(a)

It is first necessary to determine whether the distribution is a dividend to either or both of the shareholders. Section 301 provides a four step process: First, we must determine the amount of the distribution under S301(b); second, how much of that distribution is a dividend as defined in S 316; third, the specific tax treatment of the amounts as provided in S301(c); and fourth, whether the dividend is qualified and entitled to preferential long-term capital gains rates under S1(h). A divididend is a distribution made with respect to stock, which appears to be the case here.

Section 301(b) provdies that the amount of the distribution is the amount of cash received by the shareholder plus the FMV of any other property received. As such, Randy receives $100,000, while Sam receives $82,000 worth of stock.

A distribution is a dividend to the exent it is made out of "earnings and profits". The distribution may be made out of E&P of the current taxable year or out of accumulated E&P. Since Cresco has a deficit in its accumulated earnings and profits, and a positive current earnings and profits, the dividend will be made out of "current E&P". If current E&P exceed cash distributions made during the taxable year, then each distribution is a taxable dividend out of current E&P. Any remaining current E&P are added to the accumulated E&P account. If cash distributions exceed current E&P, the portion of each distribution that is treated as coming from current E&P is determined by the following formula found in Reg. 1.316-2(b): amt. of each dist x (current E&P / Total curr. distribs). The remainder of each distribution is a dividend to the extent of the accumulated E&P available on the date of hte distribution. Any further amount is treated as a reduction in the shareholder's basis. E&P will be reduced by the amount of any dividend,

however, not below zero.

Applying the forumula, 96% of each distribution will be characterized as a dividend (175K / 182K = .96). As such, Randy will be treated as receiving a dividend of $96,000, and Sam will be treated as receiving a dividend of $79,000. Although stock dividends (such as in Sam's case) are typically tax-free, this is not treated as such since it is not pro-rata or in respect to stock as required by S305. Each shareholder will be taxed on the amount of amount of dividend received, and although dividends generally subject to ordinary income, will likely qualify for *qualified dividend* treatment. As such, the dividend will be taxed at the capital gains rate under S1(h)(11). A dividend is not a deductible expense by the corporation. The corporation will have zero E&P for the year, and will retain its accumulated deficit.

The excess distribution ($4K for Randy and $3K for Sam) will be treated as a return of capital. This reduces the shareholder's basis in their stock. As such, Randy's basis will be lowered to $106K ($110 original basis less $4K reduction), and Sam's will be lowered to $87K ($90K original basis less $3K reduction). Further, Sam's basis will be spread across all of her shares, including the additional 10 received as a dividend. Assuming each of the parties later sells their stock, they will essentially pay capital gain taxes on the amount that their basis was reduced by this transaction.

(b)

The above transaction essentially subjects the shareholders to additional tax. If the goal is to provide the parties with equal ownership and allow Randy to take out cash, it could be achieved without (for the most part) tax consequences to Sam through a redemption of stock. The

corporation could redeem 10 of Randy's shares at their FMV ($10,000 each). This would lower his ownership to 45 shares (equal to Sam's ownership, thus making them 50/50 owners) and give him $100,000 cash.

The tax consequences of a redemption depend on whether the distribution more resembles a dividend or sale. A redemption is taxed as a distribution under S301 unles sit qualifies for "exchange" treatment under one of the four tests in S302(b). It is important to note that when analyzing the four S302(b) tests, one must not only consider the shares actually owned by the individual, but shares which they may constructivly own under the attribution rules of S318. Because Sam and Randy are brother and sister, attribution will not apply (because of the S318 (a)(5)(B) limit on multiple familiy attribution).

If Randy qualifies under one of the four categories described in S 302(b)(1)-(4), his redemption will receive sale or exchange treatment, and he will be able to use his basis to offset any gain, and will also receive capital gain treatment.

First, Randy will qualify for sale or exchange treatment if the distribution is "substantially disproportionate" with respect to the shareholder. To qualify as substantially disproportionate, it must meet three machanical requirements. (1) immediately after the redemption, the shareholder must own less than 50% of the combined voting power of all classes of stock entitled to vote. Randy fails this first requirement, as he owns exactly 50% of the voting stock after the redemption. Therefore, Randy will not qualify under the "substantially disproportionate" test.

Second, Randy will qualify for sale or exchange treatment if it is a complete termination of his

interest. Since Randy retains a 50% interest in the organization, he obviously does not qualify for this.

Third, Randy will qualify for sale or exchange treatment if the redemption "is not essentially equivalent to a dividend". Although the service has not explicitly defined what this means, the Supreme Court in *Davis* stated that a redemption is not essentially equivalent ot a dividend if it results in a *meaningful reduction* of the shareholder's proportionate interest in the corporation. Dividend equivalence depends upon the facts and circumstances of each case. Once such example of a meaningful reduction is where a shareholder suffers a significant loss of control. In Rev. Rul. 75-502, the IRS ruled considered a loss of control to be meaningful when a redeeming shareholder went from 57% to 50%. Here, Randy went from 55% to 50%, which is very similar. Therefore, it is expectable that Randy would qualify under the "not essentially equivalent to a dividend" test and receive sale/exchange treatment.

Since Randy's redemption would likely qualify for sale/exchange treatment under S302(b), he will be entitled to offset his gain with his basis. Therefore, if he redeemed 10 shares, he would realize a total gain of $80K ($100k amt. rec. less $20K a.b.). Further, Randy would receive long-term capital gain treatment on the sale/exchange (although this is less important now, since the qualified dividend rate and LTCG rates are the same). The key is that Sam would likely not have any gain as a result of the transaction, unlike the proposal suggested by the shareholders. The only possible exception would be if the transaction were reclassified as the corporation transferring cash to Sam and Sam purchasing the shares from Randy. Reg. 1.305-3(b)(3), however, suggests that it is highly unlikely that the IRS would reclassify a lone redemption without evidence of evasion. Since Sam and Randy have a substantial business purpose for conducting such a transaction, this should not pose a significant risk.

END OF EXAM