You just got done with eight hours of mind-numbing orientation during your second day at Hamlin, Hamlin & McGill, one of the world’s fastest rising and most successful law firms. After spending your whole day on a mountain of paperwork with HR yesterday, you forced yourself to drink an unhealthy number of energy drinks while watching a series of orientation videos featuring managing partner Howard Hamlin.

Right after getting back to your tiny office (at least it has a window), one of the firm’s newest partners, Kim Wexler, walks in and asks if you have a minute. You eagerly respond that you are ready to help her with anything that she needs. She explains that she represents several smaller clients who could really benefit from some tax advice at a (slightly) lower billable rate. She thanks you for your help as she heads out of your office and mentions she will email you directly with the details before taking a call with someone named Harvey Specter.

About an hour later you receive an email entitled “Assignments” from Ms. Wexler’s assistant, Vince Gilligan (so much for direct communication). The body of the email just says “See Attached.” You open the attachment and find the following memorandum:
To: Newest Tax Associate  
From: Erin Brill  

Re: Saul and Heisenberg  

Dear Newest Tax Associate:  

Welcome to Hamlin, Hamlin & McGill. We haven’t met in person yet (and hopefully never will), but I am one of the associates who came over from Davis & Main to work with Ms. Wexler. She has been looking for someone to help some of her “special” clients handle a wide range of tax issues.  

The assignment is very simple. Ms. Wexler has two clients who currently need help with several pressing tax issues. Those issues are outlined below. We need you to draft two things. First, we need a memorandum, no more than ten (10) pages in length, addressing each issue. Second, we need a brief client letter, no more than five (5) pages in length, explaining your solutions for each issue.  

Ms. Wexler’s first client is The Chicken Brothers, LLC (“TCB”). TCB is a barbecue chicken restaurant owned and operated by Saul Goodman and two of his “friends,” Walt and Gus (apparently Walt wanted to “cook” something, and the restaurant idea stemmed from there). Walt believes he has an unbeatable “formula” for barbecue sauce. They formed TCB as an LLC, taxed as a partnership for Federal income tax purposes, in 2013. After coming into a substantial sum of money in recent years, Saul has been looking to Ms. Wexler to help him and his partners deal with various issues.  

Ms. Wexler’s second client is Heisenberg, Inc. Heisenberg, Inc. is a publicly traded domestic C corporation, formed on January 20, 2008. Saul and TCB are the largest and controlling shareholders (but do not consider Saul and TCB’s ownership of Heisenberg in your analysis of this issue). I don’t know much about the company aside from the corporation being heavily involved with distribution services, exhibiting outstanding leverage and liquidity ratios, and wanting to make sure that everybody knows and says its name.  

You are not permitted to communicate with Saul or anyone else from TCB or Heisenberg directly. Instead, any questions that you have or additional facts that you need should be included in the memorandum and/or the client letter. Address the client letter to Saul. Note that even though Saul is an attorney (I think), tax is not his area of expertise. The client letter should address the issues in a clear manner. Please address only U.S. federal income tax issues.  

The issues are broken down into three sub-sections and discussed below.
I. The Chicken Brothers, LLC

TCB’s LLC agreement states that i) each partner is entitled to an equal share of TCB’s income and losses, and ii) TCB will use the “traditional method” of allocation. TCB is a calendar year taxpayer and uses the accrual method of accounting. TCB would like to better understand the tax consequences involving several of its transactions over the past few years. The transactions do not pertain to the current taxable year, but understanding them will help TCB make some decisions moving forward.

As part of the initial formation, each person contributed the following in exchange for a one-third (⅓) membership interest in the LLC:

- Saul: $750,000 cash;

- Walt: Kitchen equipment valued at $750,000 in which he had an adjusted basis of $900,000; and

- Gus: Two parcels of land that he had previously purchased for $240,000 (Lot A) and $200,000 (Lot B), respectively, and that were valued at $450,000 (unencumbered by any liability) and $360,000 (subject to a $60,000 recourse liability), respectively, at the time of the contributions. TCB assumed the mortgage upon Gus’s contribution of Lot B, and the lender agreed to look only to TCB for repayment. Gus acquired both lots before 2013, and both were capital assets in his hands.

A) TCB would like to understand the federal income tax consequences to the LLC and to each member upon formation. Calculate each member’s initial tax basis in his LLC interest and the gain or loss, if any, that the member recognized upon formation. What initial basis did TCB hold in each piece of property contributed to it?

B) In 2014 TCB sold Lot A for $510,000. The land was a capital asset in TCB’s hands and remained undeveloped. How much of the resulting gain did each member have to recognize?

