

Question 1

The redemption of 50 shares of Ana's stock by Xco is treated as a sale if it is described in any of the categories listed in section 302(b) of the Code. Here, assuming the redemption is not in partial liquidation of Xco (which would cause it to be treated as a sale), the three relevant categories test for a reduction in the shareholder's percentage interest in the corporation's stock. In applying these tests, constructive ownership, or attribution, rules in section 318(a) apply. IRC § 302(c)(1).

Here, Ana is treated as owning the 25 shares owned by her daughter, Dylan. IRC § 318(a)(1). Although Dylan is treated as owning the shares held by Trust No. 2 (because Dylan's husband, Som, is the sole beneficiary of Trust No. 2, see IRC § 318(a)(2)), there is no double family attribution from Som to Ana via Dylan. IRC § 318(a)(5)(B). Thus, immediately before the redemption, Ana actually and constructively owns 100 out of the 150 outstanding shares of Xco, or 66 2/3 percent. Immediately after the redemption, Ana actually and constructively owns 50 out of the 100 outstanding shares of Xco, or 50 percent. The redemption fails to qualify under section 302(b)(3) (complete termination) or section 302(b)(2) (requiring less than 50 percent ownership of common and voting stock). The redemption does qualify, however, as a redemption not essentially equivalent to a dividend under section 302(b)(1).

As a result, Ana can use two thirds of her overall \$300,000 stock basis (because she redeemed two thirds of the stock she actually owned) to offset the \$700,000 cash redemption proceeds. She has \$500,000 capital gain. Her basis in her remaining Xco shares is \$100,000.

If this is an isolated redemption, there are no consequences to Dylan or Trust No. 2 under section 305(c).

Xco's earnings and profits (E&P) are reduced by the lesser of one-third of the E&P or \$700,000. IRC § 312(n)(7). Xco may not deduct the redemption payment or any related expenses. IRC § 162(k).

The demand note may be disguised stock. If it is reclassified as stock, the payments made over the years will be treated as section 301 distributions (dividends to the extent of E&P). Moreover, Xco would be denied any deduction for interest payments, although this recharacterization might also result in Ana being able to use the special tax rates applicable to "qualified dividends" under section 1(h)(11).

As for the payoff of the note, if the note is reclassified as stock, it would likely be treated as a preferred stock. That stock is being fully redeemed as part of a redemption covered by section 302(b)(1). Thus, Ana should be able to use her \$600,000 basis in the note to offset the payoff amount in full. This is the same result that would apply if the note is accepted as debt.

Is the note debt or equity? It is similar to the demand notes at issue in *Indmar Products*. In that case, the regular payments of interest were highly influential in the appeals court's determination that the note was truly debt for tax purposes, despite subordination, irregular payments of principal based on the holder's cash flow needs, and the absence of a payment schedule or maturity date. Here, the note is not held proportionally to stock by all of the shareholders, which would be another factor in favor of debt treatment. Other factors not disclosed in the facts are Xco's debt-equity ratio and any convertibility feature in the note.

Question 2

In alternative A, the stock sale, Leon and Meghan each have a capital gain on their stock. The gain on the sale is \$550,000 each – the excess of the \$750,000 cash each receives (the down payment plus principal payments on the notes) over each shareholder's \$200,000 stock basis. (Any interest received on the notes would be additional ordinary income.) The gain is eligible for deferred reporting on the installment method under section 453 of the Code, unless the shareholder elects out of installment treatment.

In the stock sale, Purco gets a cost basis in the Targ stock of \$1,500,000. The basis of Targ's assets remain unchanged, as do Targ's accumulated earnings and profits. Targ realizes no gain or loss on being acquired.

If the Purco wishes, the stock sale can be treated as an asset sale (with consequences described next) by making an election under Section 338. On these facts, however, this election would bring about an unfavorable outcome because it would trigger immediate tax to Targ.

In alternative B, the asset sale, Targ recognizes gain or loss on the sale of each of its assets. The total amount realized on all of the assets, which is also Purco's basis, consists of the \$900,000 cash, the \$600,000 promissory note, plus the \$400,000 of assumed liabilities, or \$1,900,000. This purchase price must be allocated among the assets both for purposes of determining Targ's gain or loss on each asset and for purposes of determining Purco's cost basis in each asset.

