MEMORANDUM
TO: Senior Partner
FROM: LL.M. Team Number __
DATE: November 6, 2019
SUBJECT: 2019-2020 Law Student Tax Challenge Problem

I. A. U.S. Federal Income Tax Consequences on Formation of the LLC

Gain or loss is not recognized by the partners or the partnership on a contribution of property in exchange for a partnership interest. I.R.C. § 721. The term property is interpreted broadly by the courts. See United States v. Stafford, 727 F.2d 1043, 1052 (11th Cir. 1984). In 2013, Saul, Walt and Gus each made contributions to The Chicken Brothers, L.L.C. (“TCB”). Saul contributed cash, Walt contributed equipment, and Gus contributed two parcels of real property. In return, each member received an interest in TCB equal to $750,000, the fair market value of their individual contributions. Under the broad interpretation of the courts, neither TCB nor TCB’s members recognize gain or loss on the exchange under § 721. Id.

The outside basis of a partner’s partnership interest is equal to the adjusted basis of the property contributed, plus any money contributed. I.R.C. § 722. Saul contributed $750,000 cash, so he has an initial outside basis of $750,000 in TCB. Walt contributed kitchen equipment with an adjusted basis of $900,000, so he has an initial outside basis of $900,000 in TCB. Gus contributed two parcels of land with an adjusted basis of $240,000 and $200,000, so he has an initial outside basis of $440,000 in TCB. Note that had the equipment been sold prior to 2019, the built-in loss would have been recognized as a capital loss. I.R.C. § 724.

However, one of Gus’s parcels, Lot B, is subject to a $60,000 recourse liability. There are two steps to address the liability. First, the partnership assumes the liability of the contributing partner. I.R.C. § 752(b). The assumption of liability by the partnership then triggers a decrease in
the partner’s outside basis. I.R.C. § 733. Thus, when TCB assumes the $60,000 liability of Lot B, Gus reduces his outside basis by $60,000, resulting in a basis of $380,000.

Second, the partnership distributes the liability back out to the partners in accordance with their partnership interests. Treas. Reg. § 1.752-1(e). Since each partner has a one-third interest, the $60,000 is divided into shares and distributed in increments of $20,000. The liability increases each of their bases. I.R.C. §§ 752(a), 722. Therefore, Saul has an initial outside basis of $770,000, Walt has an initial outside basis of $920,000, and Gus has an initial outside basis of $400,000.

The initial inside basis of property contributed to a partnership is the adjusted basis in the property at the time of contribution. I.R.C. § 723. Thus, TCB takes the carryover basis of each of its members, resulting in an initial basis in the cash of $750,000, an initial basis in the equipment of $900,000, and initial bases of $240,000 and $200,000 in Lots A and B, respectively. As for the liability attached to Lot B, it does not affect the partnership’s basis because the liability is ultimately transferred to the members. Treas. Reg. § 1.752-1(e) (2019).

I. B. U.S. Federal Income Tax Consequences on the Sale of Lot A

Gain or loss recognized on the sale of property is the amount realized over the adjusted basis of the property. I.R.C. § 1001. The sale of Lot A results in an amount realized of $510,000, which is reduced by the adjusted basis of $240,000. TCB’s income from the sale is included in the distributive share of each of its members. I.R.C. § 701. The distributive share of a partner is determined by the partnership agreement. I.R.C. § 704(b). Each member of TCB was allocated a one-third interest under the agreement and, therefore, they each receive one-third of the gain recognized on the sale of Lot A in their distributive shares.
However, § 704(c) imposes income-shifting safeguards on partnership income arising from the sale of contributed property with built-in gain or loss. At the time Gus contributed Lot A, it had built-in gain of $210,000. Under the traditional method used by TCB, “if the partnership sells § 704(c) property and recognizes gain or loss, built-in gain or loss on the property is allocated to the contributing partner.” Treas. Reg. § 1.704-3(b). Lot A was § 704(c) property because it had built-in gain of $210,000 at the time of contribution. Thus, of the $270,000 gain recognized by TCB, $210,000 first must be allocated to Gus before the remaining $60,000 is distributed equally between all the members of TCB. Therefore, Gus recognizes gain of $230,000, and Saul and Walt only recognize gain of $20,000.

