

UNDERSTANDING TAXATION OF BUSINESS ENTITIES

LexisNexis Law School Publishing Advisory Board

Bridgette Carr

Clinical Professor of Law University of Michigan Law School

Steven I. Friedland

Professor of Law and Senior Scholar

Elon University School of Law

Carole Goldberg

Jonathan D. Varat Distinguished Professor of Law

UCLA School of Law

Oliver Goodenough

Professor of Law

Vermont Law School

Paul Marcus

Haynes Professor of Law

William and Mary Law School

John Sprankling

Distinguished Professor of Law

McGeorge School of Law

UNDERSTANDING TAXATION OF BUSINESS ENTITIES

Walter D. Schwidetzky
Professor of Law
University of Baltimore School of Law

Fred B. Brown
Associate Professor of Law
University of Baltimore School of Law

ISBN: 978-0-7698-6904-9

ISBN (ebook): 978-0-3271-9415-6

Library of Congress Cataloging-in-Publication Data

Schwidetzky, Walter D., 1952- author.

Understanding taxation of business entities / Walter D. Schwidetzky, Professor of Law, University of Baltimore School of Law; Fred B. Brown, Associate Professor of Law, University of Baltimore School of Law.

pages cm

Includes index.

ISBN 978-0-7698-6904-9 (softbound)

1. Business enterprises--Taxation--Law and legislation--United States. I. Brown, Fred B., author. II. Title.

KF6450.S39 2015

343.7306'7--dc23

201404146

This publication is designed to provide authoritative information in regard to the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional services. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

LexisNexis and the Knowledge Burst logo are registered trademarks of Reed Elsevier Properties Inc., used under license. Matthew Bender and the Matthew Bender Flame Design are registered trademarks of Matthew Bender Properties Inc.

Copyright © 2015 Matthew Bender & Company, Inc., a member of LexisNexis. All Rights Reserved.
2015

No copyright is claimed by LexisNexis or Matthew Bender & Company, Inc., in the text of statutes, regulations, and excerpts from court opinions quoted within this work. Permission to copy material may be licensed for a fee from the Copyright Clearance Center, 222 Rosewood Drive, Danvers, Mass. 01923, telephone (978) 750-8400.

NOTE TO USERS

To ensure that you are using the latest materials available in this area, please be sure to periodically check the LexisNexis Law School web site for downloadable updates and supplements at www.lexisnexis.com/lawschool.

Editorial Offices

630 Central Ave., New Providence, NJ 07974 (908) 464-6800

201 Mission St., San Francisco, CA 94105-1831 (415) 908-3200

www.lexisnexis.com

MATTHEW  BENDER

DEDICATION

To my parents, wife, and children, who have supported me in so many ways.

Fred Brown*

To my grandmothers Mary Augusta Jones and Suzanne Schwidetzky, both of whom attended university around 1900, and one of whom came from a working class background. There were feminist pioneers decades before the word “feminist” entered our vocabulary.

Walter Schwidetzky

* I am very grateful to Stacey Morris for her excellent research assistance.

PREFACE

This book is an overreaction to a problem that I experienced in teaching business entity taxation. I could not find a single-volume supplemental text to recommend to students that I felt fully met their needs. From my own experience in teaching the course, I know that there are some areas a professor covers in detail, others that are just skimmed over, and still others that are somewhere in between. Fred Brown and I wanted a book that is user-friendly and that would allow students to opt for just a broad overview or dive into the material in more detail. At the same time, we wanted a “twofer,” a text that would be valuable to students who take separate courses in corporate and partnership taxation. Students would be spared the cost of buying two different texts. Further, it is common for professors teaching one subject to refer to the other. For example, if an owner contributes property to a corporation subject to debt that exceeds the owner’s basis, the corporate tax rules typically have a different answer from the partnership tax rules. Having a single-volume text makes it easy for a student to get up to speed in both areas. Since we could not find what we wanted, we wrote what we wanted. We hope you find our effort helpful.

Walter Schwidetzky
Fred Brown

TABLE OF CONTENTS

Chapter 1	INTRODUCTION	1
A.	Overview	1
B.	The Classification of Domestic Business Entities for Tax Purposes	2
C.	The Classification of non-U.S. Business Entities for Tax Purposes	4
D.	Publicly Traded Entities	5
E.	Taxes Doing the Driving	6
F.	State Taxation	6
PART I:	PARTNERSHIPS	7
Chapter 2	DEFINING PARTNERSHIPS AND PARTNERS FOR TAX PURPOSES	9
	BASIC OVERVIEW	9
	DETAILED DISCUSSION	12
§ 2.01	THE EXISTENCE OF A BUSINESS ENTITY	12
§ 2.02	CLASSIFYING PARTNERSHIPS FOR TAX PURPOSES	13
A.	The Nature of Partnerships	13
§ 2.03	DISTINGUISHING PARTNERSHIPS FROM OTHER CONTRACTUAL ARRANGEMENTS	14
A.	Distinguishing Partnerships from Loans	14
B.	Distinguishing Partnerships from Service Agreements	14
C.	Distinguishing Partnerships from Leases	15
D.	Distinguishing Partnerships from Co-Ownerships	16
§ 2.04	DETERMINING WHO IS A PARTNER	17
§ 2.05	ELECTING OUT OF SUBCHAPTER K	18
Chapter 3	FORMATION OF THE PARTNERSHIP	21
	BASIC OVERVIEW	21
	DETAILED DISCUSSION	25
§ 3.01	TRANSFER OF PROPERTY TO PARTNERSHIP	25
A.	General Rules	25
B.	What Constitutes Property	25
1.	Cash	25
2.	Contract Rights	25
a.	Promissory Notes	26
i.	Contributor's Promissory Note	26
ii.	Third-Party Promissory Note	26
iii.	Installment Note	26
iv.	Partnership's Indebtedness to the Partner	27
b.	Option to Acquire Property and Letters of Intent	28

