You have noticed that the set of class lecture materials for Chapter 8 (distributed in class earlier and posted on my webpage) is very long. (I will bring extra copies to class.) Actually, that document is a shortened version. Students and faculty members want shorter books with fewer chapters, but they also want all the important material to be provided. So, what we have is a book with fewer chapters. Of course, a chapter may be a combination of material from several chapters of the old-style book. The pages are larger and the print is smaller. Result, a shorter book.

A class is more effective when both the faculty member and the students are prepared for class. I am providing this information to let you know how I plan to cover the material, and what I suggest that you do to be prepared.

Chapter 8 is a combination of 3 chapters. The main topics (old chapters) are:

1. Tax rules for **ORGANIZING** a corporation, contributing assets to the Corporation, receiving stock in exchange, etc.
2. Tax rules for **REORGANIZING** a corporation, such as splitting the Corporation into 2 separate entities or acquiring another corporation.
3. Tax rules that apply when stockholders **LIQUIDATE** a corporation, receive a distribution of assets from the corporation, and terminate the entity.

We have a lot of important rules to cover this week, and it’s important that we have a very specific plan for the class – and follow that plan closely.

The last 3 pages of this document contain 3 sets of important rules, one set for each of the 3 topics described above. It is my hope that these 3 sets of rules will provide valuable help for you in preparing for the next test in this class, and also help you in preparing for the CPA exam.

**MINIMUM SUGGESTION**

I recommend that you read the last 3 pages of this document very thoroughly, several times, before class. Memorize the rules. It is not fun to read a lot of technical rules, actually it’s like work. But it can be very productive.

As a minimum, I suggest that you follow the steps below, through the Peracchi case on page 13. More would be better, but I hope you will be able to complete these steps before class, as a minimum.

**The first set of rules (below) covers organization of a corporation.**

After studying the first set of rules in this document I recommend that you read the 2 pages about Ann in the lecture materials (page 2 and page 3), and review the answers for each of those cases on page 4. I will begin class by covering the rules and asking if there are questions about Ann’s tax results.

Next, I suggest that you work the short problem on page 6, about Lady Gaga.

Then, the 3 problems on page 5. Answers are on page 7.

I will ask you to apply your understanding of the tax rules by analyzing the Gus Russell Case on page 8 and the Earl Smalley case on page 9.

If you wish to study the applicable code, you may read pages 10 and 11.

The Peracchi case on page 13 shows how a taxpayer can fall into a trap.
CORPORATE REORGANIZATION.

You will note in the lecture materials on page 22 that Big Corporation has at least 4 ways in which it can acquire Local Corporation or its assets.

Corporate reorganizations often involve various types of exchanges of assets. See page 23. Duke Energy gave its stock to the stockholders of Progress Energy, in exchange for their stock in Progress Energy. That is a stock-for-stock tax-free, corporate reorganization. A Progress Energy who owns Progress stock with a basis of $8,000 and a fair market value of $45,000 will receive Duke Energy stock worth $50,000. Under the general rule, this investor will report a gain of $42,000, and the investor will have a basis in the Duke Energy stock of $50,000. Because this is a corporate reorganization, the investor will report no income and the basis of the Duke energy stock will be $8,000, even though the Duke Energy stock has a current value of $50,000.

When you have a fully taxable exchange, the asset you receive in the exchange will generally have a basis of fair market value. If you’re able to avoid reporting a gain on a transaction, the basis of the asset(s) you receive will be reduced by the amount of gain that you are deferring. The system preserves that gain so that you will report a gain and pay tax on the income now, or in the future. The same may be true for an unrecognized loss. You can read about these rules on page 27 of the lecture materials, which contains information from a letter ruling related to a corporate reorganization.

Page 29 has a series of 6 short problems that will allow you to apply the rules found on page 27. The solution is found on page 34.

Next, we will look at the case involving the sale of Disneyland, that begins on page 30. I have underlined some key words and phrases for your convenience. We will analyze the largely hypothetical information found on page 32.

Walt Disney’s Corporation (Retlaw-Walter backwards) owned Disneyland and a ranch, and other assets that we will ignore in our discussion.

Disney productions wanted to buy Disneyland, but they do not want Retlaw’s other assets.

If Retlaw sold Disneyland to Disney Productions, Retlaw would recognize a gain of $36,200,000 as shown on the page 22. That sets off a series of bad tax results. With that information, we will discuss other alternatives, most of which are not good. Ultimately, Retlaw executed a spin-off of all corporate assets, except Disneyland. That was a tax-free corporate divisive reorganization. Then, Walter executed a stock-for-stock exchange with Disney Productions, which was a tax-free exchange. Then, Disney Productions owned Retlaw as a subsidiary, which owned Disneyland. In the end, Walter Owned Flower St., Corporation which owned the assets that Disney productions did not want to buy. Also, Walter owned a lot of stock in Disney productions. All of these transactions were tax-free. Yes, you often have a choice between paying a lot of taxes or paying none.

