Corporate Tax
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QUESTION 1

In assessing the consequences of these actions the character of the distribution Larry received must be analyzed. Debt is desirable for the corporation because the interest paid is deductible. For the shareholder, each payment is part interest and part principal. The portion of the payment which is principal is not taxed, and the interest is taxed as ordinary income. Because of the desirability of debt, the tax system is skeptical of debt owed to shareholders, and if it is particularly risky debt, the parties risk reclassification of the debt by the IRS as equity.

This is particularly relevant since here, if it is reclassified as equity, rather than debt it has consequences on the characterization of the distributions received by Larry and Martha. The IRS considers a number of factors in making this assessment.

The first is form, in this case, the parties call this debt and have it set up in a way that makes it seem like debt. The taxpayers are bound by this classification but, obviously, the IRS is not. This factor weighs in favor of debt.

The court also looks at the debt to equity ratio in assessing whether this debt is so risky that it should be classified as equity. Here, the corporation has 25 mill worth in assets and 23 million in debt to non shareholders. The addition of another million of debt to Larry raises the ratio to 25:24. This is a very reasonable debt to equity ratio and weighs in favor of classifying it as debt.

The intent of the parties is another factor. In this the courts look to the conduct of the parties. Here, the interest rate seems reasonable and isn't dependent on the success of the company. The company, thus far, has been making timely payments which also weighs towards considering it debt. However, the fact that the debt is convertible at the SH's election into preferred stock makes it seem more like stock.

Another factor is proportionality. This factor weighs in favor of considering this equity. In this situation, Larry got an amount of debt equivalent to the amount of preferred stock that the other equal SH got. This makes it seem less like debt.

Subordination. In this case, Larry's debt is subordinated to the longer term bodn holders. Given the assets of the company it doesn't seem as if his debt is particularly risky which weighs in favor of considering it debt.

Martha
Normally, the issuance of stock to a corporations shareholders is not taxed under § 305. However, since Larry got debt, and she got stock, it doesn't

The tax treatment of the debenture and stock paid to Martha and Larry on July 1 will depend on how the distribution of the debt is characterized.

IF DEBT is DEBT

LARRY
If it's debt, the debt counts as property received by Larry under § 317 and he will be required to pay tax on its fair market value. It will be taxed at the favorable capital gains rates as a dividend to the extent of available E&P. If the distribution exceeds available E&P, he can use his stock basis. His basis in the note will be its FMV. As the note is paid, he will have to report the interest as ordinary income. Since the FMV is different than the face value of the note, he

will also recognize 400k gain. If he qualifies for the installment method In 453, he can report the gain proproationally as he gets payments.

CORPORATION

If Larry's debt is not reclassified, the corporation recognizes no gain on the distribution of the note because 311(b) doesn't apply to a corporations own obligation. As it makes payments on the note, the interest is deductible. The corporations E&P is reduced by the FMV of the note, 312(a)(2). Given the difference between the FMV of the note and its face value the Original Issue Discount rules may also apply.

The distribution to Martha of preferred stock is not taxable to the corporation under §311. It also has no effect on the E&P of the corporation.

MARTHA

Normally a distribution of a corporations own stock is tax free to the recipient. However, there are some circumstances where that is not the case. In this situation, if Larry's debt is not reclassified as equity, this will be a distribution where one person gets stock and the other gets property. As such, it is one of the situations in §305 that is taxable under 305(b)(2). Martha will pay tax on the value of the distribution. To the extent the corporation has E&P it will be a dividend (taxed at favorable capital gains rate), then as a return of basis (not taxed), then as money received on sale or exchange of stock under 301 (taxed at capital gains rates since stock is a capital asset and she isn't a dealer).

If DEBT is RECLASSIFIED AS EQUITY

LARRY AND MARTHA

If Larry's debt is reclassified as equity, it will probably be reclassified as preferred stock. In that case, since he and the other SH (Martha) both got stock from the corporation in proportion to their current holdings, it's a stock dividend and not taxable to either of them under 305(a). None of the exceptions in (b) apply which would make this a taxable dividend. Pursuant to Reg 1.307-1 the basis in their shares is apportioned between their old shares and their new shares based on their relative FMVs. Since this stock is received in a tax free stock dividend it will be considered §306 stock (306(a)(1)(A)) which will effect the tax treatment of further sale or redemption of the stock.

CORPORATION

If the debt is reclassified as equity, the corporation will not have any tax consequences since the distribution of a corporations own stock is not taxable to it. §311. This distribution will not adjust E&P.