TABLE OF CONTENTS

3.	Services	28
4.	Right to Use Property	29
5.	Recapture Property	29
6.	Inventory and Unrealized Receivables	29
7.	Recapitalizations	29
C.	“Contribution”	30
D.	Effect on Depreciable Assets	30
E.	Stock of Corporate Partners	30
F.	Disregarded Entity Becoming Partnership	31
§ 3.02	EFFECT OF RECEIPT OF “BOOT”	31
§ 3.03	EFFECT OF LIABILITIES	32
§ 3.04	BASIS OF PARTNERSHIP INTEREST TO PARTNER	33
§ 3.05	HOLDING PERIOD OF PARTNERSHIP INTEREST	33
§ 3.06	PARTNERSHIP’S BASIS FOR CONTRIBUTED PROPERTY	34
§ 3.07	PARTNERSHIP’S HOLDING PERIOD FOR PROPERTY RECEIVED	34
§ 3.08	CHARACTER OF GAIN OR LOSS FROM SALE OF CONTRIBUTED PROPERTY	35
A.	Contributions of Ordinary Income Assets	35
1.	Unrealized Receivables	35
2.	Inventory Items	35
B.	Contributions of Capital Loss Property	36
§ 3.09	ORGANIZATION AND SELLING EXPENSES	36
A.	Selling Expenses	36
B.	Organizational Expenses	36
C.	Start-Up Expenses	37

Chapter 4	OUTSIDE BASIS AND ALLOCATION OF LIABILITIES	39
	BASIC OVERVIEW	39
	DETAILED DISCUSSION	43
§ 4.01	INTRODUCTION	43
§ 4.02	GENERAL RULES FOR COMPUTING BASIS	43
A.	Adjustments to Basis of Partnership Interest — Generally	43
B.	Special Adjustments	44
1.	Tax-Exempt Income	44
2.	Natural Resources Property	44
3.	Nondeductible Expenditures	45
4.	Distributions	45
C.	No Negative Basis	45
D.	Time for Computing Basis	45
E.	Ordering Rules	46
§ 4.03	EFFECT OF PARTNERSHIP LIABILITIES	46

TABLE OF CONTENTS

A.	General Rules	46
B.	Definition of Recourse and Nonrecourse Liabilities	47
1.	Definition of Recourse Liability	48
2.	Assumption of Liability	50
3.	Definition of Nonrecourse Liability	50
4.	Bifurcated Liability	51
C.	Allocation of Recourse Liabilities: Examples	51
D.	Allocation of Nonrecourse Liabilities	52
E.	Contributions and Distributions of Encumbered Property	54
F.	Tiered Partnerships	56
G.	Sales of Partnership Interests	56
H.	Anti-Abuse Rule	57
Chapter 5	OPERATION OF THE PARTNERSHIP: CALCULATION OF PARTNERSHIP TAXABLE INCOME	59
	BASIC OVERVIEW	59
	DETAILED DISCUSSION	61
§ 5.01	PASS-THROUGH NATURE OF PARTNERSHIP	61
A.	Generally	61
B.	Taxable Income of the Partnership	61
C.	Separately Stated Items	62
1.	Gains and Losses from Sales	62
2.	Charitable Contributions	62
3.	Dividend Income	63
4.	Foreign Taxes Paid	63
5.	Other Items	63
D.	Bottom Line Profit or Loss	63
§ 5.02	ELECTIONS	64
A.	C Corporation is Partner	64
§ 5.03	CHARACTERIZATION	65
A.	I.R.C. § 724	65
B.	Holding Period	65
C.	Hobby Loss Rules	65
D.	Discharge of Indebtedness Income	66
§ 5.04	LOSS LIMITATION RULES	66
A.	Basis Limitation	67
B.	At Risk Rules	68
1.	Limitations on Losses to Amount at Risk	68
2.	Calculations of Amount at Risk	68
3.	Nonrecourse Financing	69
4.	Carryover of Disallowed Losses	69
5.	Applicability to Partnerships	70

TABLE OF CONTENTS

6.	Disposition of Activity or Partnership Interest	70
C.	Passive Loss Limitation	71
1.	Loss Disallowance Rule	71
2.	Passive Activity	71
3.	Material Participation	71
D.	Disposition of Partnership Interest	73
§ 5.05	TAXABLE YEAR OF PARTNERSHIP	74
A.	Required Taxable Years	74
B.	Business Purpose	75
C.	§ 444 Election	76

Chapter 6	OPERATION OF A PARTNERSHIP: ALLOCATION OF PARTNERSHIP INCOME AND LOSSES	79
	BASIC OVERVIEW	79
§ 6.01	INTRODUCTION	88
§ 6.02	SUBSTANTIAL ECONOMIC EFFECT RULES	90
A.	Introduction	90
B.	Economic Effect Rules	91
1.	“Regular” Rules	91
2.	Alternate Economic Effect Rules	92
3.	Economic Effect Equivalence	95
C.	Substantiality	95
1.	General Rules	95
2.	Shifting and Transitory Allocations	97
3.	Depreciation/Recapture Gain Chargebacks	98
4.	Tax Credits	99
5.	“q” Adjustments	100
§ 6.03	PARTNER’S INTEREST IN THE PARTNERSHIP	100
A.	Introduction	100
§ 6.04	BOOK-TAX DISPARITIES — I.R.C. § 704(C) ALLOCATIONS	101
A.	Introduction	101
B.	I.R.C. § 704(c) Methods of Allocation	103
1.	The Traditional Method	103
2.	Traditional Method with Curative Allocations	105
3.	Remedial Method	106
4.	Depreciation	106
5.	Other Considerations	108
C.	New I.R.C. § 704(c)(1)(C)	108
§ 6.05	REVERSE I.R.C. § 704(C) ALLOCATIONS	109
§ 6.06	ALLOCATIONS OF NONRECOURSE DEDUCTIONS	111
A.	Introduction	111
B.	The Regulatory Safe Harbor	113

