



Dbriefs U

Supplemental Material

Taxation of Subchapter C Corporations — Beyond the Tax Return

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About the Supplemental Material

Each Dbriefs U webcast is accompanied by teaching material including discussion or homework questions, a learning activity, and related resources. Visit the Dbriefs U Faculty Resources Web site to download this material. For access to the site and more information, contact dbriefsu@deloitte.com.

To request the solutions for this material, email dbriefsu@deloitte.com.

Discussion/Homework Questions

1. List and describe the three (3) requirements necessary for the transfer of property by a transferor to a corporation to qualify for tax-free treatment pursuant to IRC section 351.
2. Explain the ordering rules for corporate distributions of property to shareholders, and whether each bucket is taxable to the shareholder. How is the distribution treated at the corporation level?
3. Describe 3 or 4 distinct differences between the treatment of corporations and individuals for income tax purposes.

Activities

To request the solutions for this material, email dbriefsu@deloitte.com.

Overview

Case Study: Tax Treatment of Corporate Distributions

Length: 20 minutes

Type: Individual and team activity (10 minutes each)

Materials: Activity sheet and solution

Learning Objectives: Understand the tax consequences when a corporation distributes property to shareholders.

Case Study: Qualification of Transfers as Tax-Free Under Section 351

Length: 20 minutes

Type: Individual or team activity (10 minutes each)

Materials: Activity sheet and solution

Learning Objectives: Understand the qualifications of tax-free transfers pursuant to section 351.

Activity

Tax Treatment of Corporate Distributions

Westco, Inc. (Westco) is a C Corporation that has been in existence for many years and has substantial earnings and profits (E&P). Westco wants to dispose of the following two assets:

- Land with a basis of \$0 and fair value of \$50, and
- A windmill (located on the land) with a \$100 tax basis but fair value of only \$50.

Karen, the sole shareholder, has been thinking about taking some value out of the corporation, and at a recent party her neighbor Jim told her that the tax laws had been changed a few years back. Jim told Karen to take the two assets out of the corporation, sell them right away, and keep the cash.

Assumptions:

- The corporate tax rate is 40% (federal and state)
- Karen will be subject to the 15% tax rate on receipt of qualified dividends
- Karen has a tax basis of \$25 in the Westco stock
- Neither the distribution of assets nor the proceeds from the sale of assets would qualify as a partial liquidation under section 302(b)(4)

Questions:

1. Explain the tax consequences of Jim's idea to Karen and to Westco. Hint: Provide the amount of the distribution, whether Westco and Karen recognize any gain or loss and how much, and the basis of the assets following distribution in Karen's hands.
2. What will you suggest to Karen, and why?
3. Assume all the same facts, except that Westco has current E&P of \$40, and no prior accumulated E&P. Revisit #1 and explain the tax consequences of Jim's idea to Karen and to Westco.

Activity

Qualification of Transfers as Tax-Free Under Section 351

Sam has developed a patent for a new cancer fighting drug, however he doesn't have the facilities or machinery to mass produce it. At a recent seminar, Sam met May, Cara, and Mike, who are interested in partnering with him on his new venture. As a result of these discussions, Sam, May, Cara, and Mike decide to form a new start-up biotechnology C corporation (Biotech), and execute the following exchanges with Biotech:

- Sam contributes a patent for the new cancer fighting drug with a fair market value of \$1 million in exchange for a note from Biotech for \$500k and \$500k worth of Biotech common stock. Sam's basis in the patent is zero.
- May contributes machinery with a fair market value of \$1 million in exchange for \$1 million worth of Biotech common stock. May's basis in the machinery is \$500k.
- Cara contributes real property with a fair market value of \$800k that is subject to a \$600k mortgage in exchange for \$200k worth of Biotech common stock. Biotech assumes the mortgage. Cara's basis in the real property is \$700k.
- Mike contributes a drug manufacturing plant with a fair market value of \$1 million that is subject to a \$200k liability in exchange for \$800k worth of common stock in Biotech. Biotech assumes the liability. Mike's basis in the drug manufacturing plant is \$300k.

Assume that each share of common stock is valued at \$1 and receives 1 vote. No other classes of stock are outstanding.

Questions:

1. What are the tax consequences of the transfers of assets and liabilities to Biotech by Sam, May, Cara, and Mike? Provide whether the transfers collectively meet the requirements under section 351, the amount of gain/loss (if any) recognized by all parties, and the basis of property contributed and common stock received by each transferor.
2. Rather than forming a new company, Sam, May, Cara, and Mike invest in Cancertech, an existing entity valued at \$1.5 million wholly-owned by Paul. Does this change your answer to #1? If so, how?

Related Resources

To access these materials, visit www.deloitte.com/us/dbriefsu.

Internal Revenue Code, Subchapter C, Sections 301 – 385

Federal Income Taxation of Corporations and Shareholders (Bittker & Eustice)

Webcast Poll Questions

To request the solutions for this material, email dbriefsu@deloitte.com.

Question

The State of Delaware is generally regarded as the easiest state to register and form a corporation, with well written statutes and widely studied rules and regulations. Approximately, how many corporations were formed in Delaware in 2009?

- 1,000
- 5,000
- 20,000
- 35,000

Question

The maximum federal corporate tax rate currently is:

- 50% — The U.S. recently followed the United Kingdom's lead
- 35% — At least for the moment
- 15% — The U.S. has followed the international trend to lower corporate tax rates
- Depends upon the state of incorporation

Question

What is a corporate liquidation?

- Nickname for a liquid similar to Brangelina for Brad and Angelina
- The distribution by a corporation of all of its assets and liabilities to its shareholders
- Being completely drenched by liquid (i.e., being sprayed with a hose)
- A party with an open bar

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