 736(b)(2): distribution rules apply if the partnership agreement provides for payment of goodwill.
- Consequences of the general rule
    - (The consequences of the exception is usually OI to the leaving partner.)
    - Basis in the distributed property:
        - § 732: a carryover basis (the leaving partner's OB), adjusted:
            1. Reduce by the amount of cash also distributed. § 732(b).
            2. Allocate the leaving partner's OB among the assets:
                1. Start with § 751 property, giving a carryover basis initially. If there's not enough OB, adjust downward.
                2. Then go to § 741 property, giving a carryover basis initially.
                3. If there's still some OB, allocate it to § 741 property *only*—*never* to § 751 property. (Thus, if there's not § 751 property, then the ceiling is a carryover basis.)
                    1. First allocate the excess to assets with unrealized appreciation.
                    2. Then allocate in proportion to FMV.

                    If there's more OB than § 751 property, and there's no § 741 property to absorb it, then you've got a capital loss. § 731(a)(2).
                        - Why? because there's no place to put the excess basis (because you're liquidating), and thus this must be recognized immediately.
                        - Do you adjust the partnership's IB if you have excess IB? Yes, if you've elected § 754. No, if not.
    - Cap accounts: see 1.704-1(b)(2)(iv)(f)(5)(ii). You may want to revalue.

<u>Wednesday, March 8</u>

- § 736(b)(2) only applies to general partners in service partnerships. § 736(b)(3).
- *Another* exception to § 736(b)(1): if a liquidating distribution is not prorata, then § 751(b) issues arise (but we're not responsible for § 751(b)).
- Note that you can apply the installment method for these interest liquidations.
- Note 1.736-1(b)(3) regarding basis.

- § 736(a) payments

    - *Foxman* (3d Cir. 1965) (p326)
        - The contract here says that this is a sale. But the source of the funds is the partnership itself—so this looks like a liquidation.
            - J reports CG.
            - F & G report a guaranteed payment (i.e., a § 162 expense, reducing their taxable income).
        - Miller: because the taxpayer can control the form, the taxpayer almost always gets stuck with the form he chose. That is, only the IRS can successfully argue substance over form, usually.
    - RR 93-80 (p330): abandonment of a partnership interest. If there are no partnership liabilities, this is an OL. If there are liabilities, there's a deemed distribution under § 752, so it's a capital loss.

<u>Thursday, March 9</u>

Liquidation of a partnership

- These are easy if the distributions are prorata.
- § 735(b): you get tacking for property distributed from a partnership.
- Mostly partnership liquidation is a nonrecognition event.

<u>Friday, March 10</u>

[missed class]

<u>Tuesday, March 21</u>

Death of a partner

- IRD: income in respect of a decedent.
    - § 691: this is taxed to the successor in interest.
    - § 1014(c): you don't get a basis bump in IRD.
        - However, the § 1014(a) general rule *does* apply to unrealized appreciation in property.
    - § 736(a): payments by the partnership to successors for certain things are IRD items.
    - § 743(b): you get a basis adjustment, *except* for IRD items.
    - Buy-sell agreements: if the *partnership* is the buyer, then treat it basically like a liquidation. § 736.
    - If there's a § 754 election, there can be multiple basis adjustments. §§ 743 & 734.

<u>Wednesday, March 22</u>

C CORPORATIONS

Formation

- § 351(a)
  - What if there was no § 351? Then the analysis would be under § 1001—and gain and loss would be recognized on formation.
  - But, § 351 provides for nonrecognition, so long as the exchange is for property. Cash is property here. RR 69-357.
    - There's nonrecognition for the corporation, too, under § 1032, *even if* § 352 wouldn't provide for nonrecognition for the shareholder.
- Basis
  - The shareholder takes the same basis in the shares as he had in the property he gave up. § 358.
    - If he gives up multiple properties, allocate in proportion to FMV. 1.358-2(b)(2).
  - The corporation takes a basis in the property equal to the basis that the shareholder had in it. § 362(a).
    - This will be true even with depreciation recapture (§ 1245) gain. Because § 1245(b)(3) makes an exception for § 351 transactions. Still, though, the corporation will get the recapture gain when the property is later sold. § 1245(a)(2).
- Holding period
  - Tacking for both the shareholder (§ 1223(1)) and the corporation (§ 1223(2)).
- What about installment notes?
  - Normally, under § 453B, the transaction would transfer all unrecognized gain. But here, 1.453-9(c)(2) says that § 351 will overrule § 453B.

<u>Thursday, March 23</u>

- §362(e): a limitation on built-in losses—don't worry about this.
- Recall: the nonrecognition rules--§ 351(a) for shareholders and § 1032 for the corporation.
- If you get two classes of stock in exchange for property, allocate the basis in proportion to the FMV of the classes. 1.358-2(b)(2).
- The § 351 regulations
  - "Person": 1.351-1(a)(1). See also § 7701(a)(1).
  - "Immediately after": control doesn't have to come simultaneously with the exchange, as long as it's part of a single plan—an "expedition consistent with orderly procedure." 1.351-1(a)(1).
  - What about services—are they property? No. So, if you receive shares for services, that's compensation, which is OI under § 61. Timing is controlled by § 83.
    - Note Rev. Proc. 77-37: if a services shareholder contributes property worth 10% or more of the FMV of the shares received, then he will be

within § 351. (This is a pretty liberal rule, Miller says.)
- "Control": § 368(c). The IRS says that you must have 80% of *each class* of stock. RR 59-259.
  - *Intermountain Lumber* (p419): itc. says that if there's a binding legal commitment at formation to transfer shares, then those shares won't be counted for the 80% test.
- § 351(g): certain kinds of stock aren't stock for § 351 purposes.
- Gifts

<u>Friday, March 24</u>

- § 362(e): limitations on built-in losses
  - This is ambiguous as to whether you apply it at the individual or the aggregate level. The legislative history is in S. Rep. 108-192, at 125.