Finally, the rules require that the character of the members’ distributive share be treated as if the income was recognized by the partnership. I.R.C. § 704(c)(1)(b)(2). Section 704 provides a “look-through” rule that allows the character of the gain to be preserved. Since TCB would have received capital treatment, each member receives capital treatment.

I. C. Accrual of Guaranteed Payments to Service Partner

Guaranteed payments are payments to a partner for services rendered to the partnership and are not part of a partner’s distributive share. I.R.C. § 707(c). Instead, to the extent a partner is remunerated for services, his income is considered ordinary income under § 61(a), and the partnership is entitled to a deduction under § 162. Id. In 2015, Jesse became a member of TCB. According to TCB’s amended agreement, Jesse has a 10% interest in TCB’s net income before considering guaranteed payments, but he shall not receive less than $300,000 for any tax year. Following the reasoning of Rev. Rul. 69-180, TCB must accrue guaranteed payments to make up the deficit, if any, between the amount Jesse receives from his distributive share and the floor amount of $300,000. Rev. Rul. 69-180, 1969-1 C.B. 183.
In 2017, TCB had net income of $4.5 million. Accordingly, Jesse was entitled to $450,000 as his share of TCB’s net income. Therefore, because Jesse’s distributive share was greater than the $300,000 floor amount, no deficit exists and TCB does not accrue any guaranteed payments. In 2018, TCB had a net income of $2.7 million, making Jesse only entitled to $270,000 as his distributive share. Since Jesse’s distributive share is below $300,000, TCB must accrue guaranteed payments to make up the deficit. Therefore, TCB accrues guaranteed payments of $30,000 to Jesse in 2018.


I. D. Redemption of U.S. Partnership Interest by Nonresident

Prior to November 27, 2017, the redemption of a partnership interest was treated as the sale or exchange of a capital asset, except to the extent the redemption was attributable to inventory or receivables. I.R.C. §§ 741, 751. While typically § 882(a)(1) would treat redemptions of foreign members as effectively connected income (“ECI”), the Tax Court ruled that a foreign taxpayer was only subject to § 882(a)(1) to the extent that the partnership interest sold was attributable to a U.S. real property interest in accordance with § 897(g). See Grecian Magnesite Mining, Indus. & Shipping Co. v. Comm’r, 149 T.C. 63 (2017), aff’d, 926 F.3d 819 (D.C. Cir. 2019). Since Spice, Inc.’s partnership interest was not attributable to any U.S. real property interest under § 897(g), Spice, Inc. would not be liable for U.S. tax under § 882(a)(1).
On or after November 27, 2017, new legislation overrides § 897(g) and the decision in
*Grecian Magnesite Mining*. The new rule requires redemptions by foreign persons to be treated
as effectively connected to the conduct of a U.S. trade or business. I.R.C. 864(c)(8). Thus, if the
redemption was made after November 27, 2017, then Spice, Inc. was subject to the application of
§ 864(c)(8) and § 882 by default, not § 897(g). Gain or loss may be determined using the
2018).

**II. A. Heisenberg, Inc. – SJI: Contribution of Built-In Gain Property transferred to
Foreign Subsidiary**

In general, gain or loss is not recognized on transfers of property to a corporation in
exchange for its stock. I.R.C. § 351(a). However, when the transfer of property is to a foreign
corporation, the foreign corporation is not treated as a corporation for the purposes of gain
recognition. I.R.C. § 367(a)(1). The Internal Revenue Code (the “Code”) provides relief for U.S.
corporations that contribute capital to controlled foreign corporations by treating their
contributions as an exchange in return for stock in an amount equal to the fair market value of
the contributed property. I.R.C. § 367(c)(2). Since Heisenberg is a 100% owner of SJI, SJI is
considered a controlled foreign corporation. Therefore, Heisenberg is entitled to relief under §
367(c)(2) and will not recognize gain on the transfer.

The rules are substantially different for the same transaction occurring before January 1,
2018, when § 367(c)(2) became effected. Previously, in order to avoid taxation under §
367(a)(1), the U.S. company would have to prove that its assets transferred were used in a trade
or business. I.R.C. § 367(a)(2) (repealed). Thus, if Heisenberg’s previously transferred property
was like the operating assets Heisenberg wants to transfer now, then the transactions would have
been tax free. Otherwise, Heisenberg was subject to the tax imposed under § 367(a)(1).

