

**Question 3**

First of all, in July of 2008, with no future liquidation under consideration, Frank (F) sold 100 of his shares in P to X for \$400,000. This may be treated as a parent-subsidary related corporation redemption under §304(a)(2), where F can be treated as redeeming his shares in P for the property. That parent-sub version of the redemption then must be tested under § 302 to see if it qualifies as an exchange. However, the §302 tests all are subject to the attribution rules of §318, under which one shareholder is deemed to constructively own the shares of related shareholders such as kids, grandkids, or spouses. F is attributed to own the shares of Dee (D), his daughter, but not those of Sarah (S), his sister, so prior to the redemption he constructively owned 300 shares, and now he constructively owns 200 shares. That reduction in ownership is unfortunately probably not enough to meet any of the §302 tests to be treated as a sale of stock. It is not really a meaningful reduction in his proportionate interest under §302(b)(1); is not substantially disproportionate under (b)(2), is certainly not a termination of his interest under (b)(3), and is not a (b)(4) partial liquidation. Therefore, the transaction is subject to the distribution rules of § 301. Because X has E&P of \$100,000, and then P has E&P of \$500,000 the total amount realized from the transaction \$400,000 will be treated as a dividend under §301(c)(1). (Use first X's E&P for the dividend, and then P's E&P). Therefore, the whole \$400,000 is taxable as a dividend (at capital gains rates) received by F. F's basis in the 100 shares of stock he sold (\$100,000) is transferred to his remaining stock in P, so that his basis is now \$200,000 in just 100 shares of stock. X takes a cost basis in P's stock of \$400,000 under §1012. Robert, S and D have no direct consequences in this transaction.

Then, in 2009, X liquidates pursuant to a plan adopted on Jan 9 of that year. Under § 332, a parent corp (P) recognizes no gain or loss on the receipt of property in a complete

liquidation of a sub if the parent owns at least 80% of the sub's controlling stock (P owns 90% here); if the sub is completely liquidating (which X is); and if the entire liquidation happens within 1 year or within 3 years, according to a plan (here, it is completed within the year the plan was adopted). Furthermore, under §337, no gain or loss shall be recognized to the liquidating corporation, X, on distributions to a parent that owns at least 80% of the sub's stock. Therefore, neither P or X have to recognize any gain or loss on the distributions in liquidation of X. Under §334, P's basis in the assets it receives is carryover basis from the sub. Under § 381, P also carries over the sub's net operating losses, E&P, and capital losses (if any of those exist). Here, that means that P carries over: cash with basis of \$10,000 and commercial real estate with basis of \$70,000; but no E&P because it was likely used up in F's redemption of stock as described in above. (If there was any remaining E&P it would carry over too).

However, the minority shareholder, Robert (R), does recognize a gain or loss on the liquidation because he is not an 80% owner as required. Attribution does not apply here. In the liquidation, R received publicly traded securities held for investment, with an adjusted basis of \$100,000 and an FMV of \$60,000. Therefore, the property has a built-in loss. This is treated as a normal liquidation under §331, under which the amounts received by a shareholder in complete liquidation are treated as full payment in exchange for the shareholder's stock. R's amount received is the FMV of the property, or \$60,000, and his basis in his stock is \$30,000. That means that despite the property's built-in loss, R has a (capital) gain of \$30,000. Furthermore, his basis in the property is its FMV, under §334. X may be able to recognize its loss under §336 subject to § 267 loss limitations on distributions to related people. Since the property distributed in the liquidation was not pro-rata, X is likely not able to recognize its loss.

The effects to Frank, Dee and Sarah of this liquidation transaction is not immediately felt by them because they did not directly receive any distributions from the liquidation (according to the problem). If P had distributed some of X's assets to its own shareholders, then they would be subject to the distribution rules of § 301. As it is in the problem here, they will not have an effect until such a distribution occurs.