Boot

- Cash boot
  - If there's boot in a § 351 exchange, then gain will be recognized to the extent of the boot. You never recognize more gain than is realized though.
  - Basis
    - § 358(a)(1)(A)(ii): decrease basis by the amount of cash received.
    - § 348(a)(1)(B)(ii): increase basis by gain recognized.

    So: old basis – cash received + GR = new basis

    An example:
      - A contributes property with 80 AB and 100 FMV for 80 shares and $20.
        - AR = 80 + 20 = 100
        - GR = 100 (AR) – 80 (AB) = 20
        - AB in the shares = 80 (AB) – 20 ($$) + 20 (GR) = 80
      - What if the property AB was 90?
        - AR = 80 + 20 = 100
        - GR = 100 (AR) – 90 (AB) = 10
        - AB in the shares = 90 – 20 + 10 = 80
    - The corporation gets a carryover basis, increased by GR.
  - Holding period: tacking for all.
  - Multiple assets contributed
    - RR 68-55 (p430): treat each asset separately, as contributing to the boot in proportion to each asset's FMV.
    - An example: A contributes land (10 AB, 20 FMV) and inventory (10 AB, 5 FMV) for 20 shares and $5.
      - Gain
        - 20/25 * 5 (boot) = 4 maximum gain on the land

            - 5/25 * 5 (boot) = 1 maximum gain on the inventory

            No loss is ever recognized on formation. So just 4 gain is recognized on the land (not the whole 20 – 10 = 10 gain realized). No gain is recognized on the inventory (because a 10 – 5 = 5 loss realized there).
        - Basis
            - The shareholder's basis = (10 + 10 (old bases)) – 5 (cash received) + 4 (gain recognized) = 19.
            - The corporation's basis
                - Land: old basis + GR = 10 + 4 = 14
                - Inventory: 10 + 0 = 10
        - Holding period: tacking on the portion attributable to the land, but none on the inventory. Thus, 4/5 of each share is tacked. RR 85-164.
    - Multiple assets received: 1.358-2(b)(2)--allocate in proportion to FMV.
- Property boot
    - For gain recognition purposes, this is the same as with cash boot (using FMV instead of the cash amount).
    - Basis in the boot is FMV. § 358(a)(2).
    - Basis in the shares: old basis – cash – FMV of the boot + GR

<u>Tuesday, March 28</u>

    - Debt instrument boot
        - 1.453-1(f)(3): use the installment method in calculating gain recognition for this boot.
            - Recall: GR = (gross profit / total contract price) * payment
                - Gross profit = selling price – AB. Here, that means GP = boot – excess basis (over that allowed to nonrecognition property; that is, old basis – FMV of the shares).
            - Shareholder's basis in his shares: old basis – boot + gain recognized. § 358. This is an immediate basis stepup.
            - Corporation's basis in the note: carryover basis + GR (by the shareholder). § 362(a). This is stepped up as the shareholder recognizes gain.

<u>Wednesday, March 29</u>

Liabilities

- § 357
    - Before § 357 there was *Hendler* (1947) (p436x), which said that assumption of liabilities was boot. Congress responded with § 357.

    - § 357(a): don't recognize gain on assumption of liabilities if not in excess of basis.
        - *But*, you must defer gain recognition by reducing basis in the shares. § 358(d)(1).
    - § 357(c): however, if the liability assumed is in excess of basis, you must recognize gain to the extent of the excess.
        - Thus, the basis in the shares will end up being 0.
    - Corporation's basis in the property:
        - A straight transfer of basis if § 357(c) doesn't apply.
        - If § 357(c) applies, thus the shareholder recognizes gain, increase the corporation's basis by the amount of GR.
    - An example:
        - A contributes property with 50 AB, 100 FMV, 20 Lb., for 80 shares.
        - B contributes property with 80 AB, 120 FMV, 110 Lb., for 10 shares.

        Gain:
            - None for A. § 352(a).
            - 30 GR. § 357(c). The character of this gain is determined by reference to the property contributed.

        Basis
            - A: AB = 50 (old basis) – 20 (Lb.) = 30. § 358(d)(1).
            - B: AB = 80 (old basis) + 30 (GR) – 110 (Lb.) = 0.
    - Some wrinkles, though
        - § 357(b): the anti-avoidance rule: e.g., if you borrow against an asset right before contributing, then § 357(b) operates to make all the assumed liability boot.
        - § 357(c)(3): excludes from § 357(c) any liabilities that will give a deduction when paid off (such as A/P). You ignore these for both GR *and* basis calculations. § 358(d)(2).
    - *Peracchi* (9th Cir. 1998) (p440)

- Some general notes
    - By its terms, § 351 is mandatory—once you're in its coverage, you have nonrecognition whether you want it or not. So, if you want recognition you must design the transaction to fall outside of § 351.
    - Personal use property contributions: the corporation takes an FMV basis.
        - There's nothing that says this in the code. See 1.167(g)(1), though: use the lesser of FMV and cost.
        - There's no authority at all to say that the shareholder would take an FMV basis in the shares—so he would take a carryover basis, maybe!!! But see 1.165-7(a)(5).
        - See also B&E ¶ 3.11[1].

