

Question 1.

Martha's stock distribution. Section 305 allows tax free treatment for preferred-on-common stock dividends, so there is nothing unavoidably taxable about Martha's dividend, in theory. Nonetheless, it does not qualify for § 305 tax free status because the transaction is not proportionate to all shareholders. Because Martha received stock and Larry received a debt obligation, the distribution falls under the § 305(b)(2) category of taxable stock distributions. Accordingly, Martha is taxed on the FMV of the preferred stock she receives (\$600,000).

The character of the income is determined by standard § 301 rules: it is a dividend up to the corporation's available E&P, then tax-free return of capital up to Martha's basis in her stock, then capital gain. Because Distco has ample E&P, Martha will likely be taxed on a \$600,000 dividend, which is ordinary income but probably qualifies for capital gains rates under § 1(h). Because the stock distribution is taxable, the preferred stock is not § 306 stock, thus Martha can sell it and enjoy capital gain treatment instead of ordinary income without a basis offset.

Larry's debt instrument. If Larry's debenture is properly classified as debt, then he will be taxed on the entire FMV (\$600,000) at the time of issuance and receive a \$600,000 basis in the note. Because there has been no sale or exchange, he cannot report the debenture income on the installment method. The interest payments would be ordinary income as received. The principal payments would be taxable based on the ratio of FMV to face value (600K : 1 million), thus 40% of each payment would be taxable as ordinary income.

The larger question is whether the debenture is properly considered a debt instrument. No single fact is dispositive but IRS and the courts would consider the following factors. The form of the transaction is relevant. Larry and Distco cannot simply make the debenture debt because it is labeled as such, however it does have some indicia of debt: the interest payments

are determined by reference to prevailing rates (not the financial activity of the issuing corporation), the note contains an unconditional promise to pay, and the debt lasts for a stated term. Moreover, the debenture does not contain indicia of an equity instrument, such as voting rights, or interest payments tied to corporate earnings. Another factor weighing in favor of debt treatment is the fact that not all shareholders own debt instruments in proportion to their equity position. Additionally, Distco's actual payment of interest may suggest a bona fide debtor/creditor relationship.

There are, however, several factors that suggest the debenture is more properly treated as stock. First, Distco's debt to equity ratio is high. Since there is no bright line test for determining a prohibitively high ratio (nor is there a controlling formula for computing the ratio itself), this factor is not necessarily fatal. Nonetheless, the \$1 million principal amount of Larry's debenture brings Distco's total debt to \$24 million, while the total FMV of its stock is only \$1 million. This suggests that the corporation may have difficulty obtaining financing from third party lenders, which would make Larry's debenture seem more like an equity interest. Second, the debenture's subordination to outside debt holders also weighs against debt classification. Distco could argue that the debenture is not junior to *all* third-party debt (which arguably reduces the potency of this factor), but since the pension fund holds over half of Distco's outside debt, the subordination probably hurts the corporation's argument that the debenture should be treated as debt. Third, the convertibility of the debenture also suggests proper characterization as equity. Convertible debt instruments are inherently suspect, but this debenture is particularly so, since the conversion mechanics relate to the value of preferred stock at the time of the debt issue, not at the time of conversion. Finally, the fact that principal payments do not start for five years also hints at equity classification, since it makes the

debenture appear more speculative. Even though Distco has kept current on interest payments, the 5-year delay may cast the likelihood of repayment into doubt.

Although the debt/equity classification is not clearcut, the equity factors probably outweigh the debt factors, meaning Larry and Distco are at risk of having the transaction reclassified as constructive issuance of non-participating preferred stock.

Distco's tax issues. Distco recognizes no gain or loss on either distribution. Because Martha's stock distribution is taxable, Distco will reduce its E&P by the FMV of the issued stock (\$600,000). The dividends it pays on the preferred stock will be classified under normal § 301 rules.

If Larry's debenture is properly considered debt, then Distco would reduce its E&P by the principal amount (\$1 million) upon distribution of the note. If, however, the transaction was reclassified, then it would likely be considered a taxable constructive issuance of preferred stock, in which case Distco would reduce E&P by the FMV of the instruments (\$600,000). Of future concern to Distco is the treatment of the purported interest payments. If the debenture is debt, then Distco could deduct the quarterly interest payments. If, alternatively, the instruments are really preferred stock, then the "interest" payments are dividends which do reduce E&P, but are not deductible by Distco.

Question 2.

Pre May 28. S-Corporations may only have one class of stock, but this requirement does not concern voting rights. Thus, Sco properly qualified for S-Corp status with the Class A and B stock.