

ID # _____

Corporate Taxation
Massachusetts School of Law- Spring 2012
Professor McLellan

CORPORATE TAX EXAM
Exam #1

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Albert and Megan are cousins. One summer, when they were young and had nothing better to do, they decided to make Grandma's secret family cheesecake recipe and sell cheesecakes from a little shack in the beach resort town where they grew up. After several lazy summers as entrepreneurs, the cheesecake business actually became a huge success. They decided to open an official business by forming A&M, Inc., a C-Corporation.

1. When they formed the business, Megan contributed some real estate with a little building that would be perfect to use as a kitchen and shop. The real estate had a basis of \$40,000, a fair market value of \$100,000, and a mortgage of \$50,000 at the time of formation. In exchange, Megan received 50 shares of voting common stock.

Assuming that §351 applies, does Megan recognize any income? If so, how much?

What is Megan's basis in the stock?

What is A&M Inc.'s basis in the real estate?

Albert, whose mother was a well-known chef, contributed commercial ovens and cooking supplies with a basis of \$35,000 and a value of \$25,000. In return, he received 25 shares of voting common stock.

Assuming that §351 applies, does Albert recognize any income? If so, how much?

What is Albert's basis in the stock?

What is A&M Inc.'s basis in the assets?

Is there a way to get a better result for A&M, Inc.?

2. A&M also requires cash to get the business going. Megan's dad (Banker- who is also Albert's uncle), impressed with their initial success, decided to contribute \$30,000 (cash) in exchange for 30 shares of voting common stock. Once the business was successful, Megan and Albert decided to redeem Banker's shares. The shares were now worth \$2,000 each. A&M had plenty of accumulated earnings and profits, but not a lot of cash on hand. They offered two options:

1. Redeem 15 shares that year and the other 15 shares two years later, or,
2. Redeem all 30 shares at once, but receive payment with a 10-year promissory note.

What are the tax consequences of each option? If you were Banker, which option would you choose and why? Would you propose something different?

3. A&M has accumulated \$250,000 of earnings and profits and has \$50,000 current earnings and profits. Both shareholders agree that A&M should make the following distributions:

Albert now owns 40 shares with a basis of \$1,000 per share. He will receive a distribution of \$200,000 cash.

Megan also owns 40 shares with a basis of \$1,000 per share. She will receive a distribution of property with a basis of \$220,000, a fair market value of \$300,000 and she assumes a loan associated with the property of \$100,000.

a) Does Albert realize any income? If so, how much?

What is Albert's basis in his stock after the distribution?

b) Does Megan realize any income? If so, how much?

What is Megan's basis in her stock after the distribution?

What is Megan's basis in the property she receives?

c) Does A&M realize any income? If so, how much?

How are A&M's earnings and profits affected by the distributions? Please show, or briefly describe, your calculation.

4. Assume that Banker's 30 shares had not been redeemed and Albert and Megan each own 40 shares. After a couple of years, the business became very successful, and they decided to move into the wholesale candy business. Megan's dad brought in a business partner (BP) who owned a factory building that would be perfect to use as a manufacturing plant. BP's basis in the plant was \$100,000 and the value was \$400,000. There was no debt assumed by A&M Inc. with the contribution of the plant. In exchange, BP received 200 shares of A&M voting common stock.

Does §351 apply? Why or why not? Does BP recognize any income as a result of the transaction?

What is BP's basis in A&M stock?

What is A&M's basis in the property?

5. Answer one of the following questions:

a) Can you think of a better way to structure the transaction in question 4? If so, how? If not, what are the impediments?

b) If Banker gave A&M \$500,000 to purchase the plant in exchange for non-voting preferred stock, would that be considered debt or equity? What would the tax consequences be?

Briefly explain your answer citing relevant cases or code sections.

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PARTNERSHIP TAX (SUBCHAPTER K) EXAM

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3. Natalie is a partner in MSL, LLC. She has an outside basis in her partnership interest of \$40,000 and the book value of her capital account is \$75,000. Describe the tax consequences (what would Natalie report on her individual income tax return) and the effect on Natalie's capital account (basis and book value) in each of the following alternative situations:

a) Natalie's distributive share of MSL profits is \$20,000 for 2011.

b) Natalie's distributive share of MSL losses is \$10,000 for 2011.

c) Natalie receives a distribution of \$5,000 cash from MSL.