<u>Thursday, March 30</u>

- Note that a *Peracchi* issue could arise in the partnership context, too. But, probably the*Peracchi* scheme wouldn't work with a partnership. See n16p447c. In the partnership, there's just too much concern about manipulation of losses.

Incorporation of an ongoing business

- *Hempt Bros.* (3d Cir. 1974) (p456): in most cases, A/R that's transferred into a corporation will be treated like any other § 351 property contribution.
  - Note RR 80-198: if there's a tax avoidance purpose, then the assignment of income doctrine may apply, rather than § 351.
- RR 95-74 (p459)
  - Why did the Parent move its assets into the Subsidiary? To insulate its other assets from those assets (and possibly to make them disappear, though bankruptcy, e.g.).
  - Itc. says that contingent liabilities are within § 357(c)(3)--so they don't trigger gain recognition or basis adjustment when transferred.
- § 118: a contribution to capital does not create income for the corporation. See 1.118-1.
  - No GR.
  - Carryover basis if transferred by a shareholder. Zero basis if transferred by a nonshareholder (this would happen if, for instance, a creditor contributed to keep an entity afloat, or here a government entity contributed to incentivize relocation).

<u>Friday, March 31</u>

Capital structure

- "Capital": a corporation's assets (the left side of the BS).
- "Capital structure": liabilities and owners' equity, or how the corporation acquired its assets (the right side of the BS).
  - OE
    - Capital surplus (capital contributions)
    - Earned surplus ("earnings and profits")
      - Accumulated E&P
      - Current E&P
  - Owner versus lender
    - It used to be that both dividend and interest were OI. Now, dividends are always OI—in 2003 § 1(h)(11) was enacted, establishing that dividends will be treated as capital gains from the shareholder's persepective (so, they are taxed at 15%).
    - Interest payments trigger deductions, though (§ 165). So, there's inherent pressure to load up an entity with debt, to zero out income with these deductions.
  - Is it debt or equity?

        - Factors:
            - Debt/equity ratio
            - Subordination
            - Convertibility
            - Debt and equity amount held by shareholders
            - (And others.)
    - Payment of salaries is also used to avoid double taxation. However, FICA and other benefits taxes are a big downside to this.

Operating distributions

- Consider:
    - An owner sells his shares to a third party.
        - This is a § 1001 transaction—a sale/exchange; capital gain or loss is recognized.
    - An owner sells his shares to the corporation.
        - This looks like a § 1001 transaction, but if the shareholder is the sole owner, then it looks like...
    - An owner receives a distribution from the corporation.
        - This is a dividend.

    The rules try to distinguish between the last two.
- § 311(b)(1): distributions of appreciated property are gain recognition events. This is a big reason to not form a C corporation.

- Dividends
    - § 301
        - (c)(1): dividend to the extent of E&P.
        - (c)(2): basis adjustment.
        - (c)(3): dividend in excess of basis is capital gain.

        Every distribution is presumed to be out of E&P to the extent of E&P, *unless* overruled by another provision. The main overruling provision is § 302 (redemptions).
    - E&P: all dividends are treated as coming *first* out of current E&P and only then from accumulated E&P.
        - Note how a dividend could come from E&P accumulated before a shareholder became an owner.
        - E&P is not really defined in the code.
        - But § 312 tells us how to adjust taxable income, though, to get E&P.
            - Calculate depreciation differently.
            - Add back some deductions.
            - Subtract certain unallowed deductions.
            - § 312(a): dividends reduce E&P.

Tuesday, April 4

        - Do not reduce E&P for contingency reserve.
    - Recall: adjusting taxable income to get E&P:
        - Add back tax-exempt income. 1.312-6(b).
        - Add back some deductions.
            - Note the dividends received deduction, § 243.
        - Subtract certain unallowed deductions.
            - E.g., § 267, disallowing deductions for some losses on sales between related taxpayers.
        - Use straight-line depreciation for E&P. §312(k)(3)(A).
  - How can we get money out of a corporation, then? Salaries (but keep employment taxes in mind).
- Cash distributions
  - These are dividends to the extent of E&P. §§ 301(c)(1) & 316(a).
    - If they exceed E&P, reduce basis. § 301(c)(2). And recognize capital gain. § 301(c)(3).
  - But they are not distributions qualifying as redemptions. § 302.
  - Distributions reduce E&P. § 312(a).
  - A corporation can have a negative E&P (§ 312(b)(1)), but a *distribution* cannot create an E&P deficit (§ 312(a)).
  - Accumulated versus current E&P
    - Each distribution is made out of current E&P *first*. § 316(a) & 1.316-1(a)(1).
    - If you have multiple distributions in one year:
        - Prorate current E&P among the distributions:
            - Amount of E&P to allocate to this distribution = (current E&P / total distribution) * this distribution.
        - Allocate accumulated E&P chronologically to distributions (i.e., first to the first distribution, then to the second, and so on). 1.316-2(b) & (c) ex.; RR 74-164.

Wednesday, April 5

- Property distributions
  - The *General Utilities* doctrine:
    - The ordinary method for distributing property: the corporation sells assets to a buyer, and the appreciation is taxed on that sale; then the corporation distributes the cash to the shareholders, and this is taxed as a divideng.
    - The method itc.: the corporation distributes assets to the shareholders, who then sell the property. This way, the appreciation is taxed only in the sale.
  - Congress ultimately overruled *General Utilities*. Now, corporation operating distributions are governing by § 311(b) if there are gains. (§ 311(a) governs if

there are losses.)

