

**MEMORANDUM**

**TO: Senior Partner**

**FROM: LL.M. Team Number \_\_\_17\_\_\_\_\_**

**DATE: November 12, 2007**

**SUBJECT: 2007 Law Student Tax Challenge Problem**

---

**I. Facts.**

Our client, Frump International, Inc. (“Frump, Inc.”), is a large, publicly-traded real estate development corporation founded by its CEO, Ronald J. Frump. Frump, Inc. is interested in forming a partnership with Sigmund and Royal Global Entertainment, LLC (“SRGE”), to be known as “FSR,” for the purpose of establishing an entertainment and casino venue in Las Vegas. Membership interests in SRGE are currently held by Hans Sigmund and Franz Royal. As part of the deal, Mr. Sigmund and Mr. Royal request that FSR establish a tax-exempt “wing,” dedicated to the conservation of lions and tigers in Africa and the Middle East. Mr. Royal has voiced an intention to retire from FSR within five years but would like to sell licensing rights to FSR and continue in the organization’s tax-exempt conservation efforts.

**II. Issues.**

Although the following issues will be discussed with respect to the goals of all parties, our primary duty is to protect the interest of our client, Frump, Inc. No representation of other parties is intended, following the American Bar Association (ABA) Model Rules of Professional Conduct as to situations where a conflict of interest may be involved. ABA Model Rule 1.7.

1. Can this transaction be structured as a like-kind exchange, and, if so, which properties should be used? Would it be more advantageous for Frump, Inc. to contribute the properties to FSR before engaging in a like-kind exchange?
2. May Frump, Inc. contribute assets to a new LLC (limited liability company), classified as a partnership and named FSR, without the contribution resulting in a taxable event?
3. If the transaction cannot be structured as a contribution of assets to a new LLC, what are the potential tax consequences to Frump, Inc.?
4. Can Mr. Frump, as CEO and shareholder of Frump, Inc., contribute services to FSR without the contribution resulting in a taxable event?
5. What is the best choice of entity and agreement terms for FSR, and what tax ramifications may result to Frump, Inc. based on these recommendations?
6. What tax implications are involved in the establishment of a tax-exempt wing?
7. What are the tax ramifications if Mr. Royal retires within the next five years, and how will profits be shared after his retirement?
8. What are the implications of Mr. Royal maintaining a presence after retirement by selling licensing rights to his name and likeness and possibly working in the organization's conservation efforts?

### **III. Analysis.**

#### **A. Issue 1: Like-kind Exchange.**

I.R.C. §1031(a)(1) provides: “No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.” I.R.C. § 1031(b) provides that where, in addition to an exchange

of property without recognition of gain, there is an exchange of “other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.” Gain is also recognized to the extent of debt assumption. Rev. Rul. 79-44, 1979-1 C.B. 265. Finally, I.R.C. § 1031(d) provides that the basis of the exchanged property is determined by taking into account debt relief and any recognition of gain. A cost segregation analysis must be performed to determine which items of personal property within the exchanged real property qualify for like-kind exchange. Rev. Proc. 87-56, 1987-2 C.B. 674, clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785.

1. Selection of Replacement Property. Lot 752 is owned by the Las Vegas Redevelopment Corporation, which indicates that it is held for development and not investment purposes. Therefore, it would not qualify for I.R.C. §1031 exchange. Krustilu and the attached parcel (“Krustilu”), with a fair market value of \$45,000,000 and subject to a \$5,000,000 mortgage, would be a logical choice, since it is also a casino property with an ideal location adjacent to SRGE’s new casino. Since Krustilu is a 1970’s style casino, upon subsequent sale, FSR may be subject to I.R.C. § 1250 depreciation recapture to the extent depreciation was taken in excess of straight line depreciation.

2. Selection of Currently Held Properties for Like-kind Exchange. Three of the properties currently held by Frump, Inc. may be eliminated from consideration for like-kind exchange based on the following assumptions: 1) Frump Marina and Yacht Club is a luxury private club and probably not held for productive use in Frump Inc.’s trade or business; 2) there may be restrictive agreements with the holder of the other 50% interest in Frump-del-la-Rey; and 3) Frump, Inc. may not want to exchange its office building in New York City because of the

cost and inconvenience in moving to a new location. Frump International Golf Dome is not needed as exchange property, as discussed below.

Frump Playland (“Playland”), with a fair market value of \$40,000,000 and subject to a \$15,000,000 mortgage, is a good candidate for a like-kind exchange for Krustilu. Considering Frump, Inc.’s current troubles with its board and the New Jersey Casino Control Commission, the exchange of Playland may have the added benefit of restoring board and investor confidence.