TABLE OF CONTENTS

C.	Subsequent Nonrecourse Borrowing	118
§ 6.07	FAMILY MEMBERS AS PARTNERS	118
A.	Introduction	118
B.	Pre-I.R.C. § 704(e) Case Law	119
C.	I.R.C. § 704(e)	119
§ 6.08	CHANGES IN PARTNERSHIP INTERESTS DURING THE TAX YEAR	120
A.	General Rules	120
B.	Closing of Partnership Taxable Year	120
C.	Requirement to Account for Varying Interests	121
D.	Methods of Allocation	121
Chapter 7	DISPOSITIONS OF PARTNERSHIP INTERESTS	125
	BASIC OVERVIEW	125
	DETAILED DISCUSSION	129
§ 7.01	INTRODUCTION	129
§ 7.02	RECOGNITION OF GAIN OR LOSS	129
A.	Amount Realized	130
B.	Basis	130
§ 7.03	CHARACTER OF GAIN OR LOSS	131
A.	General Rule	131
1.	Ordinary Income Recognition	131
2.	Unrealized Receivables	131
3.	Inventory Items	132
§ 7.04	HOLDING PERIOD	133
§ 7.05	DISPOSITIONS OTHER THAN SALES OR EXCHANGES	133
A.	Death of a Partner	133
B.	Exchanges of Partnership Interest	133
C.	Abandonment and Worthlessness	134
D.	Conversion to Corporation	135
E.	Transfers to Other Partnerships	136
§ 7.06	OPTIONAL ADJUSTMENT TO BASIS OF PARTNERSHIP PROPERTY	137
A.	I.R.C. § 743(b)	138
B.	Making the I.R.C. § 754 Election	138
C.	Effect of I.R.C. § 743(b)	139
D.	Computation of Transferee's Proportionate Share of I.R.C. § 743(b) Adjustment	140
E.	Allocation of Basis Adjustment among Partnership Assets under I.R.C. § 755	141
F.	Additional Aspects of Adjustment	143
1.	Transfer of Partnership Interest	143

TABLE OF CONTENTS

2.	Distribution of Partnership Property	143
3.	Contribution of Property to Lower-Tier Partnership	143
4.	Contribution of Property to Corporation	143
5.	Special Basis Adjustment and Depreciable Property	144
§ 7.07	TERMINATION OF PARTNERSHIPS	145
A.	What Transactions Are Taken Into Account	145
B.	Computing Capital and Profits	146
C.	The 12-Month Rule	147
D.	Effect of Partnership Termination	147
1.	Transactions Deemed to Occur	147
2.	Elections	148
3.	IRC §§ 704(c)(1)(B) and 737	148
4.	Depreciation and Amortization	148
Chapter 8	PARTNERSHIP DISTRIBUTIONS	151
	BASIC OVERVIEW	151
	DETAILED DISCUSSION	157
§ 8.01	INTRODUCTION	157
§ 8.02	NONLIQUIDATING DISTRIBUTIONS OF MONEY	158
§ 8.03	NONLIQUIDATING DISTRIBUTIONS OF PROPERTY	159
A.	General Rules	159
B.	Outside Basis Less Than Inside Basis	160
C.	Marketable Securities	161
§ 8.04	CAPITAL ACCOUNTS	163
§ 8.05	I.R.C. § 732(D)	163
§ 8.06	THE SALE OF DISTRIBUTED PROPERTY	165
§ 8.07	I.R.C. § 734(B) ADJUSTMENTS	165
A.	Introduction	165
B.	The Devil is in the Details	166
C.	Mandatory “As If” I.R.C. § 754 Elections	169
§ 8.08	SHIFTS IN ORDINARY INCOME PROPERTY	170
A.	Introduction	170
B.	Unrealized Receivables and Substantially Appreciated Inventory	171
C.	The Nuts and Bolts	172
D.	Associated Issues	177
§ 8.09	LIQUIDATIONS OF PARTNERSHIPS AND PARTNERSHIP INTERESTS	178
A.	Introduction	178
B.	Liquidations of the Partnership or of a Partnership Interest	178
C.	I.R.C. § 736 Payments	181
1.	Introduction	181
2.	I.R.C. § 736(a) Payments	181

TABLE OF CONTENTS

3.	I.R.C. § 736(b) Payments	182
4.	Allocating and Taxing I.R.C. § 736 Payments	183
Chapter 9	TRANSACTIONS BETWEEN PARTNER AND PARTNERSHIP; ISSUANCE OF A PARTNERSHIP INTEREST FOR SERVICES	187
	BASIC OVERVIEW	187
	DETAILED DISCUSSION	191
§ 9.01	INTRODUCTION	191
§ 9.02	THE DIFFERENT ROLES OF PARTNERS IN TRANSACTIONS WITH A PARTNERSHIP	191
§ 9.03	PAYMENTS TO A PARTNER AS A PARTNER OTHER THAN GUARANTEED PAYMENTS	191
§ 9.04	GUARANTEED PAYMENTS	191
§ 9.05	PAYMENTS TO A PARTNER OTHER THAN IN THEIR CAPACITY AS A PARTNER	193
§ 9.06	DISGUISED SALES	196
A.	The Disguised Sale of Assets	196
§ 9.07	LIMITATIONS ON RECOGNITION OF LOSSES AND RECHARACTERIZATION OF GAINS IN RELATED PARTY TRANSACTIONS	201
A.	Limitations on Recognition of Losses	201
B.	Recharacterization of Gains	201
§ 9.08	ISSUANCE OF A PARTNERSHIP INTEREST IN EXCHANGE FOR SERVICES	202
A.	Potential Income to Partner and Gain to Partnership	202
B.	Receipt of Profits Interests by Service Partners	204
§ 9.09	COMPENSATORY INTEREST PROPOSED REGULATIONS	206
§ 9.10	CURRENT LEGISLATIVE PROPOSALS	208
Chapter 10	BUSINESS COMBINATIONS: PARTNERSHIP MERGERS AND DIVISIONS	211
	BASIC OVERVIEW	211
	DETAILED DISCUSSION	214
§ 10.01	PARTNERSHIP MERGERS	214
A.	General Rules	214
B.	Form of a Merger	215
C.	Built-In Gain Resulting from the Merger	218
D.	Buy-Out Rule	220
§ 10.02	PARTNERSHIP DIVISIONS	221
A.	General Rules	221
B.	Form of a Division	223
C.	Built-In Gain in Divisions	223