            - Effect on E&P:
                - old E&P + GR – FMV = new E&P. § 312 (b)(1) & (2), (a)(3), and (f)(1).
                - E.g.: a corporation with 100 E&P distributes property with 25 AB and 50 FMV.
                    - New E&P = 100 (old E&P) + (50 (AR) – 25 (AB)) – 50 (FMV) = 75.
            - Effect on shareholder: a dividend = FMV, to the extent of E&P. § 301(b)(1)(A).
        - Liabilities
            - The dividend amount is the net of FMV less the liability amount. § 301(b)(1)(A) & (2)(A). *But*, the liability will not reduce the divident amount below 0.
            - E&P is reduced by (FMV – Lb.). § 312(c)(1) & (2). That is, E&P is reduced by FMV and increased by the amount of the liability.
            - The shareholder's basis in the property = FMV. § 301(d).
        - Corporate notes distributed
            - The corporation recognizes no gain. § 311(b)(1)(A) parenthetical.
            - The shareholder has a dividend, equal to FMV. 1.301-1(d)(1)(ii).
                - FMV of the note is its "issue price." See § 1274.
                    - If the instrument bears market rates, the issue price should be its face value.
                    - If it bears rates below market, then the issue price will be *less* than the note's face value, probably. In this case, the note is said to contain a "original issue discount" (OID), which is a form of interest.
                - Anything above issue price will be treated as interest income. § 212.
                    - E.g., a corporation distributes a note with a 95 issue issue price and 100 face value.
                        - 95 is a dividend; all the rest is interest income.
                        - Reduce E&P by 95 (the dividend amount, which is equal to the FMV of the note, which is equal to its issue price). § 312(a)(2) & (o).
    - Constructive distributions
        - See §§ 274 and 280A.
        - *Nicholls, North* (TC 1971) (p512): here a father's purported gift to his children, of the use of the corporate yacht, meant that the father was getting enjoyment of the yacht for personal purposes. That's a dividend, the court says.
        - A constructive distribution means that the economic substance of the transaction is the same as a real distribution. See Miller's article: 65 U. Colo. L. Rev. 1.
        - An example: "transfer pricing" (see § 482, which demonstrates the futility of attempting to tax multinational entities).

        - Parent has to subsidiaries, X and Y. Y sells assets to X for a price less than FMV. § 482 lets the IRS demand that the transaction be repriced to that of an arm's length transaction. This would be fine, except that the assets are still in X, valued at what X paid for them—so, the IRS has to assume a property dividend from Y to the Parent, then a cash dividend from P to X.
    - Another example: P, a U.S. corporation, has to subsidiaries, Irish S1 and German S2. P does drug R&D in the U.S. It sells a manufacturing license to S1 for a modest royalty. S2 pays a high price to S1 for the drugs it produces, putting all of the profits in S1 (which is in Ireland, a tax haven).

<u>Thursday, April 6</u>

Constructive ownership

- If shares are sold to a third party, it's a regular § 1001 transaction.
- If a shareholder receives a distribution on his shares, it's a dividend, taxed under § 1(h)(11).
- So, what if a shareholder sells his shares to the corporation?
    - This depends. See § 302(a) and (b). Sometimes it's a sale/exchange, sometimes it's a dividend.
- Redemptions in the real world
    - These aren't always a tax trick:
        - You may want to eliminate the interest of a dead shareholder.
        - You may want to sell to a buyer who can't afford all of the assets of the corporation.
        - You may be funding retirement.
- § 318: four kinds of attribution (deeming one shareholder to own shares of another):
    1. Family
    2. Entity to beneficiary
    3. Beneficiary to entity
    4. Options

    - Family attribution
        - You will be deemed to own the shares of your:
            - Grandchildren
                - But there's no deemed ownership by a grandchild of his grandparents' shares.
            - Children
                - Adopted children are children. § 318(a)(1)(B).
                - But there's not deemed ownership of a sibling of his siblings' shares.
            - Spouses
            - And parents

Some authorities say that there should be no family attribution if you can prove family discord. See, e.g., 510 F.2d 43.

- Entity to beneficiary attribution
  - The beneficiary is deemed to own shares in proportion to his percent interest in the entity.
  - There is no deemed ownership for a corporate shareholder at all, though, unless it owns (including constructively), at least 50% of the entity.
- Beneficiary to entity attribution
  - No attribution at all unless greater than 50% ownership.
  - An example: shareholder owns 20% of X and 60% of Y.
    - X doesn't have any of Y attributed to it—it's connection to the shareholder is only 20%.
    - But (60% * 20%) of X is attributed to Y.
- Options attribution: see § 318(a)(4).
  - Note that § 318(a)(5)(D) says that the option rule trumps the family rule.

- Double attribution: § 318(a)(5)(B)
  - An example: Brother, Mother, and Sister each own 1/3 of a corporation.
    - B and S don't own each other's shares—they're siblings.
    - But M owns S's shares and B's shares—and so the whole corporation.
    - B owns M's shares and his own, for 2/3 ownership. Same with S.
    - *§ 318(a)(5)(B) says don't attribute S's attribution to M (of 1/3) to B, or vice versa.*

__**Friday, April 7**__

- Note:
  - With entity to beneficiary attribution, you attribute in proportion to the interest.
  - But with beneficiary to entity attribution, you don't attribute in proportion. That is, if E is attributed B's shares at all, it gets *all* of them.