Pages 38 through 40 contain cases that involve: (1) a stock-for-stock exchange, (2) a stock-for-assets exchange, and (3) a divisive reorganization in which 1 Corporation is split into 2 corporations, so that each owner can focus on the product line that he or she thinks has the brightest future.

CORPORATE LIQUIDATIONS.

Page 49 (of the lecture materials) contains the rules that I have copied in this document you are now reading. The code sections are printed in the order that they are found in the code.

If you have a liquidation that does not involve a parent that is liquidating a subsidiary, you should focus on the sentences with a black bar in the left margin. You will see the rules for determining: (1) gain or loss to be recognized by the distributing corporation, (2) gain or loss to be recognized by the stockholder(s) receiving the distributions, and (3) basis of assets received in the liquidation.
If a case involves a parent that is liquidating a subsidiary, you should focus on the sentences with black bars in the right margin.

Page 50 contains a case in which IBM wishes to acquire the building owned by Ken Corporation. There are 3 ways that IBM can get the use of the building: (1) IBM may buy the building from the Corporation, (2) Ken may liquidate the Corporation, receive the building from Ken Corporation, and sell the building to IBM, and (3) IBM may buy the stock from Ken. You will see that Ken will have the greatest amount of after-tax funds, if he sells the stock to IBM. IBM will not like this result because IBM will have a lower basis in the building ($2 million). This leads to negotiation so that both parties can be happy with the result.

You will note on page 49 and on page 52 that section 338 provides a way in which IBM can buy the stock from Ken, and treat the transaction as a purchase of the building – providing a basis for the building that is equal to its fair market value of $12 million. But, of course, there is no free lunch, and section 338 has its costs.

Pages 53 and 54 contain a problem involving 2 types of liquidations, and page 55 has the solution.

We will discuss these issues and work as many of these problems in class as we can.

Howard
<table>
<thead>
<tr>
<th>Page</th>
<th>Text</th>
</tr>
</thead>
<tbody>
<tr>
<td>61</td>
<td>Generally, GROSS INCOME includes ALL gains from dealing in property.</td>
</tr>
<tr>
<td>63</td>
<td>TAXABLE INCOME is equal to gross income, minus allowable deductions.</td>
</tr>
</tbody>
</table>
| 1001 | a  The amount of gain or loss REALIZED on a sale or exchange of property equals AMOUNT REALIZED, minus the basis of the property given in exchange.  
|      | b  AMOUNT REALIZED = (1) money received plus value of other assets(s) received, plus (2) stockholder's debt that is assumed by corporation.  
|      | c  All gain or loss REALIZED should be RECOGNIZED, except for exceptions. |
| 351  | a  A shareholder reports NO GAIN OR LOSS on a transfer of property to a corporation, if the shareholder receives "only" stock in exchange. See also Sec. 368(c).  
|      | b  If a shareholder receives assets other than stock of the corporation, the stockholder may RECOGNIZE GAIN on the exchange. Receiving "BOOT" may cause a REALIZED gain to be RECOGNIZED. [Gain may be recognized on receipt of assets or certain debt relief (debt relief is like cash).] Gain recognized is not more than cash plus FMV of other property received.  
|      | d  A stockholder recognizes ordinary income when the stockholder contributes "services" in exchange for stock in the corporation. |
| 358  | a  Basis of stock received (for services) will be the FMV of the stock.  
|      | b  If the corporation assumes debt of the stockholder, the debt assumption is not treated as cash or other property received (when computing gain), unless:  
|      | c  (1) the debt assumed by the corporation is greater than stockholder's basis in the asset(s) contributed to corporation, or  
|      | d  (2) there is a tax avoidance motive for the borrowing (debt).  
| 362  | a  The corporation's BASIS of property received as a contribution to capital equals:  
|      | c  (1) stockholder's basis in the property contributed to the corporation, PLUS  
|      | c  (2) gain recognized by the stockholder that contributed the asset.  

Person making a contribution is called "stockholder" even though the person may "become" a stockholder.  
A stockholder contributing the assets may be an individual, partnership, or corporation, etc.
Corporate Reorganizations, Stock for stock. Sec. 368
Letter Ruling 9442020, (July 20, 1994) Edited by Instructor. [Sec. 368 ]

Suggestion: Memorize next 7 rulings (and code sections cited).

National Corporation will acquire all of the Target Corporation stock in exchange solely for National voting common stock.

[Assume a Target shareholder trades 1,000 target shares (with basis of $10 and FMV of $50 per share) for 1,000 National shares having FMV of $50 per share.]

Using information above, indicate the tax results for each of the 7 rulings below.

Based solely on the information submitted the IRS ruled as follows.