TABLE OF CONTENTS

§ 10.03	THE EFFECT ON THE PARTNERS AND THE PARTNERSHIP	224
Chapter 11	ANTI-ABUSE PROVISIONS	227
	BASIC OVERVIEW	227
	DETAILED DISCUSSION	232
§ 11.01	INTRODUCTION	232
§ 11.02	JUDICIAL DOCTRINES	232
A.	Introduction	232
B.	Substance Over Form	233
C.	Business Purpose	235
D.	Step Transaction Doctrine	236
E.	Failure to Form a Valid Partnership for Tax Purposes	237
§ 11.03	ANTI-ABUSE REGULATIONS	238
§ 11.04	MIXING BOWL TRANSACTIONS	240
A.	Introduction	240
B.	I.R.C. § 704(c)(1)(B)	241
C.	I.R.C. § 737	243
D.	I.R.C. § 707(a)(2)(A)	246
Chapter 12	DEATH OF A PARTNER	247
	BASIC OVERVIEW	247
	DETAILED DISCUSSION	249
§ 12.01	INTRODUCTION	249
§ 12.02	TERMINATION OF A PARTNERSHIP	249
§ 12.03	INCOME IN RESPECT OF A DECEDENT	250
§ 12.04	CLOSING OF THE PARTNERSHIP YEAR	252
§ 12.05	ADJUSTMENT TO BASIS	253
PART II:	C CORPORATIONS	255
Chapter 13	TAXING C CORPORATIONS IN GENERAL	257
	BASIC OVERVIEW	257
A.	Determination of Taxable Income	257
B.	Tax Rates	258
C.	Taxable Year	258
D.	Accounting Methods	258
E.	Special Rules for Certain Affiliated Corporations	258
F.	Alternative Minimum Tax	259
	DETAILED ANALYSIS	259
§ 13.01	DETERMINATION OF TAXABLE INCOME	259
A.	In General	259

TABLE OF CONTENTS

B.	Special Rules for Transactions between Related Parties	260
C.	Common Law of Taxation	261
1.	Substance over Form	261
2.	Step-Transaction Doctrine	261
3.	Business Purpose Doctrine	261
4.	Economic Substance Doctrine	262
§ 13.02	TAX RATES	262
§ 13.03	TAXABLE YEAR	263
§ 13.04	ACCOUNTING METHODS	264
§ 13.05	SPECIAL RULES FOR CERTAIN AFFILIATED CORPORATIONS . .	264
A.	Limitation on Multiple Tax Benefits	264
B.	Privilege to File a Consolidated Return	265
§ 13.06	ALTERNATIVE MINIMUM TAX	266
Chapter 14	CORPORATE FORMATION	269
	BASIC OVERVIEW	269
A.	General Shareholder Consequences	269
B.	General Corporation Consequences	270
C.	Shareholders' Receipt of Boot	270
D.	Corporation's Assumption of Shareholder Liabilities	271
	DETAILED ANALYSIS	272
§ 14.01	GENERAL SHAREHOLDER CONSEQUENCES	272
A.	Nonrecognition of Gain or Loss	272
1.	Property	273
2.	Control	273
B.	Basis in Stock Received	274
C.	Holding Period in Stock Received	275
§ 14.02	GENERAL CORPORATION CONSEQUENCES	275
A.	Nonrecognition of Gain or Loss	275
B.	Basis in Property Received	275
1.	In General	275
2.	Basis Limitation on Transfers of Property with Built-In Losses	276
C.	Holding Period in Property Received	277
§ 14.03	EFFECT OF SUBSEQUENT STOCK TRANSFERS ON SECTION 351 QUALIFICATION	277
§ 14.04	TRANSFERORS OF PROPERTY FOR PURPOSES OF SECTION 351	278
A.	Exclusion of Services	278
B.	Accommodation Transfers In Connection with Pre-Existing Corporations	279
§ 14.05	SHAREHOLDERS' RECEIPT OF BOOT	280
A.	Recognition of Gain	280

TABLE OF CONTENTS

1.	In General	280
2.	Timing of Gain	281
B.	Nonrecognition of Loss	281
C.	Nonqualified Preferred Stock	282
D.	Basis in Stock Received	283
E.	Corporation's Basis in Property Received	283
§ 14.06	TRANSFER OF MULTIPLE ASSETS	284
A.	Separate Application of Section 351(b) and Allocation of Boot	284
B.	Split Holding Period in Stock	285
§ 14.07	CORPORATION'S ASSUMPTION OF SHAREHOLDER LIABILITIES	286
A.	General Rule	286
B.	Assumption of Liabilities	286
C.	Effect on Shareholder's Basis in Stock	286
D.	Tax Avoidance Exception	287
E.	Gain Recognition Where Assumed Liabilities Exceed Shareholder's Basis in Transferred Property	287
1.	Basic Rule	287
2.	Effect on Corporation's Basis in Property Received	288
3.	Avoiding Section 357(c) Gain	288
4.	Excluded Liabilities	289
5.	Character of Section 357(c) Gain	290
§ 14.08	EFFECT OF OTHER DOCTRINES ON SECTION 351 NONRECOGNITION	290
A.	Assignment of Income Doctrine	290
B.	Tax Benefit Rule	290
§ 14.09	CONTRIBUTIONS TO CAPITAL	291
A.	Consequences to the Contributor	291
B.	Consequences to the Corporation	291
Chapter 15	DEBT/EQUITY CLASSIFICATION	293
	BASIC OVERVIEW	293
A.	General Tax Advantages of Debt Over Equity	293
B.	Reclassifying Debt as Equity	293
C.	Factors for Classifying Shareholder-Held Debt	294
1.	Form	294
2.	Corporation's Debt/Equity Ratio	294
3.	Proportionality	295
4.	Subordination	295
5.	Hindsight	295
6.	Applying the Factors	296
	DETAILED ANALYSIS	296