Redemptions

- § 302(a): you don't get redemption treatment if you don't qualify under § 302(b).
- § 302(b): there are four ways to get redemption treatment:
  1. Safe harbor (§ 302(b)(2)): if the distribution is "substantially disproportionate" to the shareholder. It is "substantially disproportionate" if:

1. After the redemption, the shareholder is less than a 50% owner.
2. And after the redemption, you have 80% or less of the voting stock that you owned before.
3. And after the redemption, you have 80% or less of the common stock that you owned before.

   RR 85-14 says that if you have redemptions close in time, as part of a single plan, they will be considered together.

2. Complete termination (§ 302(b)(3)): if you redeem everything, then it's a redemption.
   - The problem here, of course, are the redemption rules. But you can waive any family attributions by promising to hold no non-creditor interest for 10 years.
3. The not essentially equivalent test (§ 302(b)(1)): it's a redemption if "not essentially equivalent" to a dividend.
   - To meet this test, there must be a "meaningful reduction" in your ability to control the corporation. E.g., 57% to 50%, or 30% to 23%, would be okay.
4. Partial liquidation (§ 302(b)(4)): it's a redemption if the distribution is in partial liquidation of the corporation.
   - § 302(e) gives us the details of partial liquidation:
     1. There must be a plan.
     2. It must occur in a limited timespan.
     3. It must not be essentially equivalent to a dividend—but this is not the same as the § 302(b)(1) test:
        - § 302(e)(2) safe harbor: a partial liquidation redemption will not be considered essentially equivalent to a dividend if the corporation ceases some business while still conducting other business. (E.g., if it stops one line of business, of closes on division.)
          - The closed business part must be a "qualified" trade or business—it must have been conducted for at least five years. § 302(e)(3).
          - There's also "corporate contraction," where you operate the same business but on a smaller scale. The legislative history and caselaw suggest that this will work here.
          - RR 79-184 says that if you sell a subsidiary and distribute it to the shareholders, this does *not* qualify here.

- Effect of a redemption on the corporation
  - If the distribution is of appreciated property, § 311(b)(1) (gain recognition) still applies.
  - If the distribution is of loss property, § 311(a) (no loss recognition) still applies.

        - Any gain recognition will trigger an increase in E&P. § 312(b)(1), (a).
        - § 312(n)(7) says to reduce E&P by the redeemed stock's share of total E&P.
- Tax planning and redemptions
    - We often use redemptions with buy-sell agreements.
        - Types of buy-sell agreements:
            - Cross-purchase
            - Redemption buy-sell
    - Redemptions in divorce
        - If Husband and Wife, both owners of a corporation, sell shares to each other for money, this is a sale. But it's under § 1041—no recognition, no basis bump.
        - If, say, Wife sells her shares to the corporation, the IRS may view this as a constructive dividend to H followed by a purchase of shares from W. Thus, it would get dividend and § 1041 treatment. See 1.1041-2, which allows any agreement between H & W, as long as its consistent.

<u>Tuesday, April 11</u>

Stock dividends

- These are dividends of stock on stock.
    - The most typical kind is a stock split. This doesn't change the total value of the enterprise, and it brings to per-share price down.
- Generally, a stock dividend is not income—unless there's a § 305(b) exception. (So note that this works in sort of the opposite way as § 302).
- Preferred versus common stock
    - Preferred stock has some resemblance to debt, because of the priority in repayment (the preference).
    - Common stock gets a larger share of any growth.

    That is, once the preferred priority is satisfied, common gets all the growth.
- Basis
    - The shareholder takes his previous basis in his shares and spreads it across all the new shares.
        - So, with a split, e.g., each share will now have 1/2 the basis that it did before. § 307(a).
- Holding period: tacking under § 1223(5).
- E&P: no adjustment. § 312(d)(1)(B).
- Consequences to the corporation: no gain or loss. § 311(a).
- Taxable stock dividends: § 305(b)
    - In general, it is only *disproportionate* stock dividends that are taxable.
        - Note how this is the exact opposite from redemption treatment, where *only* disproportionate distributions get redemption treatment.
    - Four types of taxable stock dividends:
        - § 305(b)(1): a stock dividend is taxable if it's payable in stock or

property *at the election* of the shareholder—regardless of whether the shareholder makes the election. 1.305-2(a).

- § 305(b)(2): a stock dividend is taxable if its effect is that some shareholders get property and some get shares.
  - E.g., if the corporation has a preferred class and two common classes of stock, a split of *just* C2 will be taxable.
- § 305(b)(3): a stock dividend is taxable if some shareholders get common stock and some get preferred stock.
  - *But*, if a you split preferred and common, you are *not* under (b)(3), as long as there's no change in the ratio between C & P.
- § 305(b)(4): a stock dividend is taxable if it has the effect of changing the real conversion ratio. So, this will be *all* preferred dividends *unless* they are made to protect the conversion ratio.

Note § 306 stock—preferred stock issued on common. This won't be taxable if it doesn't shift the existing ratio between preferred and existing common.

* However, this is subject to special provisions. See § 306.

- If a stock dividend is taxable:
  - It will affect E&P: reduce it by FMV of the shares distributed. 1.312-1(d).

Liquidations

- A liquidation is when a corporation stops being a going concern and starts winding up.
- We'll look at:
  - Selling assets and distributing cash.
  - Distributing assets directly.
  - And transferring shares to third parties—reorganizations.
- Shareholder concerns:
  - Sale/exchange treatment.
  - Holding period.
  - Basis.
- Buyer concerns: basis—in each asset.
- Corporate concerns: gain and loss recognition.
- Note that it is difficult to appraise many businesses.