Frump, Inc. should reduce the debt on Playland to avoid recognizing gain on boot and to equalize the current net value of both properties in preparation for a like-kind exchange. If Frump, Inc. pays off the mortgage on Playland, its net value will be \$40,000,000, which will match the current net value of Krustilu, with a fair market value of \$45,000,000 and subject to a mortgage of \$5,000,000. Following a cost segregation analysis, personal property that is in the same asset class can be included in the exchange, increasing the exchange fair market values of both Playland and Krustilu in equal amounts.

The fair market value of Playland’s personal property would possibly increase the value of Frump, Inc.’s contribution by another \$5,000,000, which, with the planned contribution by Mr. Frump of \$5,000,000 in services, would reach the \$50,000,000 target contribution to FSR.

Since the potential replacement property has been identified, there should be no issue regarding the 45-day replacement requirement of I.R.C. § 1031(a)(3). The replacement property, Krustilu, must be received within the earlier of 180 days after relinquishment of Playland or the income tax return due date of the year of exchange. If Krustilu cannot be received by the earlier of those two dates, an extension of time within which to file the income tax return should be obtained. I.R.C. § 1031(a)(3); Treas. Reg. § 1.1031(k)-1.

3. Contribution of Properties into FSR Pre-exchange. Under Rev. Rul. 75-292, 1975-2 C.B. 333, the like-kind exchange may be disallowed if Frump, Inc. attempts to exchange Playland for Krustilu prior to contribution to FSR. Under this revenue ruling, an exchange did not qualify for gain nonrecognition where taxpayers, in a prearranged transaction, engaged in a like-kind exchange, and then contributed the acquired property. *But, see, Magneson v. Commissioner, 753 F.2d 1490 (9<sup>th</sup> Cir. 1985).*

**B. Issue 2: Contribution of Assets into an LLC, Classified as a Partnership.**

To form a new partnership with SRGE, Frump, Inc. should first create a new single purpose subsidiary to receive Playland. Frump, Inc. will then contribute Playland to the new subsidiary in exchange for subsidiary stock in a divisive D reorganization governed by I.R.C. § 368(a)(1)(D) and I.R.C. § 355.

After the spin-off, Frump, Inc. must be in control of the Frump, Inc. subsidiary under I.R.C. § 355(a)(1)(A). Control is defined in I.R.C. § 368(c) as ownership of stock representing at least 80% of the voting stock and 80% of all other classes of stock.

Immediately after the distribution, both Frump, Inc. and its subsidiary must be engaged in the active conduct of a trade or business under I.R.C. § 355(b)(1). Active conduct includes performing “active and substantial management and operational functions.” Treas. Reg. § 1.355-3(b)(2)(iii). Under I.R.C. § 355(b)(2), the active business must have been conducted for at least a five-year period prior to the transaction. Frump, Inc. must distribute enough stock of the subsidiary to constitute control. I.R.C. § 355(a)(1)(D). The primary purpose of the distribution cannot be to distribute earnings and profits. I.R.C. § 355(a)(1)(B).

If Frump, Inc. pays off the debt on Playland, there will be no gain recognized by Frump, Inc. on the transfer of Playland to the subsidiary under I.R.C. § 361(a), and Frump, Inc.

shareholders will recognize no gain on the distribution of subsidiary stock under I.R.C. § 361(c) (1). The subsidiary will hold Playland with a substituted basis under I.R.C. § 362(b).

The Frump, Inc. subsidiary can then contribute Playland to FSR, which will be formed as an LLC and treated as a partnership for tax purposes. If the debt amount is eliminated, no gain or loss will result to the subsidiary or FSR upon the subsidiary's contribution of Playland in exchange for an LLC membership interest under I.R.C. § 721(a). FSR will take a carryover basis in Playland under I.R.C. § 723. After the conversion of assets to FSR, both the Frump Inc. subsidiary and SRGE will be taxed separately on their share of profits, losses, deductions, and credits under I.R.C. § 702.

If the debt amount is not reduced, it is not clear whether Playland is subject to recourse or nonrecourse debt. Generally, no LLC member can be forced to assume a debt obligation. If Playland is subject to recourse debt, and Frump, Inc. does not reduce this debt amount prior to contribution, the subsidiary should indemnify SRGE in order to avoid a taxable gain upon the deemed cash distribution in the amount of the reduction of Frump Inc.'s liability in the indebtedness, pursuant to I.R.C. § 752. The Frump, Inc. subsidiary should also obtain indemnification from SRGE, whose contributed property, the SRGE casino, is subject to recourse debt.