A foreign corporation that disposes of a United States real property interest (USRPI) must recognize gain or loss under § 882(a)(1) as if the gain or loss were effectively connected with a trade or business conducted within the United States during the taxable year. I.R.C. § 897(a). The Code imposes a tax at the rate of 21% on any gain on a foreign corporation’s sale of USRPI. I.R.C. §§ 11, 882(a)(1). However, if a foreign corporation files a return, it will be allowed any deductions and credits available under the Code. I.R.C. § 882(c)(2). Accordingly, SJI must file form 1120F and must pay any tax due by June 15 of the year after the transaction. I.R.C. § 6072(c); Treas. Reg. § 1.1445-1(f).

Additionally, the Code requires that the transferee (HoldCo) of USRPIs from a foreign corporation deduct and withhold a tax equal to 15% of the foreign corporation’s (SJI) amount realized on the disposition of the USRPI. I.R.C. § 1445(a). Note that the amount § 1445 requires withheld cannot exceed SJI’s maximum tax liability. I.R.C. § 1445(c)(1). At the request of either SJI or HoldCo, the Secretary will determine SJI’s maximum tax liability for disposition of its USRPIs. I.R.C. § 1445(c)(1). HoldCo must report and pay over the amount withheld by the twentieth day after the date of the transfer. Treas. Reg. §§ 1.1445-1(b)-(c). The date of transfer is the first date HoldCo pays consideration or assumes a liability for the USRPIs. Treas. Reg. §§ 1.1445-1(g)(8). If HoldCo fails to withhold tax under § 1445, § 1461 renders HoldCo liable for payment of the tax and any applicable penalties and interest. I.R.C. § 1461; Treas. Reg. § 1.1445-1(e). HoldCo is indemnified against any claims by SJI for payment of the tax, and the tax HoldCo withholds under § 1445 will be credited against the income tax computed on SJI’s return. I.R.C. § 1461; Treas. Reg. § 1.1445-1(f).

Alternatively, SJI can elect to be treated as a domestic U.S. corporation for purposes of
§ 897. I.R.C. § 897(i). If SJI makes this election, it may provide HoldCo with a certification of non-foreign status in connection with its disposition of USRPIs. Treas. Reg. §§ 1.1445-2(b)(2)(ii), -7(b). Then SJI would not be considered a “foreign person” under § 1445, and HoldCo would not be required to withhold tax under that section. Treas. Reg. § 1.1445-2(b)(1). SJI is eligible to make a § 897(i) election because it holds a USRPI, and the United States Tax Convention with Ireland entitles SJI to nondiscriminatory treatment. Tax Convention with Ireland, Ir.-U.S., art. 25, Jan. 1, 1998; Treas. Reg. § 1.897-3(b). The decision to make the election will turn on whether SJI and HoldCo prefer HoldCo to withhold 15% of SJI’s amount realized, or if they prefer that SJI pay the full amount of tax when filing its return.

Under § 951, a United States shareholder of a controlled foreign corporation must include in income his pro rata share of the corporation’s subpart F income for such year. I.R.C. § 951(a). However, subpart F income does not include income from sources within the United States which is considered effectively connected with a trade or business within the United States. I.R.C. § 952(b). Accordingly, since SJI’s sale of USRPI is treated as income effectively connected with a trade or business within the United States under § 897(a), it is not considered subpart F income, and § 951 does not apply to this transaction.

If SJI incurs any losses upon the sale of its USRPIs to HoldCo, § 267 will apply. SJI and HoldCo are considered part of a controlled group for purposes of § 267(b)(3) because they are part of a chain of corporations connected through stock ownership with their common parent, Heisenberg, Inc., who owns at least 50% of the stock of both SJI and HoldCo by vote and value. I.R.C. §§ 267(f)(1), 1563(a). Therefore, if SJI realizes a loss on the sale or exchange of any of the USRPIs that it sells to HoldCo, it must defer such loss until the time the property is
transferred outside of the controlled group. I.R.C. § 267(f)(2)(B). SJI should consider this consequence if it plans to sell any loss property to HoldCo.

