

Question 3.

July 16, 2008. Frank's sale of shares is the type of parent-subsidary stock acquisition described in § 304(a)(2) (because P owns at least 50% of X's stock). Under the terms of (a)(2), the transaction is treated as a purported redemption of Frank's P stock, analyzed under § 302(b).

Under § 302, Frank's dealings must be analyzed through the lens of the § 318 attribution rules. Prior to the redemption, Frank owns 200 shares of P stock directly. He constructively owns Dee's 100 shares. His sister's shares are not attributed. Accordingly, Frank is treated as owning 300 shares of P stock. In addition, as a majority P shareholder, he constructively owns his proportionate share of X stock, but that does not impact the analysis since he is treated as redeeming his P shares directly to P. The redemption does not qualify under § 302(b)(1) because Frank remains a controlling shareholder (75% of voting power before, 66% after). Likewise, because he does not satisfy the applicable 50% test, it does not qualify as a § 302(b)(2) redemption. He still retains shares, so § 302(b)(3) doesn't apply. And there has not been a bona fide business contraction, so § 302(b)(4) doesn't apply. As a result, the \$400,000 Frank receives is treated as a § 301 distribution, but it reduces X's E&P before reducing P's E&P. Thus, the \$400,000 will be applied first to X's current E&P, and then exhaust it's \$100,000 in accumulated E&P. Then it will reduce P's current E&P, and if necessary reduce P's \$400,000 in accumulated E&P. The entire amount will be taxed to Frank as a dividend, presumably qualifying for capital gains rates under § 1(h). Frank keeps a \$200,000 basis in his P stock, reallocating it among the 100 shares he still owns.

X Liquidation. X distributes loss property to Robert. Whether X can recognize this loss depends on whether the property was obtained in a non-recognition transaction (it doesn't appear to have been) and whether Robert is a majority shareholder. He is Frank's brother in law, so he does not constructively own any shares that Frank may own. He is married to some sibling of Frank's, possibly Sarah who is a P shareholder. Even if this is the case, Sarah (and Frank for that matter) is a one-third shareholder, so P's holdings of X stock are not attributed to her. As a result, Robert does not own any X stock beyond the 10% he owns directly. Accordingly, X recognizes its \$40,000 loss on the securities it distributes to Robert. Since the securities were held for investment, they are capital assets, and the loss is a long- or short-term capital loss, depending on X's holding period.

Robert treats the distribution as a complete sale/exchange of his stock. Thus, he realizes and recognizes a capital gain of \$30,000 (\$60K FMV property received, less his \$30K basis in X's stock). His holding period of X stock determines the nature and tax rate of the recognized capital gain. He receives a FMV (\$60,000) basis in the securities received.

Because P owns at least 80% of X's stock and the liquidation is complete within one tax year, the liquidating distributions to P are subject to §§ 332 and 337. As a qualifying subsidiary liquidation, P will not recognize gain or loss on the distributions it receives in return for its X stock (this assumes it remains an 80% or more shareholder for the duration of the liquidation proceedings). It will take a carryover basis in the assets from X. P will also inherit X's E&P (reduced by the \$40,000 recognized loss on the securities distributed to Robert) and other tax attributes (including NOL carryforwards). Under § 337, X recognizes no gain or loss on the assets distributed to X but may be subject to depreciation recapture on the rental real estate. The cancellation of P stock has no tax effects.