TABLE OF CONTENTS

§ 15.01	TAX TREATMENT OF DEBT VERSUS EQUITY	296
A.	General Tax Advantages of Debt over Equity	296
1.	Interest versus Dividends	296
2.	Repayment of Debt versus Redemption of Stock	297
3.	Other Advantages of Debt as Compared to Stock	297
B.	Worthlessness of Debt and Stock	298
1.	Debt	298
a.	Securities	298
b.	Non-Securities	298
2.	Stock	299
a.	In General	299
b.	Section 1244 Stock	299
§ 15.02	RECLASSIFYING DEBT AS EQUITY	300
A.	In General	300
B.	Effect of Reclassification	300
§ 15.03	FACTORS FOR CLASSIFYING SHAREHOLDER-HELD DEBT	300
A.	Overview	300
B.	Form	301
C.	Corporation's Debt/Equity Ratio	302
D.	Proportionality	303
E.	Subordination	303
F.	Hindsight	303
G.	Applying the Factors	303
H.	Effect of Shareholder Guarantees of Third Party Loans	306
§ 15.04	HYBRID INSTRUMENTS	306

Chapter 16	NONLIQUIDATING DISTRIBUTIONS OF PROPERTY	307
	BASIC OVERVIEW	307
A.	General Shareholder Treatment on Distributions of Cash and Other Property	307
B.	Dividends and Earnings & Profits	308
C.	Corporate Consequences on Distributions of Property	309
D.	Constructive Distributions	309
E.	Taxation of Dividends Received by Non-Corporate Shareholders	310
F.	Dividends-Received Deduction for Corporate Shareholders	310
	DETAILED ANALYSIS	311
§ 16.01	DISTRIBUTIONS OF CASH AND OTHER PROPERTY	311
§ 16.02	DIVIDENDS AND EARNINGS & PROFITS	312
A.	Dividends in General	312
B.	Determining E&P	313
C.	Allocating E&P to Distributions	315

TABLE OF CONTENTS

1.	Allocating Current E&P	315
2.	Allocating Accumulated E&P	315
D.	Examples	316
E.	Reduction of E&P Due to Distributions	318
§ 16.03	CORPORATE CONSEQUENCES ON DISTRIBUTIONS OF PROPERTY	319
A.	Taxable Income Consequences	319
1.	Distributions of Appreciated Property	319
2.	Distributions of Depreciated Property	320
B.	E&P Consequences	320
§ 16.04	EXAMPLES DEMONSTRATING CORPORATE AND SHAREHOLDER CONSEQUENCES ON DISTRIBUTIONS OF PROPERTY	321
A.	Distribution of Appreciated Property	321
B.	Distribution of Depreciated Property	321
C.	Distribution of Property Subject to a Liability	322
D.	Distribution of Corporation's Own Obligation	323
§ 16.05	CONSTRUCTIVE DISTRIBUTIONS	324
A.	Excessive Compensation Paid to Shareholder-Employees	324
B.	Interest Paid on Shareholder-held Corporate Debt	324
C.	Excessive Rent Paid to Shareholder-Lessors	325
D.	Bargain Sales of Property to Shareholders	325
E.	Interest-free Loans to Shareholders	325
§ 16.06	TAXATION OF DIVIDENDS RECEIVED BY NON-CORPORATE SHAREHOLDERS	325
§ 16.07	DIVIDENDS-RECEIVED DEDUCTION FOR CORPORATION SHAREHOLDERS	326
A.	Dividends-Received Deduction: General Rules	326
B.	Dividends-Received Deduction: Limitations and Special Rules	327
1.	Holding Period Requirements	328
2.	Extraordinary Dividends	329
3.	Debt-Financed Portfolio Stock	331
C.	Use of Dividends in Bootstrap Acquisitions	333
Chapter 17	STOCK REDEMPTIONS	335
	BASIC OVERVIEW	335
A.	General Framework for Treating Redemptions as Either Exchanges or Section 301 Distributions	335
B.	Constructive Ownership of Stock	336
1.	In General	336
C.	Tests for Treating Redemptions as Exchanges	337
1.	Substantially Disproportionate Redemptions	337
2.	Complete Termination Redemptions	338

