Here, Newco exchanged for Blackacre on March 1, 2006, so Newco must have existed by then. So even if Newco was formed on March 1, by May 28, more than 2.5 months would have passed in this fiscal year, and so the election would not take effect until the next taxable year. Thus, assuming Newco is eligible, the S election would take effect at the next taxable year.

Question 3

A. Dividend

Dividend is a distribution of money/property just for being S/Hs. Dividends from a US corp are taxed at CapGain rate, but may not be used to offset Caplosses.

Randy (R) - Cash Dividend

Dividends first reduce E&P and receive no deduction for basis. If there is no E&P, the distribution reduces basis.

E&P

Reg 1.316-2(b) says that if one cannot determine E&P to the date of the distribution, prorate E&P to the date of the distribution (presumably the distribution will be done now, or Cresco will continue to earn at the same rate).

E&P is determined at the date of the distribution. Here, this year's E&P to date is $175K.

Accum E&P = Old E&P + Present Year E&P = -$50K + $175 K = $125K

Here, there is sufficient E&P that all of the $100K dividend will be taxed to R at CapGain rate (presumably the distribution will be done now, or Cresco will continue to earn at the same rate). R's Basis is in his stock is still 55 * $2K = $90K b/c R will not be able to use any basis on the dividend from Cresco.

Sam (S) - Stock Dividend

305a requires that a stock dividend that is a non-event is not income.

Here, the

Stock Dividend Treated as a Dividend

Treatment as a Dividend (301) requires

305b1) S/H can elect to receive stock or property, or

305b2) distribution results in some S/H getting stock and another getting money/property, or

305b3) some S/H get common, some get pfd, or

305b4) any distribution on Pfd, or

305b5) distribution on Pfd, unless S/H can show the result is not 305b2.

Here, 305b2 is met b/c S is getting 10 shares and R is getting $100K cash. Thus, both R and S are taxed in this transaction.

S's CapGain = # shares * FMV/sh = 10shares * $8,200 = $82K.

Basis in the new shares is $82K for a total basis of $90K(45*2K) + $82K = $172K for S's 55 shares.

Assuming the distribution is done now, E&P (currently $125K from above) will be reduced to $0 with the distributions to R and S. Thus, from the total distribution R + S = $100K + $82K = $182K, R and S will be able to use some basis (182-125 = $57K) to offset their gain.

Cresco

Dividends are paid out of the E&P of a Corp.

Here, the dividends paid to R and S decrease Cresco's E&P

B. Alternative Structure

Stock Redemption

Cresco could have redeemed 10 of R's shares at FMV. The result would have been that R would have received 10sh * $10K/sh = $100K. Also, R and S would each have 45 shares and would each own 50% of Cresco, just as they each own 55 shares (50% of Cresco) in the original transaction.

305c - Same economic effect

305c allows that if a transaction has the same economic effect as 305b, the IRS can make regs treating it as the same. However, this is an isolated redemption and 302b sale/exchange treatment will be met.

Sale/exchange treatment 302b

Sale/exchange treatment requires 1) not essentially equivalent to a dividend, or 2) substantially disproportionate distribution, or 3) complete termination of S/Hs interest, or 4) partial liquidation of corporation.

Here, there is no complete termination of R's interest, nor a partial liquidation of Cresco.

302b2 Substantially disproportionate distribution

Substantially disproportionate distribution requires 1) S/H owns less than 50% of voting power following redemption (including attribution), 2) votin pwer must be less than 80% of voting power pre-redemption, and 3) common stock % after redemption less than 80% of stock pre-resemption.

Here, the first element is not met b/c R ownership following redemption is equal to 50%, not below. Thus, 302b2 substantially disproportionate distribution is not met.

302b1 Not essentially equivalent to a dividend

Not essentially equivalent to a dividend requires a meaningful reduction in S/Hs proportionate interest (Davis). RevRul 75-705 says that a substantial change in the voting structure of a corporation can be a meaningful reeduction. Attribution does not apply to siblings, and so would not affect this transaction.

Here, R's redemption would qualify b/c R would go from control with 55% of the vote pre-redemption to a 50-50 deadlock post redemption. Thus, 302b1 not essentially equivalent to a dividend would apply to a redemption of 10 of R's shares.

Reasons for superiority

Randy

R would be able to use his basis for the 10 redeemed shares and R's gain would be CapGain = SalePrice(FMV) - Basis = 10 * ($10K - $2K) = $80 of CapGain, as opposed to $100 of CapGain.

Sam

S would not realize any gain due to this alternative transaction.

END OF EXAM