The allocation of the purchase price is governed by section 1060. If the parties include a price allocation in their purchase and sale agreement, they are bound by their agreement (although the IRS is not). Beyond this rule, the price must be allocated using the residual method, meaning that tangible assets are valued first, and price assigned to them first, before intangible assets.

Based on the values given in the facts of the question, Targ recognizes a gain on each of its assets, except its investments, as to which it recognizes a loss (\$100,000). The loss on the investments is a capital loss. The gain on the off-balance-sheet intangibles (\$500,000) is capital gain. The gain on the inventory (\$100,000) is ordinary income, and it is likely that all of the gain on the equipment (\$100,000) is also ordinary due to depreciation recapture. More facts are required to determine the character of the gain on the patents (\$400,000).

Targ, as a C corporation, is liable for corporate tax on its gains. Targ may be eligible to use the installment method to report its capital gains, but the gain is accelerated at the corporate level when Targ distributes the Purco note to the shareholders.

On the liquidation of Targ, Leon and Meghan are treated as selling their stock to Targ. IRC § 331. Each would receive cash and a share of the note, but the available cash would be reduced by the corporate tax that Targ must pay. Under section 453(h), Leon and Meghan may use the installment method to defer part of their gain until payments are made on the Purco note. This will be the result, except as to a shareholder who elects out of installment treatment.

Purco must amortize the goodwill, going concern value, and workforce in place over a 15-year period. IRC § 197.

Question 3

Sasha's receipt of the new stock is ordinary income to Sasha, as compensation for services rendered, in an amount equal to the fair market value of the stock, \$185,000. IRC § 83(a). That amount also becomes Sasha's basis in the stock.

Assuming that the nature of Sasha's work is not such that it gives rise to a capital expenditure, then Company is entitled to deduct under section 83(h) of the Code the amount that Sasha is required to report as income – \$185,000.

The tax consequences to Regina depend on whether section 351 applies to her exchange of Blackacre and cash for the stock.

- *If section 351 applies*, no gain or loss is recognized to Regina on the transfer of Blackacre and cash in exchange for stock. Under section 358, Regina's basis in the stock carries over from Blackacre (\$650,000), which when added to the \$500,000 cash paid gives her a stock basis of \$1,150,000. Company's basis in Blackacre is governed by section 362. Section 362(a) would give Company a carryover basis of \$650,000, but under section 362(e)(2), the basis is reduced to \$500,000 unless Company and Regina make an election under section 362(e)(2)(C). If such an election is made, Company has a basis in Blackacre of \$650,000, and Regina's basis in her new Company stock is \$500,000.
- *If section 351 does not apply*, then loss is recognized to Regina on the transfer of Blackacre in exchange for stock. Regina recognizes a \$150,000 loss on Blackacre, but a deduction for the loss is disallowed under Section 267(a)(1), because Regina and Company are related parties under Section 267(b)(2). Company takes Blackacre with a cost basis of \$500,000. Regina's basis in her stock is a "cost" basis of \$1,000,000 (cash paid plus fair market value of property surrendered).

Does section 351 apply to Regina's exchange? It depends on whether Regina's and Sasha's transactions were part of an integrated plan. If they were, then the 80 percent "control" test of Section 351(a) would be applied immediately after the last phase of the plan, Sasha's exchange, was completed. At that point, Regina, the only shareholder transferring property in the transaction, had only 75 percent of the stock of Company – 120 shares out of 160 outstanding. Therefore, section 351 would not apply.

If Regina's and Sasha's transactions were *not* part of an integrated plan, then Section 351 would apply to Regina's exchange, because immediately after Regina's exchange, she owned 120 shares of Company stock out of 150 outstanding – exactly 80 percent, which satisfies the "control" test of Section 368(c) ("at least" 80 percent).

No gain or loss is recognized by Company on the issuance of its stock to Regina in exchange for Blackacre and cash. IRC § 1032.