FSR will then exchange Playland for Krustilu. FSR's basis in Krustilu will be its adjusted basis in Playland, increased by any debt assumed, any cash paid, and any gain recognized; and decreased by any debt relief and any cash received. I.R.C. § 1031(d).

The parties have agreed that \$100,000,000 will be required for initial operating costs, including contributed assets and services, construction costs, and cash-at-hand, and Frump, Inc.

and SRGE have each agreed to contribute \$50,000,000 in property and services. Frump, Inc. will be able to satisfy its part of the bargain, as discussed above.

SRGE will contribute its casino, valued at \$30,000,000 and subject to a recourse note of \$10,000,000. In order to bring its contribution amount to \$50,000,000, SRGE should consider obtaining an additional \$30,000,000 in nonrecourse debt and contributing the proceeds to FSR. Since Mr. Royal plans to retire within five years, Mr. Sigmund should personally guarantee the nonrecourse debt, resulting in an allocation of that debt to him. Treas. Reg. § 1.752-2(e).

**C. Issue 3: Tax Consequences if the Contribution of Assets Fails.**

If the spin-off of Playland to the Frump, Inc. subsidiary fails, it will be taxed as a distribution under I.R.C. § 301, which is dividend to the extent of earnings and profits, with the remaining balance treated as a recovery of basis, then capital gain.

**D. Issue 4: Tax Consequences of Contribution of Mr. Frump's Services.**

Mr. Frump has indicated his willingness to contribute his services to FSR. This would be a nontaxable event if he receives a profits interest in FSR, following the guidance provided in PLR 200329001, citing Rev. Proc. 93-27, 1993-2 C.B. 343, as clarified by Rev. Proc. 2001-43, 2001-2 C.B. 191. Under Rev. Proc 93-27, 1993-2 C.B. 343, a profits interest exists where nothing would be distributed to the partner in a hypothetical liquidation. While Mr. Frump would become an LLC member based on his profits interest, he would not have a capital interest, a position that should be reinforced in the LLC agreement with a specific provision that allocations of gain or loss on assets are to be allocated to the other LLC members. Mr. Frump would be taxed on his distributive share of FSR profits as they are earned. The Frump, Inc. subsidiary and SRGE would still have equal 50% capital interests in FSR.

**E. Issue 5: Choice of Entity, Agreement Terms and Tax Consequences.**

The best choice of entity for FSR is an LLC, treated as a partnership for tax purposes. Partnership income is recognized at the partner level. I.R.C. §§ 701, 702. Losses are passed through to partners, subject to partnership basis limitations (I.R.C. § 704(d)), at risk limitations (I.R.C. § 465) and passive activity limitations on loss deductions (I.R.C. § 469). This transaction is not eligible for a subchapter S election, because corporations may not be shareholders. I.R.C. § 1361(b). An LLC agreement should be drafted to define such issues as management authority; transfer of LLC interests; admission of new members; allocation of income, gain, losses, deductions and credits; retirement of members, liquidations and termination.

Basis in an LLC is increased by each member's share of liabilities, thus enabling members to deduct losses attributable to borrowed funds. I.R.C. § 752. It would be best for Frump, Inc. to allow FSR to assume the loan on Krustilu. If it is necessary for Frump, Inc. to assume the loan on Krustilu, First Bank of New York's single-asset entity limitation should be satisfied by the fact that after the like-kind exchange and the renovation of Krustilu are completed, FSR will hold only a single asset, the combined venue of the former Krustilu and the former SRGE casino. Income, losses, deductions and credits may be allocated between the Frump, Inc. subsidiary and SRGE in a manner that best meets their tax needs. I.R.C. § 704(a).

**F. Issue 6: Tax Implications of Establishing a Tax-exempt Wing.**

In order to qualify as a tax-exempt organization under I.R.C. § 501(c)(3), the entity must be a corporation, community chest, fund or foundation established exclusively for permissible purposes, including educational, charitable, or prevention of cruelty to animals. An exempt organization must establish that it is not organized or operated for the benefit of private interests,

such as, for instance, conservation of lions and tigers for use in the SRGE show or for publicity purposes. Treas. Reg. 1.501(c)(3)-1(d)(1)(ii).

An organization which operates a trade or business unrelated to the exempt purposes is not an exempt organization, even if it has certain exempt purposes and otherwise meets the requirements of an exempt organization. Treas. Reg. § 1.501(c)(3)-1(e), I.R.C. § 511. An LLC would qualify as a tax-exempt organization only if it is wholly owned by tax-exempt organization or if it is operated exclusively for charitable purposes. FSR, therefore, would not qualify as a tax-exempt organization, since it will not be operated exclusively for charitable purposes. Finally, charitable activities attempted in the Middle East, given the current political situation, may result in the denial or suspension of exempt status under I.R.C. § 501(p).