TABLE OF CONTENTS

3.	Redemptions Not Essentially Equivalent to Dividends	338
4.	Partial Liquidation Redemptions	339
D.	Stock Purchases by Related Corporations Treated as Redemptions	340
1.	Brother-Sister Acquisitions	340
2.	Parent-Subsidiary Acquisitions	341
	DETAILED ANALYSIS	342
§ 17.01	GENERAL FRAMEWORK FOR TREATING REDEMPTIONS AS EITHER EXCHANGES OR SECTION 301 DISTRIBUTIONS	342
§ 17.02	CONSTRUCTIVE OWNERSHIP OF STOCK	344
A.	In General	344
B.	Family Attribution	344
C.	Entity to Owner or Beneficiary Attribution	345
D.	Owner or Beneficiary to Entity Attribution	346
E.	Option Attribution	347
F.	Chain Attribution	347
§ 17.03	TESTS FOR TREATING REDEMPTIONS AS EXCHANGES	349
A.	Substantially Disproportionate Redemptions	349
1.	In General	349
2.	Simultaneous Redemption of Nonvoting Preferred Stock	350
3.	Series of Redemptions	350
B.	Complete Termination Redemptions	351
1.	Waiver of Family Attribution by Individuals	351
2.	Waiver of Family Attribution by Entities	353
C.	Redemptions Not Essentially Equivalent to Dividends	354
D.	Partial Liquidation Redemptions	357
E.	Redemptions by Certain Regulated Investment Companies	359
§ 17.04	SHAREHOLDER BASIS CONSEQUENCES WHERE REDEMPTION TREATED AS 301 DISTRIBUTION	360
A.	Current Law	360
B.	Proposed Regulations § 1.302-5	361
§ 17.05	REDUCTION OF E&P DUE TO REDEMPTIONS	362
§ 17.06	REDEMPTIONS AND INTEGRATED TRANSACTIONS	363
§ 17.07	REDEMPTIONS TO PAY DEATH TAXES AND EXPENSES	364
§ 17.08	STOCK PURCHASES BY RELATED CORPORATIONS TREATED AS REDEMPTIONS	365
A.	Introduction	365
B.	Brother-Sister Acquisitions	366
1.	Consequences Where a Section 302(b) Test Is Satisfied	366
2.	Consequences Where All of the Section 302(b) Tests Are Failed . . .	367
C.	Parent-Subsidiary Acquisitions	368
D.	Section 304 versus Section 351	369

TABLE OF CONTENTS

Chapter 18	STOCK DIVIDENDS AND SECTION 306 STOCK	371
	BASIC OVERVIEW	371
A.	General Framework for Treating Stock Distributions as Either Taxable or Nontaxable	371
B.	Taxable Stock Distributions Under Section 305(b)	372
1.	Stock Distributions in Lieu of Money	372
2.	Disproportionate Stock Distributions	372
3.	Distributions of Common and Preferred Stock	372
4.	Stock Distributions on Preferred Stock	373
5.	Distributions of Convertible Preferred Stock	373
6.	Constructive Stock Distribution	373
C.	Treatment of Taxable and Nontaxable Stock Distributions	374
1.	Taxable Stock Distributions	374
2.	Nontaxable Stock Distributions	374
D.	Section 306 Stock	375
1.	Preferred Stock Bailout	375
2.	Definition of Section 306 Stock	375
3.	Dispositions of Section 306 Stock	375
	DETAILED ANALYSIS	376
§ 18.01	GENERAL FRAMEWORK FOR TREATING STOCK DISTRIBUTIONS AS EITHER TAXABLE OR NONTAXABLE	376
§ 18.02	TAXABLE STOCK DISTRIBUTIONS UNDER SECTION 305(b)	378
A.	Stock Distributions in Lieu of Money	378
B.	Disproportionate Stock Distributions	379
C.	Distributions of Common and Preferred Stock	380
D.	Stock Distributions on Preferred Stock	381
E.	Distributions of Convertible Preferred Stock	382
F.	Constructive Stock Distribution	383
§ 18.03	TREATMENT OF TAXABLE STOCK DISTRIBUTIONS	385
A.	Shareholder Consequences	385
B.	Corporation Consequences	385
§ 18.04	TREATMENT OF NONTAXABLE STOCK DISTRIBUTIONS	386
A.	Shareholder Consequences	386
B.	Corporation Consequences	387
§ 18.05	SECTION 306 STOCK	388
A.	Background: Preferred Stock Bailout	388
B.	Definition of Section 306 Stock	389
1.	Principal Category	389
2.	Stock with Basis Determined with Reference to Section 306 Stock	389
3.	Certain Stock Received in Reorganizations	391
4.	Certain Stock Received in Section 351 Transactions	391
5.	Exception to Section 306 Stock Where No E&P	392

TABLE OF CONTENTS

C.	Dispositions of Section 306 Stock	392
1.	Dispositions Other than Redemptions	393
2.	Redemptions	395
3.	Dispositions Exempt from Section 306 Treatment	396
Chapter 19	COMPLETE LIQUIDATIONS AND TAXABLE ACQUISITIONS	397
	BASIC OVERVIEW	397
A.	Taxable Liquidations	397
1.	Shareholder Consequences	397
2.	Corporation Consequences	397
B.	Nontaxable Parent-Subsidiary Liquidations	398
1.	Shareholder Consequences	398
2.	Subsidiary Corporation Consequences	399
C.	Taxable Acquisitions	399
1.	Taxable Asset Acquisition	399
2.	Taxable Stock Acquisition	400
3.	Section 338	400
	DETAILED ANALYSIS	401
§ 19.01	GENERAL FRAMEWORK FOR COMPLETE LIQUIDATIONS	401
§ 19.02	TAXABLE LIQUIDATIONS	401
A.	Shareholder Consequences	401
1.	Gain or Loss Recognized	401
2.	Basis in Distributed Property	403
B.	Corporation Consequences: Recognition of Gain or Loss	403
1.	In General	403
2.	Limitations on Recognizing Losses	404
a.	Certain Distributions to Related Persons	404
b.	Distributions or Dispositions of Transferred Basis Property with a Tax Avoidance Purpose	406
§ 19.03	NONTAXABLE PARENT-SUBSIDIARY LIQUIDATIONS	408
A.	Shareholder Consequences	408
1.	Parent Corporation Consequences	408
a.	Nonrecognition of Gain or Loss	408
b.	Basis in Distributed Property	409
c.	Effect on E&P	409
2.	Minority Shareholder Consequences	409
B.	Subsidiary Corporation Consequences: Recognition of Gain or Loss	410
1.	Distributions to the Parent Corporation	410
2.	Distributions to Minority Shareholders	411
§ 19.04	TAXABLE ACQUISITIONS	412
A.	In General	412

