

## **PROBLEM #VA - Distributing Corporations's Income Recognition**

**All the Years mentioned in Problems VA-1 through VA-9 are after 1990. Ignore §355(e) in Problems VA-1 through VA-9.**

**VA-1** As of January 1, Year One, P Corporation owned all of the stock of the S Corporation. Individual A owned 35 shares of P's stock; Individual B owned 35 shares of P's stock; and Individual D owned the remaining 30 shares of P's outstanding stock. On February 3, Year One, Individual C purchased from B for cash the 35 shares of P stock that B owned. On August 5, Year One, C created the X Corporation; and C transferred 20 shares of P stock to X in exchange for all 100 shares of X's stock. That exchange qualified for nonrecognition under § 351. On March 2, Year Four, P distributed all of its S stock to A in exchange for A's 35 shares of P stock; and that split-off qualified for nonrecognition under § 355(a). At the time of the split-off, P's stock had a value of \$2,000 per share; and all of the S stock had an aggregate value of \$70,000. P had a basis of \$30,000 in its shares of S stock; and A had a basis of \$15,000 in her 35 shares of P stock. What was the tax consequence of the March 2, Year Four exchange between P and A? What basis does A have in the S stock that A received from P?

**VA-2.** The same facts as those stated in Question **VA-1** except that on August 5, Year One, C transferred only 5 shares of P stock to X in exchange for 50 shares of X stock. the exchange between C and X did not qualify for nonrecognition under § 351 because X already had 150 shares of stock outstanding, all of which were held by other persons. On November 3, Year Two, X purchased 15 shares of P stock from D. As Of March 2, Year Four, when P executed the splitoff with A, X had 200 shares of stock outstanding of which C held 50 shares. None of the shareholders of X is related. What was the tax consequence to P of the March 2, Year Four exchange with A? What would have been the tax consequence to P of that exchange if P's basis in the S stock had been \$80,000?

**VA- 2A** Same facts as those stated in **VA-2** except that: the exchange between C and X qualified as a § 351 exchange, C transferred only 5 shares of stock to X in that exchange, C received only 50 shares of X's stock in that exchange, and X transferred 200 shares of its stock to other unrelated persons. So, C owns only 20% of X's stock.

**VA-3** The same facts as those stated in Question **VA-2** except that as of March 2, Year Four, X had 800 shares of stock outstanding of which C held 50 shares. None of X's shareholders were related. What was the tax consequence to P of the march 2, Year Four exchange with A?

**VA-4** The same facts as those stated in Problem **VA-3** except that on March 2, Year Four, C's brother, *F*, owned 150 shares of X's outstanding common voting stock. What was the tax consequence to *P* of the March 2, Year Four, exchange with A?

**VA-5** P Corporation owned and operated two businesses – a hardware business and a retail furniture business. P had 100 shares of voting common stock outstanding of which A owned 40 shares and B owned 60 shares. On May 3, Year One, B sold his 60 shares of P stock to C for cash. A, B, and C are unrelated individuals. On September 5, Year Two, P created the S-1 and S-2 Corporations; P transferred the furniture business to S-1 in exchange for all of S-1's outstanding stock; and P transferred the hardware business to S-2 in exchange for all of S-2's outstanding stock. Those exchanges qualified for nonrecognition under § 351. On November 10, Year Two, pursuant to its liquidation, P distributed its S-1 stock to C and its S-2 stock to A in a split-up that qualified for nonrecognition under § 355(a). P had a basis of \$200,000 in its S-1 stock, which had a value of \$600,000; and P had a basis of \$30,000 in its S-2 stock, which had a value of \$400,000. What was the tax consequence to P of distributing its S-1 and S-2 stock to A and C pursuant to the split-up? Cf. Treas. Reg. § 1.355-7 (f).

**VA-6** P Corporation owned all 100 shares of outstanding stock of S-1. S-1 owned all 100 shares of outstanding stock of S-2. P had 200 shares of stock outstanding of which A owned 50 shares, B owned 30 shares, and C owned 120 shares. All of the outstanding shares of stock of P, S-1, and S-2 are voting common stock. On April 7, Year One, C sold her 120 shares of P stock to D for cash. A, B, C, and D are unrelated individuals. On June 4, Year Five, S-1 distributed its S-2 stock to P in a spin-off which qualified for nonrecognition under § 355(a). S-1 had a basis of \$60,000 in its S-2 stock which had a value of \$100,000. Immediately before the spin-off, P had a basis of \$20,000 in its S-1 stock, which had a value of \$200,000. What was the tax consequence to S-1 of distributing the S-2 stock to P? See Reg. § 1.355-6(b)(3).

**VA-7** The same facts as those stated in Problem **VA-6** except that on August 6, Year Five, P made a pro rata distribution to its three shareholders, A, B, and D, of the S-2 stock that it had acquired from S-1. The spin-off of S-2 stock to A, B, and D qualified for nonrecognition under § 355(a). What was the tax consequence to S-1 of the distribution of the S-2 stock that S-1 made to P? What was the tax consequence to P of the distribution of the S-2 stock that P made to its three shareholders? See Reg. § 1.355-6(b)(3).