To appease Mr Sigmund and Mr. Royal, FSR could adopt a policy providing for a certain percentage of FSR's annual profits to be donated to an appropriate animal conservation charity.

**G. Issue 7: Tax Implications if Mr. Royal Retires within the next Five Years.**

A possible exit strategy is discussed by Daniel S. Goldberg, *Choice of Entity for a Venture Capital Start-up: The Myth of Incorporation*, 55 Tax Law. 923, (Summer 2002). When FSR reaches a point of financial stability, a new C corporation can be formed as a managing member of FSR, which will serve as the entity through which a public offering can be made. Upon retirement, Mr. Royal will be able to exchange his share of SRGE membership interest in FSR for income-producing stock of the new C corporation at such intervals as determined to be appropriate, thereby recognizing gain only on the appreciated portion of the stock. Profit and loss allocations would not be altered with respect to the Frump, Inc. subsidiary or FSR, but adjustments would be necessary for SRGE, which is beyond the scope of our representation. In

the alternative, Mr. Sigmund could buy out Mr. Royal's interest in SRGE, which again would not have any tax ramifications pertaining to FSR or its members.

**H. Issue 8: Implications of Mr. Royal Selling Licensing Rights.**

Under the exit strategy discussed above, Mr. Royal could also be paid for any licensing rights to which FSR determines Mr. Royal is entitled by issuance of C corporation stock, which, if resold immediately, would not result in any additional recognizable gain with respect to Mr. Royal. Any compensation in the form of the new C corporation stock paid to Mr. Royal for services to FSR would be taxable to FSR and allocated to the partners under I.R.C. § 704. However, the new C corporation would not recognize any of that allocated gain. I.R.C. § 1032, Rev. Rul. 99-57; 1992-2 C.B. 678.

**IV. Conclusion.**

To accomplish a tax-free joint venture with SRGE, Frump, Inc. will need to create a new subsidiary to receive Playland. Frump, Inc. should reduce or eliminate the debt on Playland prior to transfer to avoid gain recognition. The subsidiary will contribute the property to FSR, an LLC treated as a partnership for tax purposes. SRGE will contribute its existing casino and additional amounts, preferably obtained through nonrecourse financing personally guaranteed by Mr. Sigmund, given Mr. Royal's planned retirement. FSR will then engage in a like-kind exchange of Playland for Krustilu. Once FSR obtains a level of financial stability, an exit strategy can be implemented by forming a new C corporation as a managing member of FSR, which will serve as the entity for a future public offerings and enable Mr. Royal to retire and to be compensated for his licensing rights with income-producing stock. Mr. Royal would recognize gain on the appreciated portion of the stock. A nonprofit entity created for the animal conservation purposes envisioned by Mr. Sigmund and Mr. Royal must be formed separately from FSR.

**LAW OFFICES OF LL.M TEAM \_\_\_\_\_17\_\_\_\_\_**  
**Tax Town, ABA State, 10000**

**Client,**  
**Tax Town, ABA State, 10000**

**Re: 2007 Law Student LSTC Problem**

Dear Mr. Frump:

This letter is response to your request for advice concerning the formation of a partnership between Frump, Inc. and Sigmund and Royal Global Entertainment (“SRGE”) to be known as “FSR.” At the outset, as you know, our client is Frump, Inc., and we are not representing SRGE. If a conflict of interest develops between Frump, Inc. and FSR, we would need to determine to what extent this firm could continue to represent Frump, Inc. in this joint venture.

With respect to the formation of FSR, we have determined that: 1) this transaction can be structured to include a like-kind exchange of property; 2) the creation of FSR as a limited liability company would yield the most favorable tax treatment; 3) you may contribute your personal services to FSR in exchange for a profits interest in FSR; 4) in light of Mr. Royal’s planned retirement, Mr. Sigmund should contribute \$30 million in personally guaranteed loans to FSR to make up SRGE’s \$50 million share of contributions; 4) a tax exempt animal conservation element should not be included in FSR; 5) an exit strategy can be developed to facilitate Mr. Royal’s planned retirement; and (6) Mr. Royal’s ongoing involvement with FSR can be specified in separate licensing and compensation agreements. These issues will be discussed separately.

