Case 30C/31C

Issues

1. Your clients' would like you to contrast and compare, with particular reference to your their proposed venture, the treatment of S corporation with the treatment of a general and limited partnership and a limited liability company with particular reference to the following areas:

   a. The eligibility of the entity for use in carrying on the proposed business activity;

   b. The ability of the participants in the entity to separate their interests in future earnings from their interests in capital and their interests in capital and earnings from their interests in management;

   c. The determination of the bases of the participants in their interests in the entity;

   d. The taxation of the income of the entity to the participants;

   e. The pass-through of the tax losses of the entity to the participants;

   f. The ability to have the participants share the income of the entity in a manner different from that used to share the losses and the ability to change the sharing ratios during the life of the entity;

   g. The treatment of the tax losses of the entity which cannot, in the year incurred, be passed through to the participants;

   h. The income tax treatment of pro rata current distributions of money by the entity to the participants;

   i. The income tax treatment of non-pro rata distributions of money by the entity to the participants; and

Scanned with CamScanner

j. The ability of the participants to transfer or dispose of the "tax attributes" of their interests in the entity when they sell, transfer or otherwise dispose of some, or all, of such interests.

2. A. What would be the income tax consequences to Ms. Kowalski, Mr. Dugan and Ms. Clipman of forming a limited partnership with Ms. Clipman as the general partner?

   B. What would be the limited partnership's basis in the property transferred in the formation of that partnership?

   C. What would be the basis of each partner in the limited partnership?

   D. Would any partner recognize a gain or loss as a result of the formation of the partnership?

3. What would be the income tax consequences to Ms. Kowalski, Mr. Dugan and Ms. Clipman of forming a limited liability company (LLC)?

4. A. What would be the income tax consequences to Ms. Kowalski, Mr. Dugan and Ms. Clipman of forming an S corporation?

   B. What would be the S corporation's basis in the property transferred in the formation of that corporation?

   C. What would be the basis of each shareholder in the S corporation?

   D. Would any shareholder recognize gain or loss as a result of the formation of the S corporation?

5. What course of action do you recommend to your clients and why?

6. Under what circumstances would you recommend a C corporation, i.e., regular taxable corporations?

Law: Secs. 1 (j), 11, 61, 351, 357, 358, 362, 444, 704, 705, 706, 709, 721, 722, 723, 724, 1001, 1011, 1012, 1013, 1016, 1221, 1231, 1245, 1250, 1361, 1362, 1366, 1367, &1378

Scanned with CamScanner

PROBLEM 30C [redacted]

Five of your more successful clients have just asked for your advice. In the past, the clients have invested jointly in a number of real estate development projects such as apartment and office buildings, shopping plazas and the like. You have always recommended that an unincorporated conduit form of entity, such as a general or limited partnership, a limited liability partnership or a limited liability company, be used, at least initially, to own and operate these investments. Your general explanation of the reason for this recommendation was that, despite having to give up at least two of centralized management, limited liability, free transferability and continuity of life that go with the corporate form, the income tax benefits gained through the use of an unincorporated form of entity are well worth the cost.

Your clients have heard, in casual discussions with other persons engaged in real estate development, that an S corporation is taxed like a partnership and that the shareholders who work for such a corporation can obtain, to some extent, tax-free fringe benefits which are not usually available to participants who work for their unincorporated form of entity.

Your clients are in the planning stages of a small office building project. They estimate that the office building will produce an aggregate $450,000 tax loss during the first five years of operation. It will, however, produce a positive cash flow starting the second year of operation and when, in the sixth year of operation, it begins producing taxable income, the amount of cash flow will exceed substantially the amount of taxable income for the sixth through the twelfth year. Your clients' total equity contribution toward the purchase of the land and the construction of the office building will be in

Scanned with CamScanner

the neighborhood of $600,000. The remainder, $2,400,000, of the estimated cost of purchase and construction will be borrowed from Western Savings Bank, secured by a first mortgage on the land and building. Some of the clients will take an active role in management, and some will take a passive role. In addition, some may sell, transfer or otherwise dispose of their interest in the venture prior to the end of the life of the venture.

