QUESTION 1

Does Redco's redemption of stock held by PSP qualify for exchange treatment, so that PSP may use its $50,000 basis to offset the $120,000 distributed? To do so, the redemption must meet one or more of the four criteria in section 302(b) of the Code. More facts are needed to determine whether the redemption qualifies as a partial liquidation under section 302(b)(4). This depends on whether the redemption is not essentially equivalent to a dividend, determined at the corporate level.

The other three tests for section 302(b) exchange treatment focus on the redeeming shareholder's percentage ownership of the corporation's stock before and after the redemption. In determining share ownership for this purpose, constructive ownership applies, as specified in section 318(a).

Before the redemption, in addition to the 25 shares it actually owns, PSP constructively owns the 50 shares owned by Fred. Fred's shares are attributed to Rae under section 318(a)(1), and those shares are in turn attributed from Rae to PSP under section 318(a)(3). Sally's shares are also attributed to PSP under section 318(a)(3). Thus, before the redemption, PSP is treated as owning 100 percent of the stock of Redco (100 shares out of 100 outstanding).

After the redemption, PSP constructively owns the 50 shares owned by Fred. Fred's shares are attributed to Rae under section 318(a)(1), and those shares are in turn attributed from Rae to PSP under section 318(a)(3). Sally's shares are also attributed to PSP under section 318(a)(3). Thus, after the redemption, PSP is treated as owning 100 percent of the stock of Redco (75 shares out of 75 outstanding).

Section 302(c)(2) allows an entity to obtain a "waiver" of family attribution in certain circumstances. Such a "waiver" would prevent attribution of Fred's 50 shares to Rae, and then to PSP. However, under section 302(c)(2)(A), the "waiver" is effective only if it results in a complete termination of the shareholder's interest under section 302(b)(3). Even without family attribution, PSP would continue to own constructively Sally's 25 shares, under section 318(a)(3).

Because it results in no reduction of PSP's percentage ownership of Redco, the redemption is treated, not as an exchange, but as a distribution under Section 301. IRC § 302(d). Because Redco's earnings and profits exceed the $120,000 distribution, the entire distribution is a dividend to PSP. IRC §§ 301(c)(1), 316. As partners in PSP, Rae and Sally must report their distributive shares of the "pass-through" dividend income. The dividend income qualifies for favorable long-term capital gain rates.

PSP's $50,000 adjusted basis in the Redo stock shifts to the stock owned by Fred and Sally, in proportion to their respective actual percentages of share ownership.

Redco's earnings and profits are reduced by the amount of the distribution, $120,000. IRC § 312(a)(1). In computing its taxable income, Redco is not entitled to a deduction for the dividend it pays.

Because it may be one in a series of redemptions, Fred may be taxed on the redemption of PSP's stock, under section 305(c). Immediately before the redemption, Fred constructively owns, in addition to his 50 shares, 40 percent of the 25 shares of the stock owned by PSP, under sections 318(a)(2) and 318(a)(1). Thus, Fred owns, actually and by attribution, 65 shares out of 100, or 65 percent. Immediately after the redemption, Fred owns 50 shares out of 75, or 66.7

percent. Because Fred's percentage ownership increases, the IRS could argue that Fred should be taxed on a constructive dividend.

QUESTION 2

Ava's and Ben's exchanges of property for Corp stock qualify for nonrecognition under section 351(a), except for any "boot" taxable to the shareholders under section 351(b). Corp has no income upon issuing its stock for property. IRC § 1032.

On the exchange of Blackacre for Corp stock and Corp's assumption of the mortgage, section 357(c) would appear to cause Ava to recognize gain of $30,000, the excess of the liability over the property's adjusted basis. However, the contribution of Ava's promissory note for $30,000 provides sufficient basis to prevent this result, under Peracchi and Lessinger. Ava recognizes no gain or loss. Ava's basis in her Corp stock is zero, computed as follows: the $50,000 basis of Blackacre (IRC § 358(a)), less the $80,000 mortgage (IRC § 358(d)), plus a $30,000 cost basis under Crane. Corp's basis in Blackacre, governed by section 362(a), is $50,000. Corp has no income as Ava pays principal on her note. When Corp receives interest on the note, it has interest income (ordinary), and Ava is eligible to deduct the interest subject to the investment interest rules of section 163(d).