Like-kind Exchange of Property. Lot 752 does not qualify for a like-kind exchange because it appears that the current owner, a redevelopment company, is holding it for development and eventual sale and not for business or investment use. Krustilu, with its attached

parcel, not only qualifies for such an exchange as business property, but it has an ideal location adjacent to SRGE's new casino. Frump Playland has a similar business purpose and would be a logical choice for like-kind exchange with the Krustilu property. Much of the contained personal property would also qualify for like-kind exchange treatment, providing you with an increased value on the exchange, tax-free, and providing Frump, Inc with its target \$50 million contribution, including your \$5 million in services, as discussed below.

You should obtain a cost segregation analysis by an accountant to determine which assets in each business, Frump Playland and Krustilu, qualify for like-kind treatment and to determine the value and appropriate basis for such items. Since Krustilu is a 1970's casino, FSR may be subject to recognition of ordinary income on a subsequent sale to the extent depreciation was taken in excess of straight line. Finally, during the exchange transaction, title to Krustilu and the attached parcel must be obtained within the earlier of 180 days after relinquishing Frump Playland or the income tax return due date. If the exchange cannot be completed by the earlier of those two dates, an extension of time within which to file the income tax return should be obtained.

Establishment of and Contributions to LLC. We believe that a limited liability company is the best choice of entity because it provides insulation from liability of its members and provides partnership tax treatment. Income and losses would be recognized by LLC members, subject to limitations which we should discuss in detail at a later time. Basis in an LLC is increased by each member's share of liabilities, enabling members to deduct losses from loans. An LLC agreement should be drafted to specify such issues as management authority; transfers of membership interests; allocation of income, gain, losses, deductions and credits; and liquidation and termination of the LLC.

It is our opinion that the law precludes a like-kind exchange of property prior to the formation of FSR. Frump, Inc. should create a subsidiary for the single purpose of receiving Frump Playland and subsequently distributing it to FSR, tax free, in exchange for a membership interest in FSR. Frump Investment Management, Inc. would not be a suitable vehicle for this purpose, since it already serves as Frump, Inc.'s real estate investment and holdings group.

FSR will then exchange Frump Playland for Krustilu and the attached parcel. In order to avoid recognizing gain from debt relief of \$15 million on the exchange, Frump, Inc. should pay off the Frump Playland mortgage prior to the exchange. FSR's basis in the Krustilu property would be its adjusted basis in Frump Playland plus any Krustilu debt that is assumed. FSR should assume the Krustilu indebtedness, which would increase members' basis in the LLC interest, enabling those members to deduct any losses attributable to that debt. However, if Frump, Inc. must assume the loan on Krustilu, your bank's single-asset entity limitation on your assumption of the Krustilu debt will be satisfied, since FSR will ultimately hold a single asset, the FSR casino and entertainment facility.

If this arrangement does not work, the Frump, Inc. subsidiary would recognize gain on the assets transferred to FSR, and FSR's basis in the assets would be their fair market value at the time of the contribution.

Since Mr. Royal plans to retire within five years, SRGE should obtain \$30 million in a nonrecourse loan or loans which are personally guaranteed by Mr. Sigmund. That debt would be allocated to Mr. Sigmund. The loan proceeds would be contributed to FSR, in addition to the \$20 million net value of the SRGE casino. You, FSR and the Frump, Inc. subsidiary should be indemnified for the liabilities of SRGE and Mr. Sigmund.

In exchange for your contribution of \$5 million in services to FSR, you will receive a profits interest in FSR, tax-free. You will be taxed on your distributive share of FSR profits when they are earned. While you will be an LLC member, you will not have an interest in FSR capital. Therefore, the Frump, Inc. subsidiary and SRGE will still be equal members in terms of the FSR capital interests.

Tax Implications of Nonprofit Component. In order to qualify as a tax exempt organization, the animal conservation component would have to be wholly owned by a tax exempt organization or operated exclusively for charitable purposes. Since FSR will be operated for profit, inclusion of a nonprofit component is precluded, and the animal conservation project should be established as a separate tax exempt organization. FSR might consider adopting a policy to contribute a certain portion of its annual profits to an animal conservation charity.

Mr. Royal's Retirement and Continued Involvement. Once FSR become financially stable, a new publicly traded corporation could be created as a managing member of FSR, and Mr. Royal could exchange his share of SRGE membership interests in FSR for income-producing stock in the new corporation to fund his retirement. At that point, Mr. Royal would recognize gain on the appreciated portion of the stock issued at such intervals as he determines appropriate. Similarly, future services provided to FSR could be compensated and licensing rights could be purchased through issuance of stock.

Thank you very much for allowing us to be of service. We would be happy to assist you with the implementation of our recommendations. Please call us to discuss the specifics of this letter and any questions you may have.

**Sincerely,**  
**LL.M. TEAM NUMBER \_\_17\_\_**