In general, treaty-based return positions are also reportable transactions, however, this requirement does not apply with respect to taking a § 897(i) election. Treas. Reg. § 301.6114-1(b)(1). Additionally, loss transactions are reportable where a corporate taxpayer claims a § 165 loss of at least $10 million in a single taxable year, or $20 million in a combination of taxable years. Treas. Reg. § 1.6011-4(b)(5). Therefore, the sale of USRPIs will be reportable only if SJI will incur $10 million or more in losses attributed to the sale.

III. A. Heisenberg, Inc. – Salamanca: Treatment of Second “Check-the-Box” Election

An eligible entity may elect to be classified other than as the default classification provided by regulation, or may elect to change its classification, by filing Form 8832. Treas. Reg. § 301.7701-3(c)(1)(i). An entity may not change its classification election during the sixty months succeeding the effective date of an election to change classification. Treas. Reg. § 301.7701-3(c)(1)(iv). Salamanca’s 2012 election was an initial classification election, rather than an election to change its classification. Therefore, the sixty-month limitation does not apply.

If an eligible entity currently classified as an association elects to change its classification to a disregarded entity, as Salamanca wishes to do, there is a deemed distribution of all of the entity’s assets and liabilities to its single owner in liquidation of the association. Treas. Reg. § 301.7701-3(g)(1)(iii). The election is treated as occurring at the start of the effective day of the election, and all deemed transactions resulting from the change in classification are treated as occurring immediately before the close of the day before the election is effective. Treas. Reg. § 301.7701-3(g)(3)(i).

III. B. & C. Heisenberg, Inc. – Salamanca: Deductions for Equity and Intercompany Advance
A distribution in complete liquidation is treated as an exchange, and the amount Heisenberg, Inc. receives will be treated as full payment in exchange for the stock of Salamanca. I.R.C. § 331. In general, a receiving corporation recognizes no gain or loss on the receipt of property distributed in complete liquidation of another corporation if, inter alia, the liquidating corporation’s distribution is in complete cancellation or redemption of all its stock. I.R.C. § 332(b)(2). The issue here is whether any distribution of SJI’s property to Heisenberg will be in complete cancellation or redemption of its stock.

When corporations dissolve, with respect to the corporation’s assets, creditors have priority over preferred stockholders, and preferred stockholders have priority over common stockholders. Commissioner v. Spaulding Bakeries, Inc., 252 F.2d 693, 697 (2d Cir. 1958). Where preferred stock claims capture all of the assets of a liquidating corporation, there is nothing left to distribute to the parent as the common stockholder, and the parent receives no distribution in liquidation of its common stock. Id. A distribution only in respect of non-voting preferred stock is not a distribution in complete cancellation of all the stock as required by § 332(b)(2). Id. Additionally, there is no distribution in complete cancellation of stock where a creditor receives all the assets of an insolvent liquidating subsidiary, because no assets remain after the obligations to the creditor are satisfied. Id. Here, because Salamanca has $8 million of outstanding preferred stock, and only $1 million in assets after repaying the $5 million loan to Heisenberg, Inc., there will be no remaining assets to exchange in cancellation or redemption of SJI’s common stock. Accordingly, § 332 most likely will not apply to this transaction. Therefore, in the year of the deemed liquidation, Heisenberg, Inc. will be permitted to take an ordinary deduction for the adjusted basis amount of its Salamanca common stock, and a long-term capital
loss for the adjusted basis of its preferred stock. I.R.C. § 165(a), (g); H. K. Porter Co. v. Commissioner, 87 T.C. 689 (1986).

Because Salamanca will most likely have enough assets to pay back the $5 million loan to Heisenberg, Inc., it will be deemed to have repaid the loan before distributing any assets in cancellation or redemption of its preferred stock, and Heisenberg will not be permitted to take a deduction with respect to the loan. However, if Salamanca is insolvent at the time the transaction occurs, then the Secretary may allow a deduction for the amount of the debt Heisenberg charged off in the taxable year. I.R.C. § 166(a)(2). In that case, Heisenberg may be permitted an ordinary loss deduction for the adjusted basis of the portion of the debt that Salamanca is unable to repay, as calculated under § 1011. I.R.C. § 166(b). Salamanca would not recognize any income from the discharge of indebtedness because gross income does not include income by reason of discharge of indebtedness if the discharge occurs when the taxpayer is insolvent. I.R.C. § 108(a)(1)(B). However, the amount excluded from gross income because of insolvency reduces the tax attributes of Salamanca, beginning with NOLs and CNOLs. I.R.C. § 108(b)(1), (2).