4. Harriet is going to provide services for Business, LLC in exchange for a salary plus a 10% profits interest in the partnership. What are the resulting tax consequences to Harriet and Business, LLC?

Is there a different result to Harriet if Business, LLC offers Harriet a 10% capital interest instead? (Briefly explain your answer.)

5. Dan, Frank, and Laura form a general partnership where profits, losses, and debt obligations are shared equally. Dan and Frank each contribute \$50,000 cash. Laura contributes real property with a basis of \$40,000, a fair market value of \$80,000 and a recourse mortgage of \$30,000 which the partnership assumes.

Is any tax due at the formation of the partnership? Please state the applicable code section for your answer.

What does the beginning balance sheet look like?

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S CORPORATION TAX (SUBCHAPTER S)

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S CORPORATION TAX EXAM

1. An S-Corp. is limited to the number and type of shareholders and the type of stock. Do the following qualify under the subchapter-s rules?
 - a) Husband owns 55 shares and wife owns 50 shares.
 - b) Joe, Gary, and Robert each own 40 shares. Joe and Gary own common voting stock while Robert's shares are non-voting common stock.
 - c) A subchapter-C corporation purchases 20 out of 90 shares.
 - d) Kelly leaves 20 shares to Kristen in her will. (There are only 2 other shareholders and all are US citizens.)
 - e) A non-resident alien purchases two shares of stock for fair market value.

2. Kristen and Dennis form a subchapter S corporation. Kristen contributes \$400 on formation in exchange for 40 shares of common stock and Dennis contributes property with a fair market value of \$500 and a basis of \$300 in exchange for 40 shares of common stock. In year one, the company earns \$300 of ordinary income and has deductible expenses of \$100. The corporation does not make any distributions in year one. What do Kristen and Dennis report on their individual tax returns for year one and what is their basis at the end of the year?

3. JGR Corporation, a subchapter S corporation, has 90 shares of voting common stock. Joe, Gary and Robert each own 30 shares. Joe's basis in his shares is \$400, Gary's basis is \$500 and Robert's basis is \$600. JGR distributes property (held long-term) with a basis of \$300 and a fair market value of \$600 to Gary. Joe and Robert each receive \$600 cash. The corporation was never a C-Corporation. What are the tax consequences to the corporation and its shareholders as a result of this transaction? (Remember to account for the distribution of property first.) What is Gary's basis in the property?

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CORPORATE TAX EXAM

1. Eddie wants to start a business to manufacture products that run on an alternative fuel source that he developed. He solicits your advice about C Corporations. Based on what you have learned in the course so far, list two reasons (tax and/or non-tax) why Eddie may want to incorporate his business as a C Corporation.

2. A, B, and C are going into business together. They choose to form X Corp and have elected C Corporation status for federal tax purposes. Please describe the tax consequences to A, B, C, and X Corp when they contribute the following property to X Corporation upon formation, all as part of the same transaction.
 - A) A contributes \$40,000 cash in exchange for 40 shares of X Corp. stock.

 - B) B contributes equipment with a basis of \$25,000 and a fair market value of \$40,000 for 40 shares of X. Corp. stock.

 - C) C contributes inventory with a basis of \$50,000 and a fair market value of \$40,000 for 40 shares of X Corp. stock.

3. What are the tax consequences, if D and E also made contributions to X Corp. as follows? (Assume that D and E's contributions happened as part of the formation in conjunction with A, B, and C.)
 - A) D contributes Pepsi stock which has a basis of \$30,000 and a fair market value of \$60,000 in exchange for 40 shares of X Corp. stock and \$20,000 cash.

 - B) E contributes land with a basis of \$25,000, a fair market value of \$75,000, and a mortgage that E has been paying for 10 years and the outstanding debt is now \$35,000 in exchange for 40 shares of X Corp. stock.