TABLE OF CONTENTS

1.	Taxable Asset Acquisition	412
2.	Taxable Stock Acquisition	413
B.	Section 338	414
1.	Application of Section 338	414
2.	The Section 338 Election and Its Consequences	415
3.	Deemed Sales Price and Target's New Basis in Assets	417
a.	Aggregate Deemed Sales Price	417
b.	Adjusted Grossed-Up Basis	418
c.	Allocating ADSP and AGUB to Individual Target Corporation Assets	419
4.	Section 338(h)(10) Election	419
Chapter 20	CORPORATE PENALTY TAXES	423
	BASIC OVERVIEW	423
A.	Accumulated Earnings Tax	423
1.	Corporations Subject to Accumulated Earnings Tax	423
2.	Accumulated Taxable Income	424
B.	Personal Holding Company Tax	425
1.	Definition of Personal Holding Company	425
2.	Undistributed Personal Holding Company Income	426
	DETAILED ANALYSIS	426
§ 20.01	ACCUMULATED EARNINGS TAX	426
A.	Overview	426
B.	Corporations Subject to Accumulated Earnings Tax	427
1.	In General	427
2.	Prohibited Tax Avoidance Purpose	427
a.	In General	427
b.	Reasonable Needs of the Business	428
C.	Accumulated Taxable Income	430
1.	Adjustments to Taxable Income	430
2.	Dividends Paid Deduction	430
3.	Accumulated Earnings Credit	431
§ 20.02	PERSONAL HOLDING COMPANY TAX	432
A.	Overview	432
B.	Definition of Personal Holding Company	433
1.	Adjusted Ordinary Income Requirement	433
2.	Stock Ownership Requirement	435
C.	Undistributed Personal Holding Company Income	436
1.	Adjustments to Taxable Income	436
2.	Dividends Paid Deduction	437

TABLE OF CONTENTS

Chapter 21	CORPORATE REORGANIZATIONS	439
	BASIC OVERVIEW	439
A.	Types of Reorganizations and Requirements	439
1.	Non-Statutory Requirements for Reorganizations	439
2.	“A” Reorganizations: Statutory Mergers and Consolidations	440
3.	“B” Reorganizations: Stock-for-Stock Acquisitions	440
4.	“C” Reorganizations: Asset-for-Stock Acquisitions	441
B.	Tax Treatment of Parties to a Reorganization	441
1.	Tax Consequences to Shareholders and Security Holders	442
2.	Tax Consequences to Target Corporation	442
3.	Tax Consequences to Acquiring Corporation	443
	DETAILED ANALYSIS	443
§ 21.01	INTRODUCTION	443
§ 21.02	TYPES OF REORGANIZATIONS AND REQUIREMENTS	444
A.	Overview	444
B.	Non-Statutory Requirements for Reorganizations	445
1.	Business Purpose Requirement	445
2.	Continuity of Business Enterprise Requirement	445
a.	Continuing Target’s Historic Business	445
b.	Using a Significant Portion of Target’s Historic Business Assets	446
3.	Continuity of Interest Requirement	447
a.	In General	447
b.	Type of Consideration Received	447
c.	Portion of Qualifying Consideration Received	448
d.	Effect of Stock Dispositions Before or After a Potential Reorganization	449
i.	Dispositions of Target Corporation Stock Prior to Potential Reorganization	449
ii.	Dispositions of Acquiring Corporation Stock After Potential Reorganization	449
C.	“A” Reorganizations: Statutory Mergers and Consolidations	450
D.	“B” Reorganizations: Stock-for-Stock Acquisitions	451
E.	“C” Reorganizations: Asset-for-Stock Acquisitions	452
1.	In General	452
2.	Modifications to the Solely for Stock Requirement	453
F.	Triangular Reorganizations and Drop Downs	455
1.	Triangular “A” Reorganizations	455
a.	Forward Triangular Mergers	455
b.	Reverse Triangular Mergers	456
2.	Triangular “B” Reorganizations	457
3.	Triangular “C” Reorganizations	458

TABLE OF CONTENTS

4.	Drop Downs of Assets or Stock	459
G.	“D” Reorganizations: Transfers of Assets to Controlled Corporations	459
1.	Acquisitive “D” Reorganizations	459
2.	Divisive “D” Reorganizations	461
H.	“E” Reorganizations: Recapitalizations	462
1.	Stock for Stock	462
2.	Holders’ Exchange of Corporate Debt Instruments for Stock	463
3.	Corporate Debt Instruments for Corporate Debt Instruments	463
4.	Shareholders’ Exchange of Stock for Corporate Debt Instruments	463
I.	“F” Reorganizations: Changes in Identity, Form or Place of Organization	464
J.	“G” Reorganizations: Insolvency Reorganizations	464
1.	Acquisitive “G” Reorganizations	465
2.	Divisive “G” Reorganizations	466
§ 21.03	TAX TREATMENT OF PARTIES TO A REORGANIZATION	467
A.	Introduction	467
B.	Tax Consequences to Shareholders and Security Holders	468
1.	Recognition of Gain or Loss	468
a.	In General	468
b.	Receipt of Boot	469
c.	Dividend Treatment of Recognized Gain	470
2.	Basis in Property Received	472
3.	Holding Period in Stock or Securities Received	473
B.	Tax Consequences to Target Corporation	474
1.	Recognition of Gain or Loss on Transfer of Assets to Acquiring Corporation	474
a.	In General	474
b.	Receipt of Boot	475
2.	Recognition of Gain or Loss on Distribution of Property to Shareholders and Creditors	476
C.	Tax Consequences to Acquiring Corporation	477
1.	Recognition of Gain or Loss	477
2.	Basis in Property Received	478
3.	Holding Period in Property Received	479
Chapter 22	CORPORATE DIVISIONS	481
	BASIC OVERVIEW	481
A.	Types of Corporate Divisions	481
B.	Tax Stakes Involved	481
C.	Requirements for Nonrecognition Treatment	482
1.	Control Requirement	482

