

The 2003 Law Student Tax Challenge Official Problem

I. The Assignment.

A senior partner has come into your office with an assignment and has brought your fellow associate with her. The partner says that the client just called her with the outline of a proposed deal. The partner wants to meet with you and your fellow associate to discuss the tax issues raised by the proposed deal at the Winter meeting of the American Bar Association Tax Section and wants you both to meet with the client afterwards. Specifically, the partner wants to discuss whether the client's corporation is engaged in an active trade or business for purposes of Section 355(b) of the Internal Revenue Code of 1986, as amended (the "Code"), whether the client has sufficient business purpose for the proposed Section 355 transaction and whether the transaction constitutes a "reportable transaction" under Sections 1.6011-4 and 301.6112-1 of the Income Tax Regulations.

Before that meeting, she wants you to draft a memorandum to her and a letter to the client discussing these issues. The memorandum must not be longer than 10 pages. The letter must not be longer than 4 pages. The memorandum and letter should follow the rules established by the Young Lawyers Forum and legal writing rules established in the Blue Book, 17th edition. Any state, local, foreign, international, ERISA, gift, estate, employment or excise tax issues should not be discussed. Similarly, state laws or Federal farm or securities laws should not be addressed. With the logistics out of the way, the senior partner launches into the details of the proposed deal.

II. Background Information.

The client, Fermier Smith, owns 100 shares of stock in LandCo, Inc. ("LandCo"). LandCo is a corporation that made a valid election to be treated as a small business corporation under subchapter S of the Code effective January 1, 1980. LandCo has 400 shares of stock outstanding. The client's wife, Mimi Smith, owns 100 shares of stock in LandCo. The client's sister, Colona Smith, owns 200 shares of stock in LandCo. All of the shares are common stock.

LandCo's sole asset is a 320-acre piece of farmland. LandCo bought the land in 1965 for approximately \$500 per acre. When it was initially purchased, Fermier and Colona thought they would grow wheat on the farm for the rest of their working years and then pass it to their children. In 1997, however, Colona changed her mind. She decided that she could make a better living by making compost, and she formed Tenant Farm Company, LLC ("TFC") to do this.

TFC is owned entirely by Colona and engages in the business of manufacturing compost. TFC purchases manure from local ranchers, which gets mixed with straw and water to make the compost. This process occupies most of the land that TFC leases. TFC has a few employees that help with this business and several large pieces of equipment. TFC has not filed an election to be an association taxable as a corporation.

Another limited liability company, Grain & Seed, LLC (“G&S”) is owned entirely by Fermier. G&S grows traditional farm products, including wheat, barley and other grains. Fermier is able to operate his farm without any assistance other than the bookkeeping that is done by Mimi. G&S has not filed an election to be an association taxable as a corporation.

The eastern 160 acres of the land is leased to TFC. The western 160 acres of the land is leased to G&S. Each lease is a triple-net lease. LandCo was recently approached by two independent buyers that are willing to pay \$50,000 per acre due to the proximity of the land to a very pricey development area.

LandCo’s president is Colona, its secretary is Fermier and its treasurer is Mimi. Each performs approximately 100 hours of work each year for LandCo in those capacities, including maintaining the road through the land, spraying for weeds on the edges of the land, and keeping the books. In addition, Fermier and Colona are the two directors of the corporation. The most recent minutes of the Board of Directors state that Fermier and Colona are each entitled to a salary of \$3,000 per year for their services. Mimi is to be paid minimum wage for her time. In addition, the minutes reflect a policy of declaring annual dividends equal to any earnings and profit that the company may have accumulated. Fermier has informed you that LandCo still has about \$100,000 in C corporation earnings and profits.

III. The Transaction.

Fermier is six years away from retirement and has one child who became a freshman in high school this year and two children that will be freshman next year. All three children eventually want to become tax lawyers. In addition to Fermier’s retirement needs, he anticipates the need for quite a bit of cash for his children’s college and law school educations.

This need for cash and the recent purchase offers prompted Fermier to approach Colona about selling the farm. Colona is resolutely against the sale. She feels that she earns a good living in her compost business and that the price for the land will continue to increase. She would prefer to work until 2015 and then retire on the farm. Colona believes that her son will want to inherit her share of the farm.

A friend of Fermier recently suggested a way to resolve the tension between the siblings. The friend explained that a corporation can contribute half of its assets into a new corporation and half of the shareholders can take all of the stock in the new corporation in exchange for their stock in the old corporation. The friend mentioned that he recently did the same transaction with his sibling to divide a farm that they had been farming together through their corporation for years.

Because Fermier was worried that potential buyers may be deterred by tax planning, Fermier modified a broad confidentiality agreement from a transaction that he engaged in many years ago to cover this new transaction. He, Mimi and Colona signed the confidentiality agreement, in their capacities as shareholders and officer, and then

went to talk to Colona's accountant about the transaction. Colona's accountant told them that the transaction should be tax-free. The accountant also informed them that the corporation would have a book gain (i.e., a gain for financial accounting purposes) of \$49,500 per acre or a total of \$15,840,000.

Colona has told Fermier that she will only participate if the transaction is tax-free, as the accountant described. For her part, Colona has said that this will assist her with her estate planning because she will no longer need to worry about her son inheriting the G&S portion of the farm. She also believes that, once she is the sole shareholder of a corporation that owns the eastern 150 acres of the farm, she will finally be able to sell a small percentage of stock to certain employees of TFC that are critical to the success of her compost business. Colona has long believed that LandCo stock would be too expensive for these key employees of TFC if such an offering were arranged. Nevertheless, these key employees have always said that they would be willing to hold stock in a LandCo subsidiary, if necessary.

Fermier likes the idea of the transaction, but has certain specific concerns. He wants to make sure that he remains an S corporation shareholder after the transaction until the time of his retirement. He also wants to be able to continue to farm until his children graduate from high school, at which time he would sell the land.

Fermier has come to the senior partner to verify that the transaction is tax-free and that no separate filings are required other than the Federal and state income tax returns. The senior partner expects the total fees for this transaction to exceed \$50,000 and is worried that the firm will be subject to the list-keeping requirements due to the fees. The senior partner does not have time to do this work and asks you to prepare the memorandum and letter described above.