

July 1, 2008 Distribution

Martha – IRC § 301 does not include distributions of stock because of IRC § 317. In general, a distribution of stock does not represent income under IRC § 305(a) and the golden oldie *Eisner v. Macomber*, however, IRC § 305(b), lists several exceptions to this general rule. While the label applied by the corporation is not controlling, Martha's receipt of nonvoting, nonparticipating, preferred stock since it does not participate in growth will almost certainly be classified as a distribution of preferred stock on common stock. Pursuant to IRC § 305(b)(2), should qualify as a disproportionate distribution because her buddy Larry received an IOU which counts as property disposed of under IRC § 301 and OID under IRC § 1237. Since this distribution will not qualify for the general rule that stock distributions are not income, Martha's receipt will receive IRC § 301 dividend treatment, which means she cannot utilize her basis and must recognize gain. Martha received a distribution worth \$600,000 and must pay capital gain. Martha's basis in her stock remains the same.

Larry – If you distribute an IOU as a corporation, the shareholder will get gain based on the Fair market value of the IOU. This occurs immediately as long as the corporation has E&P to distribute. Such distributions are governed by IRC § 301(b) and Larry will recognize \$600,000 gain based on the FMV of the IOU. Pursuant to IRC § 1237, the difference between the face value of \$1,000,000 and the \$600,000 will be treated as having an Original Issue Discount value of \$400,000. This \$400,000 will be treated as interest that triggers ordinary gain every year until the transaction is completed 20 years hence. Larry will not be let out of gain or loss by

application of IRC § 311(b) either and the installment method is not allowed. In year 1, Larry will be forced to recognize a \$600,000 capital gain. Larry will be forced to recognize ORDINARY gain on the remaining \$400,000 as it is disbursed. Given that Larry's debt instrument is pegged to prime at a reasonable interest rate, it is unlikely to be viewed as a sham or tax avoidance mechanism. The

It is possible, however, that Larry's "debt" may be reclassified as stock. This may occur despite the corporation's classification of the distribution as a debenture, because while the corporation and the taxpayer are bound by how they classify the payment, the IRS is not. Under IRC § 385, debt may be classified as equity depending on the debt to equity ration, the intent of the parties, the proportionality of the debt and the subordination of the debt. The debt to equity ratio of this corporation, \$25,000,000 to \$2,000,000 which is about 12.5:1. This is not unreasonable and under the Bojack test, this will likely qualify as debt. The debt is, however, highly subordinated to about \$15,000,000 in mortgage debt and this degree of subordination may make this look more like stock. If this is treated as stock, it may actually change the situation for the better for both Larry and Martha because if they are both receiving preferred stock, they may actually be able to avoid a disproportionate distribution under IRC § 305(b)(2), however, under that scenario the convertibility of Larry's Stock will mean it at least falls under IRC § 305(b)(5) as a distribution of convertible which would mean he will receive dividend treatment and will not be able to use his basis.

Distco – Since the corporation has E&P, the distribution of its own IOU does not trigger anything for the corporation. The corporation will be able to deduct the interest at the same time

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CORPORATE TAX

BOGDANSKI

the shareholder is getting the interest income.