TABLE OF CONTENTS

2.	Distribution Requirement	483
3.	Active Business Requirement	483
4.	Corporate Business Purpose Requirement	484
5.	No Device Requirement	484
6.	Continuity of Interest Requirement	484
D.	Tax Treatment of Parties to a Section 355 Transaction	484
1.	Tax Consequences to Shareholders and Security Holders	485
2.	Tax Consequences to the Distributing Corporation	486
	DETAILED ANALYSIS	486
§ 22.01	INTRODUCTION	486
§ 22.02	TYPES OF CORPORATE DIVISIONS	486
A.	Overview	486
B.	Spin-off	487
C.	Split-off	487
D.	Split-up	488
§ 22.03	TAX STAKES INVOLVED	488
§ 22.04	REQUIREMENTS FOR NONRECOGNITION TREATMENT	489
A.	Control Requirement	489
B.	Distribution Requirement	489
C.	Active Business Requirement	490
1.	In General	490
2.	Active Conduct of a Trade or Business	490
a.	“Trade or Business” and “Actively Conducted”	490
b.	Five-Year Requirements	491
D.	Corporate Business Purpose Requirement	492
E.	No Device Requirement	493
1.	Device Factors	494
2.	Nondevice Factors	495
3.	Applying the Device and Nondevice Factors	496
F.	Continuity of Interest Requirement	496
§ 22.05	TAX TREATMENT OF PARTIES TO A SECTION 355 TRANSACTION	497
A.	Tax Consequences to Shareholders and Security Holders	498
1.	Recognition of Gain, Loss or Income	498
a.	In General	498
b.	Receipt of Boot	498
c.	Dividend Treatment of Recognized Gain	500
2.	Basis and Holding Period in Property Received	501
B.	Tax Consequences to the Distributing Corporation	503

TABLE OF CONTENTS

Chapter 23	CORPORATE TAX ATTRIBUTES	507
	BASIC OVERVIEW	507
A.	Carryover of Corporate Attributes in Certain Acquisitions Under Section 381	507
B.	Limitations on Using NOLs Under Section 382	508
C.	Other Limitations on Using Corporate Tax Attributes	509
1.	Limitation on Using Certain Credits and Net Capital Losses under Section 383	509
2.	Limitation on Using Preacquisition Losses to Offset Built-In Gains Under Section 384	509
3.	Authority Under 269 to Disallow Tax Benefits in Connection with Tax-Avoidance Acquisitions	509
	DETAILED ANALYSIS	510
§ 23.01	CARRYOVER OF CORPORATE ATTRIBUTES IN CERTAIN ACQUISITIONS UNDER SECTION 381	510
A.	In General	510
B.	Transactions Covered	510
C.	Corporate Attributes Covered	510
D.	Section 381 Limits on Using Corporate Tax Attributes	511
§ 23.02	LIMITATIONS ON USING NOLs UNDER SECTION 382	511
A.	In General	511
B.	Ownership Change	512
C.	Operation of the Section 382 Limitation	515
1.	In General	515
2.	Increases in Limitation: Carryforward of Unused Limitation and Built-In Gains	516
3.	Continuity of Business Enterprise Requirement	516
§ 23.03	OTHER LIMITATIONS ON USING CORPORATE TAX ATTRIBUTES	517
A.	Limitation on Using Certain Credits and Net Capital Losses under Section 383	517
B.	Limitation on Using Preacquisition Losses to Offset Built-In Gains Under Section 384	518
C.	Authority Under 269 to Disallow Tax Benefits in Connection with Tax-Avoidance Acquisitions	519
PART III:	S CORPORATIONS	521
Chapter 24	TAXATION OF S CORPORATIONS AND SHAREHOLDERS	523
	BASIC OVERVIEW	523
A.	Eligibility for Electing S Corporation Status	523

TABLE OF CONTENTS

B.	Electing S Corporation Status	524
C.	Terminating S Corporation Status	525
D.	Treatment of S Corporation Shareholders	525
1.	Pass-Through Taxation of S Corporation Income or Loss	525
2.	Adjustments to Basis	526
3.	Treatment of Distributions	526
E.	Taxing the S Corporation	527
F.	Application of Subchapter C to S Corporations	527
	DETAILED ANALYSIS	527
§ 24.01	INTRODUCTION	527
§ 24.02	ELIGIBILITY FOR ELECTING S CORPORATION STATUS	528
A.	Definition of an S Corporation	528
B.	Small Business Corporation	528
1.	Ineligible Corporation	528
2.	Number of Shareholders	529
3.	Permitted Shareholders	530
a.	In General	530
b.	Permitted Trusts	530
4.	One Class of Stock	531
a.	In General	531
b.	Straight Debt Safe Harbor	532
§ 24.03	ELECTING, REVOKING AND TERMINATING S CORPORATION STATUS	533
A.	Electing S Corporation Status	533
B.	Terminating S Corporation Status	535
1.	Shareholder Revocation	535
2.	Ceasing to be a Small Business Corporation	536
3.	Having Excess Passive Income and E&P	536
4.	Inadvertent Terminations	537
§ 24.04	TREATMENT OF S CORPORATION SHAREHOLDERS	538
A.	Pass-Through Taxation of S Corporation Income or Loss	538
1.	In General	538
2.	Computing an S Corporation's Taxable Income	538
3.	Pass-Through of Items to Shareholders	539
a.	In General	539
b.	Limitations on the Pass-Through of Losses and Deductions	540
B.	Adjustments to Basis	541
C.	Treatment of Distributions	544
1.	S Corporations with No E&P	544
2.	S Corporations with E&P	545
§ 24.05	TAXING THE S CORPORATION	546
A.	Tax on Built-In Gains	547

TABLE OF CONTENTS

B.	Tax on Excess Net Passive Income	549
§ 24.06	APPLICATION OF SUBCHAPTER C TO S CORPORATIONS	551

Table of Cases		TC-1
-----------------------	------------------	-------------

Table of Statutes		TS-1
--------------------------	------------------	-------------

Table of Agency Decisions		TOA-1
----------------------------------	------------------	--------------