**VA-8** A owned all 100 shares of P Corporation's outstanding stock. P owned 80 shares of the stock of S, and the remaining 20 shares of S's outstanding stock were owned by U. On March 4, Year One, B purchased 40 shares of P stock from A, and B paid cash for those shares. On May 2, Year Two, B purchased from U the 20 shares of S stock that U held, and B paid cash for that purchase. A, B, and U are unrelated individuals. On September 2, Year Four, P distributed 48 shares of S stock to A and distributed 32 shares of S stock to B in a proportionate spin-off that qualified for nonrecognition under § 355(a). P had a basis of \$500 per share in its S stock, which had a value of \$1,000 per share at the time that the spin-off took place. What was the tax consequence to P of the spin-off of the 80 shares of S stock to A and B?

**VA-9** The same facts as those stated in Problem **VA-8** except that:

- (1) P owned all of the outstanding stock of S-1 as well as the 80 shares of S stock; and
- (2) On September 2, Year Four, P distributed all 80 shares of S stock to B and distributed all of its S-1 stock to A in a proportionate spin-off that qualified for nonrecognition under § 355(a). P had a basis of \$50,000 in its S-1 stock, which had a value of \$120,000 at the time that the spin-off took place.

What was the tax consequence to *P* of distributing the *S* and *S-1* stocks to its shareholders? Cf. Treas. Reg. § 1.355-7(f).

**For purposes of problems V-10 through V-13, you are to take into account the provisions of § 355(e) and should assume that all of the events occur after April, 2005.**

**VA-10** Corporation T conducts two distinct active trades or businesses – business A and business B – and has conducted each of them for at least 10 years. Business A has been appraised to have a fair market value of \$15,000,000; and T has a basis of \$10,000,000 in the assets used in the conduct of business A. Business B has been appraised to have a fair market value of \$10,000,000 and the assets used in the conduct of that business have a nominal tax basis that for planning purposes can be considered to be zero. The stock of T is divided equally among three individuals, E, F, and G. Corporate P, a large publicly traded corporation, would like to effect a merger of T into P. Under the terms of the contemplated merger, E, F, and G would receive only P voting common stock in exchange for the T stock. However, P is interested only in business A. P does not want to either conduct or acquire business B and is willing to effect the combination with T only if T does not hold business B at the time of the merger. Accordingly, the management of T proposes to organize a new corporation, S, to which it would contribute all of the assets that comprise business B and then would distribute pro rata to E, F, and G the stock of S in a transaction intended to qualify as a tax-free spin-off under § 355. Thereafter, it is contemplated that T would merge into P and the shareholders of T, in exchange for their T stock, would receive P stock with a fair market value of approximately \$15,000,000 and representing less than 5% of the value and voting power of P’s outstanding stock. What recommendations and conclusions do you have regarding these proposed transactions and their tax consequences to P, T, S, E, F, and G?

**VA-11** The same facts as those stated in Problem **VA-10**, except that P and T arrived at a different arrangement. Instead of T's creating S and spinning it off, P acquired T's assets in a tax-free reorganization in which T received P stock. T then liquidated and gave its P stock to E, F, and G as liquidating distributions. You will assume that all of those transactions qualified for nonrecognition treatment, and none of the parties recognized any income therefrom. Shortly after T's liquidation, P formed the S Corporation and transferred the B business to S for the latter's stock. P then distributed the S stock to E, F, and G in exchange for some of their shares of P stock. The split-off of S stock took place four months after P had acquired T's assets. After the split-off, the remaining stock of P that E, F and G owned constituted less than 5% of the value and voting power of P's outstanding stock. What were the tax consequences to P, E, F, and G of the split-off of the S stock?

**VA-12** The same facts as those stated in Problem **VA-10**, except that P did not have any discussions about a merger with T prior to T's spin-off of S. T made that spin-off principally because it qualifies T for access to loans at preferential interest rates; however, T was aware that, by removing business B from its holdings, it made itself a more attractive target for an acquisition. Seven months after the spin-off took place, P approached T about acquiring T in a tax-free reorganization transaction, and such a transaction in fact took place three months later. What were the tax consequences of the spin-off to T, S, E, F, and G?

**VA-13** The same facts as those stated in Problem **VA-10**, except that after the spin-off of S took place, P and T came to serious disagreements and could not agree on an acquisition contract; and they broke off any further discussions regarding an acquisition. Seven months after the spin-off, M, a corporation unrelated to P or T, approached T about acquiring T in a reorganization transaction. Prior to that contact, T had never discussed, either with M or with anyone else, the possibility of being acquired by M. After brief but fruitful negotiations, M acquired T in a tax-free acquisitive reorganization only one month after M had first contacted T. What were the tax consequences of the spin-off to T, S, E, F, and G?