- Consequences to the shareholder
  - No gain or loss. § 331(a).
  - If property is distributed:
    - The shareholder takes an FMV basis. § 334.
    - If subject to liabilities, the net amount coming out is AR.
  - If multiple blocks of stock (bought at different times) are liquidated, then you must calculate gain and loss with respect to each block. (But this shouldn't

make a difference if all of the blocks were held long term.)

- Note that payout can come across tax years:
  - "Open transaction" treatment: this is what the shareholder wants—recover all basis first, before recognizing any gain. The IRS says that this is okay. RR 85-48 (see fn8p642x).
  - Installment method: § 453(j)(2). If you don't know the total payout, but do know the recovery period, recover the basis in equal proportions across years.
    - § 453(h)(1)(A) says that you can apply the installment method on a liquidation with installment notes that are distributed down to the shareholders.

- Consequences to the corporation
  - § 336: the corporation recognizes gain if it distributes appreciable property. It will also recognize losses if it distributes loss property.
    - *Except* in certain situations—this is more generous than with operating distributions.
  - § 267: losses between certain related parties will not be allowed.
    - This section doesn't apply here *directly*, but comes into play through § 336(d).
      - § 336(d)(2) isn't that important anymore, because it applies only to built-in losses at contribution. § 362(e)(2) now steps down basis at contribution.
    - So, we focus on § 336(d)(1).
      - (d)(1)(A) refers to § 267. Mainly, it's § 267(b)(2) & (3) that matter here.
      - *All* property contributed, within five years, in a § 351 transaction, is "disqualified property."

<u>Wednesday, April 12</u>

- An example:
  - Parent owns all of Subsidiary, with 100 AB. S has assets of 250 FMV, 500 AB.
    - Parent:
      - No gain or loss. § 332(a). Because P has 80% of shares in S by both value and voting power. § 1504(a)(2), § 332(b)(1).
        - There are also timing requirements: § 332(b)(2) & (3)--the liquidation must occur within one taxable year, or within three years if a liquidation plan is adopted.
      - Carryover basis. § 334(b)(1).
      - E&P: § 381(a).
      - Any minority shareholders in S would have to recognize gain and loss, because they are within § 331(a). They would take an FMV basis, under § 334(a).
    - Subsidiary:

            - The distribution to P of S's assets is a nonrecognition event. § 337.
            - See §§ 1245(b)(3), 1250(d)(3), and 453B(d)(1).
            - Carryover basis.
            - If S has minority shareholders, they recognize gain (§ 334(a)), but not loss (§ 336(d)(3)).
- *Riggs* (TC 1975) (p659)
    - Here, S takes money for shares from its shareholders, then adopts a liquidation plan for liquidating into P.
        - This is a way to get in § 332 if you're not quite there. You'll have to squeeze minority shareholders out, though.
- Adopting liquidation plans: normally, these must be adopted by a shareholder resolution. See 1.337-2(b).

Reorganizations

- § 368(a)(1)(A), (B), (C), and so on. We will focus on (A), (B), and (C) reorganizations—the "acquisitive" reorganizations.

<u>Thursday, April 13</u>

[missed class]

<u>Friday, April 14</u>

[missed class]

<u>Tuesday, April 18</u>

- A reorganizations
    - Continuity of interest is required—there's no set amount, but 50% will usually work.
    - You can pick up hidden liabilities here—this is no good.
- B reorganizations
    - Here, "control" is required—A must get at least 80% of T's shares.
    - You can only get voting shares in consideration, here.
- C reorganizations
    - These are like A reorganizations, in effect. But, these are not statutory mergers—they're more like asset acquisitions.
        - C is unlike A, for tax purposes, because:
            - Liabilities are disregarded, unless there is real boot.
            - Under C, you must:
                - Get most of T's assets.
                    - The "substantially all" requirement
                        - The RR 77-37 safe harbor: you're okay if

you get 90% of the net assets, 70% of the gross assets.
        - Note that you can have a pre-reorganization sale, by the Target, as long as the Acquirer gets the proceeds. RR 88-48.
        - Also, RR 57-518 says that if A gets all of T's *operating* assets, then the "substantially all" requirement is satisfied.
    - Give up only shares.
      - Exception: § 368(a)(2)(B): you can use *some* boot—up to 20% ((a)(2)(B)(iii)). This is the "boot relaxation rule."
        - If there's any real boot at all, any liabilities assumed will be treated as cash boot and *not* disregarded.

        An example:
          - 200K total amount given up.
          - 30K liabilities.
          - Thus, you can use up to 10K of real boot.

          (So, note that if liabilities are greater than 20% of the total, then you can't use any real boot at all.)
  - Creeping C reorganizations: the IRS used to disallow these, but no you can do them—as long as the old exchange is "old and cold." See 1.368-2(d)(4).
- Dissenters: you have to buy these out, and those payments are boot. RR 73-102.
  - Also, the "substantially all" test applies to assets that were used for redemptions just prior to reorganization (i.e., transactions to redeem out dissenters).
- Drops: under A, B, and C reorganizations, you can "drop" all of the acquired assets into a new or existing subsidiary immediately after the reorganization.
- Triangular reorganizations
  - Forward A triangular: § 368(a)(2)(D).
  - Forward C triangular: § 368(a)(1)(C) parenthetical.
  - Reverse triangular: § 368(a)(2)(E)
    - This looks like:
      - An A reorganization—because it's a merger.
      - A B reorganization—because P must get control.
      - A C reorganization—because you must get "substantially all" of

T's assets.