While your clients realize that an S corporation is not treated just like other unincorporated forms, they would like you to contrast and compare, with particular reference to your clients' proposed venture, the treatment of an S corporation with the treatment of a general, limited and limited liability partnership and a limited liability company with particular reference to the following areas

Scanned with CamScanner

PROBLEM 31C

At one time, Dakota Beach was a thriving summer resort community on the shores of Cavern Lake. Over the years, it has fallen into disrepair and has lost most of its vacation trade. The area, however, still possesses many natural amenities which would be attractive to vacationers such as the clear deep lake, mild climate and attractive rolling countryside. The accommodations presently located in Dakota Beach, including the once-elegant Grand Hotel, are quite outmoded and decrepit. Stephanie Kowalski (Stephanie), Matthew Dugan (Matthew) and Rose Clipman (Rose), residents of Dakota Beach, think they have found a way of building up the vacation trade.

Stephanie owns, as a sole proprietor, the Grand Hotel, which she inherited from her parents a number of years ago. While many of the accommodations and amenities presently in the hotel are quite outmoded, the hotel buildings are basically very sound and solid structures. To attract more vacation trade, at least $1,200,000 in renovations would have to be made to the hotel to bring the accommodations and amenities up to the standard expected in a first-class hotel. Stephanie, Matthew and Rose feel that the present fair market value of the hotel buildings is about $1,000,000, and the value of the land on which the buildings are situated is about $220,000. Stephanie has an adjusted basis in the hotel buildings of $500,000 and a basis in the land of $100,000. The hotel buildings and land presently are unencumbered, and Stephanie does not owe any debts with respect to the operation of the hotel except about $20,000 in trade accounts payable left over from last summer's operation.

Matthew is a very well-to-do land speculator. He has acquired most of the land surrounding the Grand Hotel and between it and the lake. The old

Scanned with CamScanner

cottages, which were located on some of the land, have been demolished since they had little value as vacation accommodations. Matthew financed a substantial portion of the purchase price of the land and has increased the amount of liabilities to which the land is subject in order to pay the carrying costs of the land such as taxes, interest on the liabilities, etc. Matthew, Stephanie and Rose feel that the fair market value of Matthew's land is about $2,400,000. The land is subject to liabilities of $1,200,000, and Matthew's basis in the land is $900,000.

Rose is the former executive vice-president and manager of Sea Pines Resort in Hilton Head, South Carolina. She is noted as one of the most innovative resort planners and managers in the country. She has developed plans for the renovation of the Grand Hotel and for recreation and vacation oriented uses of Matthew's land. The plans contemplate, as mentioned above, making the Grand Hotel a first-class facility and improving Matthew's land with a variety of recreational facilities to be available to guests of the hotel. Facilities such as a golf course, tennis courts, swimming pools and health and athletic clubs will be constructed. The cost of such facilities is estimated to be about $2,600,000.

For Rose's plan to be carried out, the Grand Hotel and Matthew's land must be owned, or at least controlled, by the same entity. The entity, using the Grand Hotel and Matthew's land as a capital base, might be able to finance the renovations to the hotel for $1,200,000 and the construction of the recreational facilities for $2,600,000 — a total of $3,800,000. Rose would contribute $600,000 of her savings to the entity for this purpose. She believes that $1,200,000 can be raised from about thirty outside investors in exchange for the equivalent of a one-quarter interest in the entity, and the remaining $2,000,000 can be borrowed from a bank. Consequently, Stephanie and Matthew have each agreed to contribute the Grand Hotel and the land to an entity, and in return, each will receive a one-quarter interest in the entity. Rose will contribute the plans and $600,000, arrange for the investors and the bank financing, and supervise the renovations and the construction of the recreational facilities in return for a one-quarter interest in the entity. The projections of taxable income and loss indicate that the entity will lose, for tax purposes, an aggregate of about $800,000 over the first five years of operations. The cash flow of the entity, however, will be positive after the first year.

Stephanie, Matthew and Rose have considered using, as a business entity to own and operate the renovated Grand Hotel, either a limited partnership with Rose as the general partner, a limited liability company or an S corporation. They have asked for your advice. What problems will they face if they decide to form and use a limited partnership or a limited liability company? What if they choose to form and use an S corporation? Which would you recommend and why?

Scanned with CamScanner