C) In 2015, Walt’s former student and local barbecue enthusiast Jesse contributed cash to TCB and agreed to perform future services for the benefit of TCB in exchange for a 10% membership interest in the LLC. TCB was particularly happy to have Jesse on board because of his culinary skills and understanding of the barbecue clientele. The LLC agreement, as amended, stated that Jesse would receive 10% of TCB’s net income, as determined before taking into account any guaranteed payment, but not less than $300,000. In 2017, TCB earned $4,500,000 in net income before taking into account any guaranteed payments. In 2018, TCB earned only $2,700,000 before taking into account any guaranteed payments. What guaranteed payments to Jesse did TCB accrue in 2017 and 2018?
D) In 2016, Spice, Inc., a foreign corporation, contributed cash in exchange for a 15% interest in the partnership. In 2017, the partnership redeemed the interest, resulting in a $3,200,000 gain to Spice, Inc., none of which was attributable to a U.S. real property interest. Spice, Inc. had no offices in the United States or any property in the United States other than its interest in the partnership. Spice, Inc.’s attorneys are fairly sure that Spice, Inc. will not be subject to U.S. income tax on the redemption of its partnership interest. TCB wants to know whether the attorneys are correct. You’ll want to pay attention to case law, particularly from the United States Tax Court and the D.C. Circuit Court of Appeals.
II. Heisenberg, Inc. - SJI

A) As mentioned above, we are also giving advice to Heisenberg, Inc. (Heisenberg). Heisenberg owns 100% of the stock of a foreign subsidiary, an Irish “per se corporation,” Slippin’ Jimmy, PLC. (SJI). Heisenberg formed SJI in Ireland in 2015 with a $5 million capital contribution to help expand TCB’s reach into Europe. Both Heisenberg and SLI are accrual method, calendar year taxpayers.

SJI has proven to be wildly successful and has seen its profits increase annually since 2015. SJI and Heisenberg have worked together in creating several of the ideas that have helped drive this success, such as a state of the art online BBQ delivery service that is the one who “knocks” with advertisements on various online media platforms.

Heisenberg has an interest in continuing to grow and expand SJI and would like to contribute certain of Heisenberg’s operating assets constituting a trade or business to SJI to facilitate this future development. Heisenberg has informed us that all of the assets transferred have significant “built-in gain.”

Heisenberg has made similar contributions of both trade or business assets and stock in the past and has not recognized any income or gain on such transfers. Nonetheless, Heisenberg is requesting advice on the tax consequences, if any, for U.S. federal income tax purposes of the proposed transfer of the trade or business assets if completed during the 2019 tax year.

B) Additionally, SJI invests passively in certain items of U.S. real property. SJI would like to sell its U.S. real property interests for cash to Heisenberg Holding Company, Inc. (Heisenberg HoldCo), a domestic C corporation and wholly-owned subsidiary of Heisenberg. In other words, SJI and Heisenberg HoldCo are brother-sister subsidiaries under Heisenberg. Heisenberg is requesting advice on whether there are any U.S. federal income tax consequences of the sale, and whether there are any IRS reporting requirements. Assume for this purpose that i) the sale will be for full fair market value, ii) the sale is expected to be treated as a bona fide sale; and iii) transfer pricing is not an issue to be discussed.
Heisenberg’s only other significant asset is a wholly-owned, domestic subsidiary, Salamanca, LLC (Salamanca). Heisenberg formed Salamanca as a limited liability company (LLC) at the beginning of 2012 with a $17 million capital contribution in exchange for 100% of the common equity of Salamanca. At formation, Salamanca filed an initial “check-the-box election” to be treated as a corporation for U.S. federal income tax purposes. Salamanca only had one class of equity outstanding. The purpose of forming Salamanca was to have a separate entity conduct pharmaceutical research and development (R&D) to advance the treatment and management of electromagnetic hypersensitivity (E.H.), a condition which was shared by Saul’s recently deceased brother, Chuck.

Due to recent controversies about the very nature of E.H. (i.e., whether it is real) and the corresponding negative press, Salamanca has been largely unsuccessful in its efforts. The subsidiary burned through its entire capital contribution by the end of 2015. To continue the R&D efforts, Heisenberg contributed $8 million to Salamanca in exchange for a newly issued class of Salamanca’s preferred equity in 2016. Heisenberg also contributed an additional $5 million in 2017, documented as an intercompany debt and accompanied by a stated interest rate of 6.5%. Despite the fact that Salamanca has not generated positive cash flow to date or gone to market with a product, Heisenberg had remained positive during this time that success was inevitable.

Heisenberg has since come to realize that its investment is foregone, and would like to recoup some of its costs, but because Salamanca’s endeavors are personal in nature to Saul, Heisenberg would still like to continue Salamanca’s endeavors as a separate legal entity. To accomplish this result, Salamanca has planned to file a second “check-the-box election” to be treated as an entity disregarded as separate from its owner for U.S. federal income tax purposes, effective January 1, 2020. It is expected that at the time, the fair market value of Salamanca’s assets will be approximately $6 million.

Heisenberg has asked the following questions:

A) What is the treatment of the second “check-the-box election” of Salamanca for U.S. federal income tax purposes?

B) Is Heisenberg entitled to take a deduction with respect to its common or preferred equity interests in Salamanca, or the $5 million intercompany advance? If so, in what tax year is a deduction appropriate and in what amount?

C) Would any permitted loss related to such a deduction be capital or ordinary in character?

D) Would this transaction constitute a reportable transaction if effected?
Assume that i) Heisenberg and Salamanca do not file a consolidated tax return, ii) the $5 million loan would be respected for U.S. income tax purposes as a bona fide intercompany debt rather than equity, and iii) Salamanca would satisfy any applicable gross receipts tests.