Wednesday, April 19

- Reorganization operating provisions
  - A “party” to a reorganization: § 368(b): all the operating provisions either explicitly or implicitly require you to be a “party” to the reorganization.
    - A, T, P, S, and X (a consolidated entity), are all parties.
  - Consequences to the target shareholders
    - § 354(a)(1): no gain or loss if they receive only stock or securities.
      - “Securities” means debt instruments, here.
    - § 356(a)(1): if there's any boot, then there will be gain recognized.
      - (a)(2): says that boot can be treated as a dividend. See § 356(a)(2), which sometimes treats this boot as a dividend, not gain from a sale/exchange. To determine whether it's a dividend or capital gain, use the § 302(b)(2) redemption rules. See *Clark*.
        - This isn't so important now because of § 1(h)(11). It will only affect whether the shareholders get basis recovery or not.
        - *Clark* (p742x) says to compare the interest that the shareholder gets to what the shareholder would have if he'd gotten no boot.
          - E.g., if the shareholder would have a 10% interest if he'd gotten no boot, but because he's getting boot will have an 8% interest, then there's a change in his relative interest, and thus a “dividend” (really a distribution under § 301).
            - If there were essentially no change, then it's a sale/exchange.
      - § 354(a)(2): if securities are received in greater amount than securities surrendered, the extra securities received will be treated as boot. See also § 356(d).

So, §§ 354 and 356 work sort of like § 351(a) & (b).

- Basis: § 358(a)(1): the same rule as with § 351 transactions:
  - New basis = carryover basis – FMV of boot + divident amount + GR.

Thursday, April 20

- Guide to reorganization operating provisions
  - T shareholders: §§ 354 (solely shares), 356 (boot), 358 (basis), 453(b)(6) (securities boot), 1223(1) (tacking).

- T: §§ 361(a), 361(b)(1), 357, 361(c), 361(b)(3)
- A: §§ 1032, 1001, 362(b), 1.358-6, 1223(2)

- Consequences to T shareholders, continued
  - If securities are received as boot, you may be able to recognize gain under the installment method. See § 453(b)(6) flush language.
    - This will *not* apply to publicly-traded targets.
    - If it does apply, the basis in the securities is initially 0 (otherwise, basis in boot is FMV (§ 358(a)(2)).
- Consequences to T
  - Nonrecognition on the transfer between T and A. § 361(a).
    - But T might receive boot from A. There's no recognition on this boot if it's transferred to T's shareholders.
    - Assumption of T's liabilities by A will not be boot, usually. § 357.

    So, T usually escapes without gain recognition. But, if, when T distributes down to T's shareholders:
      - There's no gain to T on "qualified property" distributed.
      - There *is* gain to T on appreciated property distributed. § 361(c).
      - T can't recognize loss on any boot, whether distributed or not. § 361(b)(2).
- Consequences to A
  - Issuance of new shares is a nonrecognition event. § 1032.
  - If A transfers appreciated boot, § 1001 applies, for gain recognition.
  - Basis
    - A takes a carryover basis in what it receives from T, increased by any gain recognized by T on the transaction. § 362(b).
    - See 1.358-6 for A's basis in subsidiary shares in a triangular reorganization.

Friday, April 21

S CORPORATIONS

- Generally, an S corporation is a pass-through entity. So, there's no corporate level tax.
  - Note, though, that two corporate level taxes apply to S corporations with C corporation histories.
- Advantages over partnerships
  - Limited liability
  - Centralized management
  - An employment tax advantage—distributions of profits by an S corporation escape employment taxes.
- Disadvantages
  - The basis rules are better for partnerships—partners get a basis bumpt for

        sharing in liabilities.
    - And, S corporations can't make special allocations. Everything must be distributed pro rata. There is no § 704(b) equivalent.
- Liquidation: when an S corporation liquidates:
    - It recognizes gain, like a C corporation.
    - But the gain flows through to the shareholders, thus raising the shareholders' bases. (Thus, you should put any appreciating property into a partnership.)
- Eligibility: § 1361(b)
    - (b)(1)(A): 100 shareholders or less (liberally interpreted—see (c)).
    - (b)(1)(B): shareholders must be individuals, generally.
    - (b)(1)(C): shareholders cannot be nonresident aliens.
    - (b)(1)(D): only one class of stock.
    - (b)(2): business activity prohibitions—no banks, insurance companies, or DISCs.
    - An S corporation can have a subsidiary, if it's a Qualified Subchapter S Subsidiary (QSSS), which must normally be 100% owned.
    - An S corporation can own a C corporation, but it can't file a consolidated return with the C corporation.
    - An S corporation can participate in reorganizations, as long as it is only momentarily owned by a C corporation.

<u>Tuesday, April 25</u>

- Special note on reorganizations—the boot relaxation rule is applied to *aggregate* FMV. That is, you must get at least 80% of value *not counting liabilities*. I.e., *not* net worth. See B&E ¶ 12.24[3][d].
    - This is the aggregate FMV of *all* the target's assets, not just those received by A. See § 368(a)(2)(B).