On the exchange of the LLCo interest for Corp's stock and debenture, Ben realizes a $25,000 capital gain. The gain is recognized only to the extent that Ben receives "boot" from Corp. The Corp debenture, which is not stock, is "boot," the treatment of which is governed by section 351(b). Under section 351(b), Ben's entire realized gain is recognized because the fair market value of the debenture exceeds his realized gain.

Pursuant to the proposed regulations under section 453, Ben reports his recognized gain on the installment method unless he elects out of such reporting. Under the installment method, because the payments on the note are spread evenly over 10 years, Ben may report his $25,000 recognized gain ratably over that period, or $2,500 per year. Prop. Reg. § 1.453-1(f)(3)(ii). Additionally, as Ben collects interest on the debenture, he has interest income (ordinary), and the Corp is eligible to deduct the interest under section 163(a).

Ben's basis in the Corp stock he receives is $150,000 – a carryover basis of $125,000, plus the $25,000 gain to be recognized on the Corp debenture. Corp's basis in the LLCo interest starts off at $125,000, increasing by $2,500 a year as Ben reports gain on the debenture. Prop. Reg. § 1.453-1(f)(3)(ii).

If Ben elects out of the installment method under section 453(d), he must report his entire $25,000 capital gain at the time of the exchange, and Corp's basis in the LLCo interest, determined under section 362(a), is $150,000 immediately after the exchange.

QUESTION 3

The distributions to Mai and Ned are treated as in full payment in exchange for their stock. IRC § 331(a). All the distributions, including the initial distributions are covered by section 331 because they are part of a series of distributions pursuant to a plan of liquidation. IRC § 346(a).

Upon the initial distribution, the shareholders are permitted to use their stock basis to offset the entire amounts they receive. Thus, Mai's adjusted basis in her Acme stock is reduced from $30,000 to $18,000; Ned's adjusted basis in her Acme stock is reduced from $10,000 to $6,000. Neither shareholder recognizes any income or loss at that point. Acme realizes no income upon distributing cash. In the liquidation, Acme's accumulated earnings and profits disappear.

In the final distribution, Mai receives $20,000 cash and supplies with a fair market value of $4,000, for a total amount realized of $24,000. Subtracting Mai's $18,000 remaining stock basis, she recognizes a $6,000 capital gain. Also in the final distribution, Ned receives the Flyer stock with a fair market value of $8,000. Subtracting Ned's $6,000 remaining stock basis, she recognizes a $2,000 capital gain.

Each shareholder receives a basis in the asset received from Acme equal to the asset's fair market value. IRC § 334(a). The supplies have a basis in Mai's hands of $4,000. The Flyer stock has a basis in Ned's hands of $8,000.

Under section 336(a), Acme realizes gain and loss on the distributions of the supplies and the Flyer stock. On the supplies, Acme's basis is zero and its amount realized is the $4,000 fair market value, for a gain of $4,000. IRC § 336(a). This is ordinary income for Acme. IRC § 1221(a)(8). On the Flyer stock, Acme's adjusted basis is $13,000 and its amount realized is the $8,000 fair market value, for a loss of $5,000. This is a capital loss for Acme.

Section 336(d) imposes limitations on a corporation's deduction of losses on account of liquidating distributions, but none of the limitations applies to the distribution of the Flyer stock. The distributee shareholder, Ned, is not a related person, and the Flyer stock was not contributed to Acme by a shareholder.

The basis of each asset received by a shareholder in the liquidating distributions is the asset's fair market value at the time of the distribution. IRC § 334(a).