III. D. Heisenberg, Inc. – Salamanca: Whether This Constitutes a Reportable Transaction

After paying back the $5 million loan, Salamanca will only have enough remaining assets to cover $1 million of the outstanding preferred stock. As discussed above, the remainder of outstanding preferred stock and the entire adjusted basis of common stock will constitute a loss. It is probable that the adjusted basis of Salamanca’s common stock and preferred stock will far exceed the $10 million loss threshold reporting requirement of Treas. Reg.§ 1.6011-4(b)(4). Therefore, this transaction will most likely result in a loss taken under § 165, that exceeds $10 million, making it a reportable transaction under the regulations.
Re: 2019-2020 Law Student Tax Challenge Problem

Dear Client,

Thank you for choosing Hamlin, Hamlin & McGill. We are here to provide all your tax solutions. Below you will find an overview of your tax issues.

I. The Chicken Brothers, LLC

In 2013, the formation of TCB resulted in no gain or loss to the members of TCB. Each partner received a book value in TCB equal to the fair market value of the property contributed — $750,000 each. Each partner received a 1/3 interest in TCB. The outside basis was carried over from the basis each partner had in the property contributed. However, Gus’s contribution of encumbered property made the transaction less straightforward. As an operation of the Internal Revenue Code, Gus was required to reduce his basis by the $60,000 liability attached to Lot B and then each member was required to increase their basis by their 1/3 share of the $60,000. As a result, Saul had an initial basis of $770,000, Walt had an initial basis of $920,000, and Gus had a basis of $400,000. The results to TCB are simpler. TCB recognized no gain or loss. TCB had an initial basis equal to the adjusted basis in the property just before contribution, but without the adjustment for liabilities. Thus, TCB had an initial basis of $750,000 for the cash, $900,000 for the kitchen equipment, and $240,000 and $200,000 for Lot A and B, respectively.

In 2014, TCB sold Lot A for $510,000, resulting in a gain to TCB of $270,000 that was allocated to each member based on their 1/3 interests. However, TCB was required to allocate $210,000 of the built-in gain to Gus under the traditional method of allocation agreed to in the
operating agreement. The remaining $60,000 should have been distributed equally among the members and reported accordingly on their K-1’s. TCB should have reported $270,000 in gain on Form 1065. You should file an amended return in the case of improper reporting.

In 2015, TCB hired Jesse. The members of TCB granted Jesse a 10% interest, and guaranteed payments to the extent his distributive share was less than $300,000. In 2017, Jesse should have received $450,000 as his distributive share, so no guaranteed payments would have accrued that year. In 2018, Jesse should have received $270,000 as his distributive share, necessitating that TCB accrue $30,000 in guaranteed payments. The guaranteed payments are ordinary income to Jesse and deductible to TCB.

Notably, the IRS has proposed a regulation that would require the entire $300,000 guaranteed payment to be treated as payments for services regardless of Jesse’s distributive share – meaning the entire $300,000 would be ordinary income to Jesse and deductible to TCB each year. If the regulation is made final, you will need to treat Jesse’s $300,000 guaranteed payment accordingly. In addition, the proposed regulations will make it more difficult to classify payments as guaranteed payments because it will require them to pass a regulatory test to prove they are disguised payments.

In 2017, Spice, Inc. sold its TCB interest for $3.2 million. If the redemption occurred prior to November 27, 2017, Spice, Inc. should not be subject to U.S. income tax because its interest in TCB is not attributable to a U.S. real property interest (“USRPI”). However, for redemptions occurring on or after November 27, 2017, new legislation requires redemptions of interests held by foreign entities to be taxed as income effectively connected with the United States, regardless of whether the interest is attributable to a USRPI. Thus, if the redemption
occurred after the enactment of the new law, Spice, Inc. will be subject to U.S. taxation on the sale.

Please let us know the date of the redemption so that we can determine your tax.