- S corporations have different distribution rules.
- Eligibility, continued: § 1361(b)
    - A C corporation can't own an S corporation, except momentarily as part of a reorganization. See GCM 39768.
    - The 100 shareholder limit
        - The shareholders must be human beings, for the most part.
            - However, trusts can hold S corporation shares.
                - But note Distributable Net Income (DNI)--you must think about the effects on DNI if you're putting S corporation shares into a trust.
        - Spouses: treated as one person. § 1361(c)(1).
        - Family members: they can *elect* to be treated as one person. § 1361(c)(1)(D). Otherwise, they're counted separately.
        - Joint owners: counted separately. 1.361-1(e)(2).
        - Shares held by a fiduciary for beneficiaries: the general rule is that we count all beneficiaries separately. 1.361-1(e)(1).

        - S corporations as partners: this used to be a violation, but now the IRS has conceded that it's okay. RR 94-43.
        - Estates and trusts
            - Trust taxation basics: they are treated as an entity, but get a deduction for distributions.
            - Certain trusts can be S corporation shareholders
                - Grantor trusts (§§ 671 – 679)
                - Voting trusts
                - QSSTs: § 1361(d)(3)(B) (these are mostly QTIPs (§ 2056(b)(7)) and § 2056(b)(5)s; it does *not* cover "sprinkle" trusts (but electing small business trusts *can* be sprinkle trusts)).
                    - Only one income beneficiary is permitted.
                    - Any corpus distributions must be to the life beneficiary.
                    - The life beneficiary's interest must terminate on the earlier of the trust's end or the beneficiary's death.
                    - If the trust terminates before the beneficiary's death, all the corpus must be distributed to the life beneficiary.
                - Testamentary trusts
                    - Grace period: a testamentary trust that inherits S corporation shares has two years to get rid of them. § 1361(c)(2)(A).
                - Electing small business trusts
                - Former grantor trusts: these can hold S corporation shares for two years after the grantor's death. § 1361(c)(2)(A)(ii).
            - So, if a trust can hold S corporation shares, who's the shareholder?
                - Grantor trusts: the grantor. § 1361(c)(2)(B)(ii).
                - Former grantor trusts: the estate.
                - Voting trusts: *each beneficiary* is a shareholder.
                - QSSTs: the life beneficiary is the shareholder.
    - The one class of stock requirement
        - This does not look at *authorized* shares—it looks only at issued and outstanding shares.
        - This doesn't prevent the creation of different voting rights. So, you can have voting and nonvoting shares, as long as the single class has equal rights with respect to distributions and liquidations. § 1361(c)(4).
        - Debt
            - You can issue debt and it won't be treated as a separate class of stock for the one-class requirement, *if* you're in the "straight debt safe harbor" (§ 1361(c)(5)(B)):

        - The debt must be for a sum certain.
        - Interest must not come as interest on profits.
        - The promise to pay must be unconditional.
        - It must bear a reasonable interest rate.
        - It must not be convertible.

<u>Wednesday, April 26</u>

- A quick survey of S corporation taxation
    - Election
        - All shareholders must file a written consent.
            - This really means *all*—e.g., both spouses.
        - The election is effective for the year when signed, if file by the 15th day of the third month of the tax year. And it's effective for all future years, until revoked or the S corporation eligibility terminates.
            - The election can be revoked by a majority of the shareholders. And a revocation can be retroactive if filed by the 15th day of the third month of the tax year.
        - It's prudent to have a buy-sell agreement, too keep control of the number of shareholders.
    - Termination
        - On termination, an S corporation becomes a C corporation.
        - It must stay, then, a C corporation for at least five years.
        - If an S corporation terminates in the middle of the year, then there will be a short S year and a short C year.
    - Operation: this resembles partnership tax.
        - The S corporation files an informational return—it doesn't pay tax itself (usually).
        - Only strictly pro rata allocations are allowed—there can be no special allocations.
        - Shareholders will report income in the shareholder's tax year in which the S corporation's tax year ends.
        - A shareholder can deduct losses up to: basis in shares + basis in any debt owed to shareholder by the corporation.
            - Excess losses carryover indefinitely.
            - As losses are allowed, they reduce the shareholder's basis.
                - Decrease the basis in the shares first.
                - Then decrease the basis in any debt.

                When increasing basis, do the opposite:

                1. Increase debt basis.
                2. Then increase shares basis.
        - Allocations of income increase share basis.
        - Distributions
            - These do no trigger gain recognition as long as they don't

exceed the share basis—no matter whether cash or property.
        - If they do exceed share basis, then there's GR to the extent of the excess. This GR is capital.
    - Distributions reduce basis.
    - *But*—distributions of appreciated property trigger GR at the corporate level. This gain flows through to the shareholder level, boosting basis.
        - The shareholder takes an FMV basis in the property.
- S corporations versus C corporations
    - Formations: C rules apply to S corporations:
        - Nonrecognition unless boot.
        - Carryover basis.
        - Etc.
    - Operating distributions: C rules apply with respect to gain at the corporate level—but not at the shareholder level.
    - Redemptions: C rules apply.
    - S corporations that own C corporations do not get a dividend received deduction—the dividends flow through to the shareholders.
    - Liquidation: C rules apply at the corporate level—gain is recognized. But, this gain flows through to the shareholders, increasing their shares basis.
        - Liquidating distributions are treated as distributions in sale/exchange.
- S corporations cannot make a § 754 election or anything like it. So, inherited S corporation shares get a § 1014 basis, but the S corporation will get no basis bump in its assets.
- Sales of S shares: there's no § 751 analog—so these are more like C corporation share sales. Everything's just capital.
- Reorganizations: C rules apply.