4. In the beginning of 2010, Y Corporation has accumulated earnings and profits of \$8,000 and current earnings and profits by the end of 2010 of \$4,000. Y Corporation makes distributions (non-liquidating) to its shareholders G and H on June 30, 2010. What are the federal tax consequences to G, H, and Y Corp. if the distribution from Y Corp. is as follows? (Consider amount realized, basis, and the effect on earnings and profits.)
- A) G receives a \$5,000 cash distribution and has an adjusted basis in Y Corporation stock of \$3,000.
- B) H receives property where Y Corporation had a basis of \$12,000 and a fair market value of \$15,000, but was subject to a \$10,000 debt. Prior to the distribution, H had an adjusted basis in Y Corporation stock of \$7,000.
5. Brother and Sister are siblings. They are involved in a family business together along with their Mother. Family Corporation has 100 shares of voting common stock outstanding and no shares of preferred stock. Brother owns 60 shares of Family Corporation stock, Sister owns 30 shares and Mother owns 10 shares. Family Corp has plenty of accumulated earnings and profits. For the most part, decisions are made collectively. However, Brother enjoys having a controlling interest when difficult decisions need to be made. Brother recently became engaged and is thinking about redeeming 40 shares of Family Corp. for \$20,000 in order to pay for his wedding. His basis in the stock is currently \$300 per share. How will that transaction be treated for federal tax purposes? Do you have any suggestions for Brother so he would get a better result? Briefly explain your answer.

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1. Matt and Karl start a business where they are going to be equal partners. Matt contributes \$200 cash and Karl contributes land with a basis of \$120 and a fair market value of \$200. Two years later, the land is worth \$400, and Dan joins the partnership. How much cash should Dan put in to be an equal partner? Assuming nothing else has changed, what is each partner's basis in the partnership? Does any partner recognize a taxable gain when Dan makes his contribution?
2. Adam and Mark form Green Partnership, an equal partnership, to bring to the US and Asian markets a new, very green technology. Adam contributes land with a basis of \$500, a fair market value of \$1,000 and a recourse mortgage of \$200. The partnership takes on the recourse debt. Mark contributes stocks with a basis of \$400 and a fair market value of \$800. Show the partnership beginning balance sheet.
3. Green Partnership is having difficulty getting off the ground. They now have \$800 cash and 10 shares of GE stock with a basis of \$200 and fair market value of \$400. Assume that Adam and Mark each have an outside basis of \$500, and their capital account balances are \$600 each. They decide to bring Bryan into the partnership. He has already begun a fantastic marketing campaign that is taking the Asian market by storm. Bryan is made an equal partner and receives a 1/3 capital interest in exchange for his services and expertise. What are the tax consequences to Bryan, Adam, and Mark? What is each partner's outside basis and the value of their capital accounts after the transaction?

4. Charlise, Lisa, and Kevin form a law partnership. They agree that since Charlise is the more experienced partner, she will be guaranteed \$50,000 per year of the profits and the remainder, if any, will be split equally. The fee splitting arrangement is to be renegotiated annually. In the fourth year of practice, Lisa wins a three million dollar settlement. The law firm collects its share, which comes to one million dollars. Charlise and Kevin agree that Lisa should get the first 20% of the firm's share of the settlement, and the remainder is divided equally. Of course, all of these terms are incorporated into the partnership agreement, which has been amended from time to time. All partners are in the same tax bracket, except in the year of the large settlement. In that year, Charlise and Kevin are in a 28% tax bracket, and Lisa is in a 35% tax bracket.

What should be included in a partnership agreement to ensure that special profit-sharing arrangements are honored by the IRS? Do these allocations have "substantial economic effect"? Please explain your answer.

5. Of course, Jeff and Ken have established a partnership as well. They share the profits and losses equally. The balance sheet for their business in the beginning of 2010 is below:

Assets			Liabilities		\$0
	tax	book	Capital Accounts:		
cash	\$1,000	\$1,000		tax	book
equipment	\$300	\$600	Jeff	\$650	\$1,000
AT&T stock	<u>\$200</u>	<u>\$400</u>	Ken	<u>\$850</u>	<u>\$1,000</u>
	\$1,500	\$2,000		\$1,500	\$2,000

What are the tax consequences to Ken and Jeff if the partnership has \$1,000 in income and they make a non-liquidating distribution of \$400 cash to Ken and all of the AT&T stock to Jeff? What is Jeff's basis in the AT&T stock? Show the new balance sheet.

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