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classes of stock A and B which have both been distributed.

Therefore, NewCo will not qualify as a small business corporation, thus not eligible for S corp status.

Question 2: Under sec. 1362, the S corp election would take effect at the beginning of the NewCo's next taxable year 1/1/X2 or if the election is made 2 1/5 months from when the tax year begins meaning when the business was formed, 3/1 (the date H, Hallie, contributed blackacre) meaning May 15, X1, the S corp election will start this taxable year, 3/1/X1.

Question 3:

sec. 318 attribution rules do not apply because Randy, R, and Sam, S, are brother and sister which are not relatives under 318.

Part A:

Stock distribution to S: Under sec 305(a), Generally, S gross income will not include a distribution of stock of C, Cresco, made by C to S with respect to its stock. However, if the distribution meets sec 305(b), (a) will not apply, and the whole distribution will be treated as a distribution of property to which sec. 301 applies. This distribution falls under sec. 305(b)(2) where there is a disproportionate distribution where some of the shareholders have an increase in the assets and E&P of the corporation. Here, S is receiving more stock which allows her to participate in 50% of the E&P and assets while R's % decreased because he received 100 cash. (S got stock while R got property - not allowed). Thus, S's stock will be treated as property for sec. 301.

Under sec. 301, a distribution of property made to C's shareholders with respect to its stock is taxable to the portion of the distribution that is a dividend as defined in sec. 316. a dividend will be taxed to the shareholder at capital gain rates under sec. 1(h)(1) if shareholder meets the

requirements for a qualified dividend income.

Under sec. 306, generally, a dividend is a distribution of property, to which sec 301 applies, out of C's accumulated E&P and current E&P. E&P is calculated at the close of the taxable year.

Although the current E&P is positive, the shareholders will have to wait until the close of the taxable year on 12/31 to see if the current E&P is actually 175. E&P is attributed to the distribution first by applying the current E&P then the accumulated E&P.

Thus, S's dividend amount can't be determined until the close of the tax year. Any non dividend portion will reduce S and R's basis in the stock and any left over that will be taxed to them as a capital gain as long as this is investment property to them under sec. 301(c)(2)

Cash distribution to R: this is under sec. 301 too. see above. to the E&P calculation problem.

Cresco, C: What ever happens, the distribution amount to S and R can't reduce C's E&P below zero, but C can reduce its E&P by the distribution amount until zero.

Under sec. 311(a), C does not recognize any gain or loss on a distribution.

Part B:

Since the attribution rules don't apply, this transaction should have been structured as a redemption because R wants to retire. This transaction which brought him from a majority shareholder to an equal shareholder with S probably would satisfy sec. 302(b)(1).

under sec. 317(b), a redemption is when the C acquires its stock from its shareholders, R, in exchange for property the 100,000 cash R got. Not using the transaction that actually happened. R should have had C redeem 10 of his shares which have a FMV of 100,000 for the cash of 100,000. The result would have been the same because now R would only have 45 shares and S would only have 45 shares.

Under sec. 302(a), a redemption is treated as an exchange (sale). Thus R would get a return of his capital and he would recognize a capital gain instead of the potential dividend which

would be taxed as ord. income or could be taxed at capital gain rates but R would not be able to offset any capital losses. This way if he did have capital losses he could offset them. R would have had an 80,000 capital gain (basis (2 basis times 10 shares = 20 basis less 100 fmv).

To qualify for a redemption R would have to qualify for 302(b)(1) unless he wanted to make S the maj. shareholder then he could probably use (b)(2). Under (b)(1), a redemption qualifies for 302(a) treatment when the "redemption is not essentially equivalent to a dividend". In Davis, the court gave a test that there is a "meaningful reduction of the shareholder's interest." R could argue that there has been a meaningful reduction because this corporation has been around for many years and he has ALWAYS been the majority shareholder, but now he is an equal shareholder with S, thus, he has lost his majority status and his influence to determine how C will be run; his control decreased a lot. Also, R's right to participate in E&P and the liquidation of assets have decreased from 55% to just 50%. Also, he was so close at missing the requirements of (b)(2). However, the IRS might argue that R has the potential to act with S because S is his sister, to still have a strong control over C, and 5% decrease in participation is not enough. R did not even meet the 20% reduction in his ownership of shares under (b)(2) (shares owned after 45/ total shares after 90 < (80% times shares owned before 55/total shares before 100) and he is a 50% owner.

C: just gets a cost basis in the stock it redeemed of 100,000. This is better than not getting anything under Part A, because if C resold the shares C would have a higher basis than the other stock which its par value is 2,000 per share. but C will not be able to deduct any exp. related to this redemption under 162(k), thus it will be capitalized into the stock

This is a better way because:

If this redemption did not qualify as a redemption, R would be in the same place because he

would be under sec. 301 again. However, This would also help S because she would not have the potential to get taxed on her stock dividend because all the dividend gave her was a 50% ownership just like would happend with a redemption. A contrustive dividend is not used to tax S.

END OF EXAM