(1) The acquisition of Target stock by National in exchange solely for voting common stock of National will qualify as a reorganization under 368(a)(1)(B). National and Target will each be a "party to a reorganization" under §368(b).

(2) The shareholders of Target will not recognize any gain or loss on the exchange of their Target stock solely for National voting stock (§354(a)(1)).

(3) National will not recognize any gain or loss on its receipt of Target stock in exchange solely for National stock (§1032).

(4) Each Target shareholder's basis in the National stock received in the exchange will equal the basis of the Target stock surrendered therefor (§358(a)(1)).

(5) Each Target shareholder's holding period for the National stock received in the exchange will include the holding period of the Target stock surrendered therefor, provided the Target stock was held as a capital asset on the date of the exchange (§1223(1)).

(6) National's basis in each Target share received in the exchange will equal the basis of that share in the hands of the Target shareholder (§362(b)).

(7) National's holding period for each Target share received in the exchange will include the period during which that share was held by the Target shareholder (§1223(2)).

IRS: We express no opinion on the tax effects of the transaction under any other provision of the Code or regulations, or the tax effects of any conditions existing at the time of, or effects resulting from, the transaction not specifically covered by the above rulings. In particular, no opinion is expressed regarding treatment under §1368 of the accumulated adjustment account distribution.

This ruling is directed only to the taxpayers who requested it. Section 6110(j)(3) provides that it may not be used or cited as precedent.

Target expects to distribute the full amount of its accumulated adjustment account (as defined in §1368(e)(1)) to its shareholders. Target is an S corporation. Not relevant for us.

National is a publicly traded corporation, and Target is a corporation owned 60 percent by A and 40 percent by B. Being an S corporation is not relevant for us now.
### Subchapter C - Part II. Corporate Liquidations

#### Subpart A - Effects on Recipients

<table>
<thead>
<tr>
<th>Rule</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>331 a</td>
<td><strong>Distributions in Complete Liquidation Treated as Exchanges.</strong> Amounts received by a shareholder in a complete liquidation of the corporation are treated as full payment for the stock. (sale of stock)</td>
</tr>
<tr>
<td>331 b</td>
<td>Sec. 301 (i.e. dividend rules) does not apply to complete liquidations. (Not a dividend. We are not concerned about E &amp; P, Etc.)</td>
</tr>
<tr>
<td>332</td>
<td><strong>Complete Liquidation of Subsidiary:</strong> No gain or loss is recognized by a corporation receiving property in complete liquidation of its subsidiary corporation.</td>
</tr>
<tr>
<td>332 a</td>
<td>Liquidations to Which Section Applies. Corporation (that receives the property) meets the 80% ownership requirements of section 1504(a)(2); Liquidation is a complete redemption of all subsidiary stock, or part of a series of distributions that will result in a complete redemption.</td>
</tr>
<tr>
<td>334</td>
<td><strong>Basis of Property Received in a Liquidation:</strong> In a complete liquidation (where gain or loss is recognized, sec. 331)), basis of the property received by parent corporation is its FMV.</td>
</tr>
<tr>
<td>334 a</td>
<td>Liquidation of a Subsidiary. Basis of property received is same as in the hands of the subsidiary.</td>
</tr>
</tbody>
</table>

#### Subpart B - Effects on Liquidating Corporation

<table>
<thead>
<tr>
<th>Rule</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>336</td>
<td><strong>Gain or Loss Recognized by corporation that distributes its property in Complete Liquidation:</strong> Liquidating corporation recognizes gain or loss on distribution of property in complete liquidation - as if the property is sold at FMV. (Unless sec. 337 applies)</td>
</tr>
<tr>
<td>336 a</td>
<td>FMV is considered to be at least as much as the debt on the property that is assumed by recipient.</td>
</tr>
<tr>
<td>336 b</td>
<td>Does not apply when liquidation is part of a reorganization.</td>
</tr>
<tr>
<td>336 d(1)</td>
<td>No loss is recognized on a distribution of property to a related person if the distribution is non-pro rata or it involves disqualified property.</td>
</tr>
<tr>
<td>336 d(2)</td>
<td>Loss is limited if depreciated property was invested in a sec. 351 transaction.</td>
</tr>
<tr>
<td>337</td>
<td><strong>Nonrecognition for a Distribution of Assets to a Parent in Complete Liquidation of Subsidiary:</strong> No gain or loss recognized by the liquidating corporation on a distribution of its assets in a complete liquidation under section 332.</td>
</tr>
<tr>
<td>338</td>
<td><strong>Certain Stock Purchases Treated As Asset Acquisitions:</strong> General Rule. If a purchasing corporation makes an election, the target corp is treated as having sold all of its assets at FMV in a single transaction, and is a new corp. which purchased all of the assets on the day after acquisition.</td>
</tr>
</tbody>
</table>