II. Heisenberg, Inc. - SJI.

In 2019, Heisenberg would like to transfer operating assets to SJI, a foreign operated subsidiary of Heisenberg. Under recently enacted tax laws, Heisenberg will not have to recognize the built-in gain upon transfer or the assets to SJI. However, under previous law, the transfer was only tax free if the assets transferred qualified as trade or business assets. Therefore, if any of the asset transfers from Heisenberg, Inc. to SJI that occurred before January 1, 2018 were transfers of assets that are not considered operating assets used in a trade or business, then those transfers were subject to tax. You should file an amended return in the case of improper reporting.

In the year of sale, SJI will recognize gain, but not loss on its sale of U.S. Real Property Interests (“USRPIs”) to HoldCo. This will not be a reportable transaction unless SJI realizes a loss of $10 million or more on its sale of USRPIs to HoldCo (although it will only be reportable in the year the loss is claimed). SJI must file a foreign corporation tax return (Form 1120F) for the tax year in which the sale of USRPIs to HoldCo occurs, and SJI can take any permitted deductions at the time it files its return.

The issue with this transaction is whether SJI should elect to be treated as a U.S. domestic corporation for purposes of selling its USRPIs (“the election”). If SJI does not make the election, HoldCo will be required to withhold 15% of the amount realized by SJI on the sale, and to pay this amount over to the IRS within twenty days of the date of first payment. However, HoldCo is not required to withhold an amount higher than SJI’s maximum tax liability on the sale. Either SJI or HoldCo can request that the Secretary of the Treasury determine SJI’s maximum tax
liability for these transactions. Any amount withheld by HoldCo will be credited against the tax owed by SJI when it files its return. If SJI does make the election, then HoldCo will not be required to withhold any amount. Therefore, the decision on whether SJI should make an election to be treated as a U.S. domestic corporation for purposes of selling its USRPIs will turn on whether SJI and HoldCo determine they want HoldCo to withhold and pay 15% to the IRS, or not.

SJI cannot take any losses on this transaction until the properties are disposed of outside of the Heisenberg-SJI-HoldCo corporate group. Therefore, SJI should consider this tax consequence before deciding whether to sell any loss USRPIs to HoldCo.

III. Heisenberg, Inc. - Salamanca

Salamanca may elect to change its classification from an association to an entity disregarded as separate from its owner by filing Form 8832. However, once this change is made, it cannot be made again until sixty months have passed from the date of election. Therefore, Salamanca should consider whether it is in the best interest of the company to remain a disregarded entity for at least sixty months after the date of election before taking steps to effectuate the change.

The tax consequences of the election will be different depending on whether Salamanca is solvent or insolvent on the day before the election takes effect. If Salamanca is solvent on the day before the election takes effect, then it will be deemed to have distributed its assets to Heisenberg, Inc., as its creditor, in satisfaction of the intercompany debt. Any remaining assets will be distributed in partial satisfaction of the preferred equity. Heisenberg can then take an ordinary deduction for the adjusted basis of its outstanding Salamanca common stock, and a capital deduction for the adjusted basis of its remaining outstanding Salamanca preferred stock.
This is the case only if the preferred stock is nonvoting stock or has a liquidation preference. Otherwise, the preferred stock may be considered only nominally different from the common stock. In that case, the assets remaining after satisfaction of the intercompany debt will be deemed to be exchanged for all the outstanding Salamanca stock, and Heisenberg will not be permitted to recognize any gain or loss on the transaction. Accordingly, it would not be permitted to take a deduction with respect to the intercompany debt or the worthless equity.

If Salamanca is insolvent the day before the election takes effect, then Salamanca will be deemed to have distributed all its assets to Heisenberg as its creditor in partial satisfaction of the intercompany debt. Heisenberg will be permitted to take a bad debt deduction for the adjusted basis of the portion of the debt not repaid, as well as a deduction for the adjusted basis of the Salamanca stock. The bad debt deduction will be ordinary in character. If the preferred stock is nonvoting or has a liquidation preference, then the preferred stock deduction will be capital and the common stock deduction will be ordinary. Otherwise, both stock deductions will be ordinary.

If Heisenberg, Inc. is permitted to take deductions that amount to $10 million or more, then this will be a reportable transaction.

Sincerely,

LL.M. TEAM NUMBER ——